PUBLIC SECTOR HEARING FOR 2012/13-2014/15 MTEF BUDGET

2012 BUDGET REVIEW & OUTLOOK PAPER (BROP)

BY

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Outline of the Presentation

- Introduction
- Recent Economic Developments
- Macroeconomic Outlook/Policies for 2012 and Medium Term
- 2012/13 Budget Framework
- Resource Envelope for Sector Ceilings

I. INTRODUCTION

INTRODUCTION

- The 2012 BROP is the first under the new Constitution and succeeds the annual Budget Outlook Papers (BOPA) that were produced under the old Constitution.

- It provides an overview of:
  - Fiscal performance in the preceding FY,
  - Implementation of the current budget, and
  - broad fiscal parameters for the 2012/13 budget and the medium-term

- The objective is to maintain fiscal discipline through establishment of **hard budget constraints** for both the National and County levels of Government by ensuring that **expenditures are consistent with affordable path of public spending** aimed at achieving national development priorities.

INTRODUCTION (Cont…)

- 2012 BROP covers the MTEF period 2012/13-2014/15, that involves transition to a devolved system of government and implementation of the new Constitution

- During this transition, safeguarding **macroeconomic stability** cannot be over-emphasized.

- The **indicative sector ceilings** therein provides a guide to Sector Working Groups in preparation of 2012 MTEF budget, thus leaving flexibility of prioritization at Ministerial level.

2012 BROP--MAIN MESSAGES

- Economy generally resilient despite shocks, but downside risks remain
- With inflationary pressures and shilling weakening, maintaining external and macroeconomic stability remain a key policy priority:
  - Appropriate mix of fiscal and monetary policies
    - Monetary policy—need to anchor inflationary expectation
    - Fiscal policy—continue to exercise fiscal restrain
- Continued structural reforms to improve competitiveness and accelerate growth, increase employment and reduce poverty
- Continued rationalization of non-productive expenditure while ensuring continued spending in priority sectors (infrastructure and social) to eliminate hurdles to growth, while laying the framework for a decentralized system

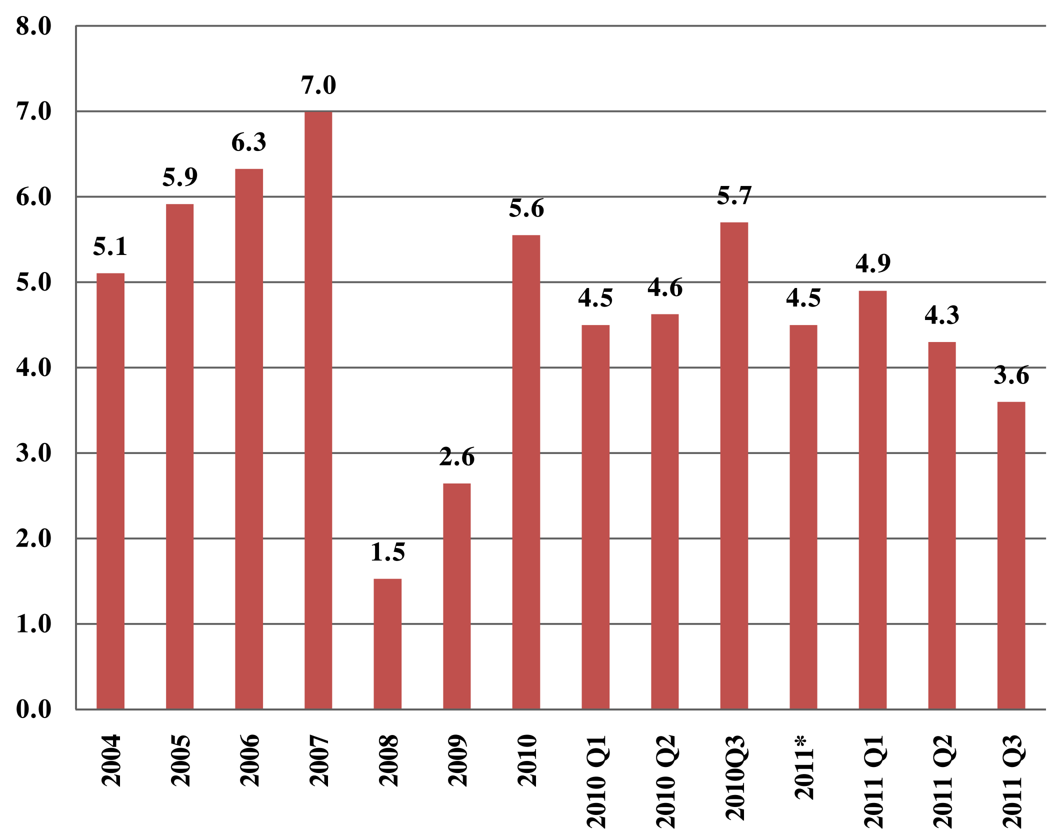
II. RECENT ECONOMIC DEVELOPMENTS

Overall, growth Resilient but downsides risk remain

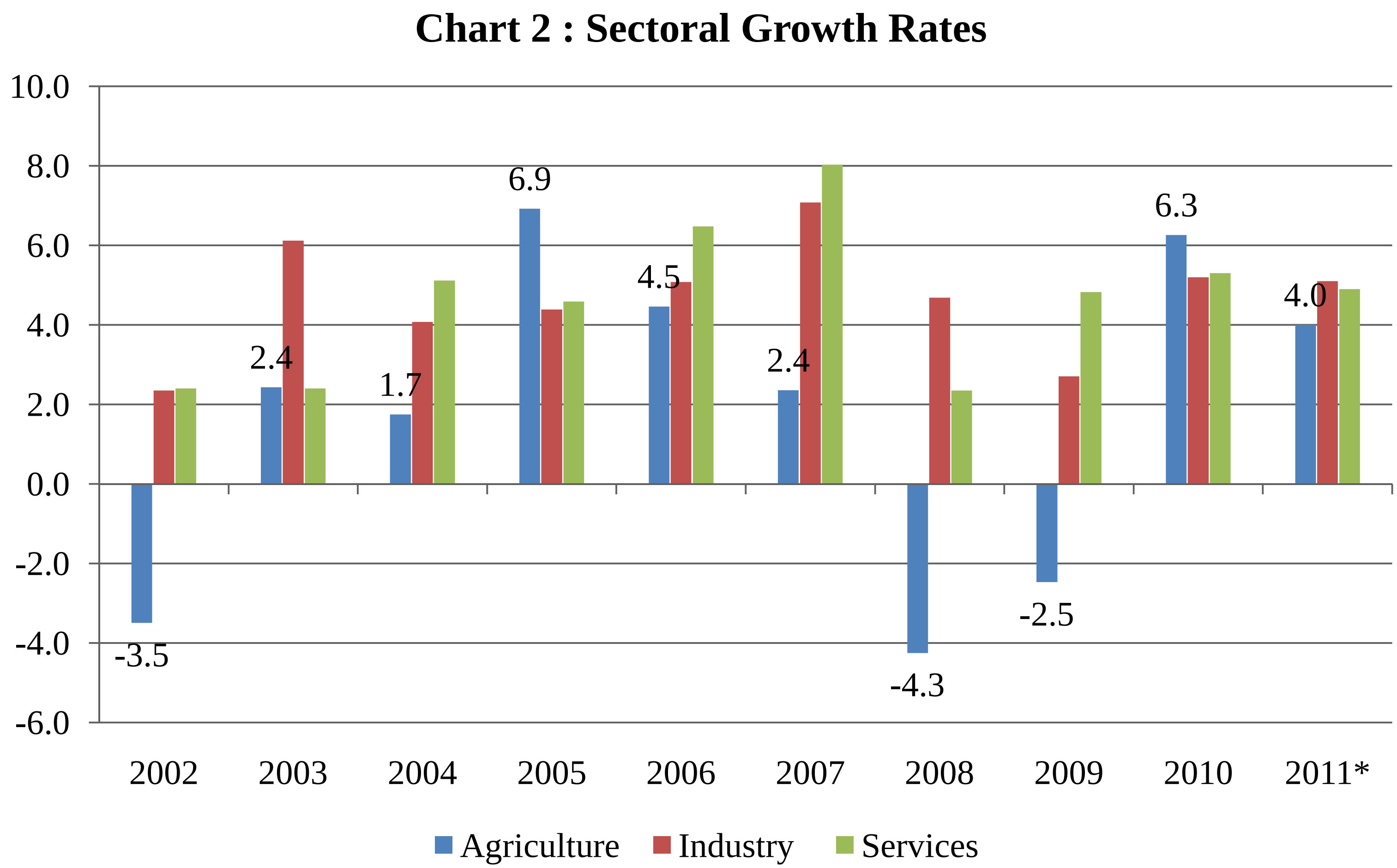
- Real GDP grew by 4.2 percent in the first nine months of 2011, down from 4.9 percent the same period 2010

- While leading economic indicators still point to continued growth despite the impact of high prices and weakening global output, we have lowered our earlier growth projection for 2011 of 5.3 percent to about 4.5 percent.

Chart 1: Real GDP growth

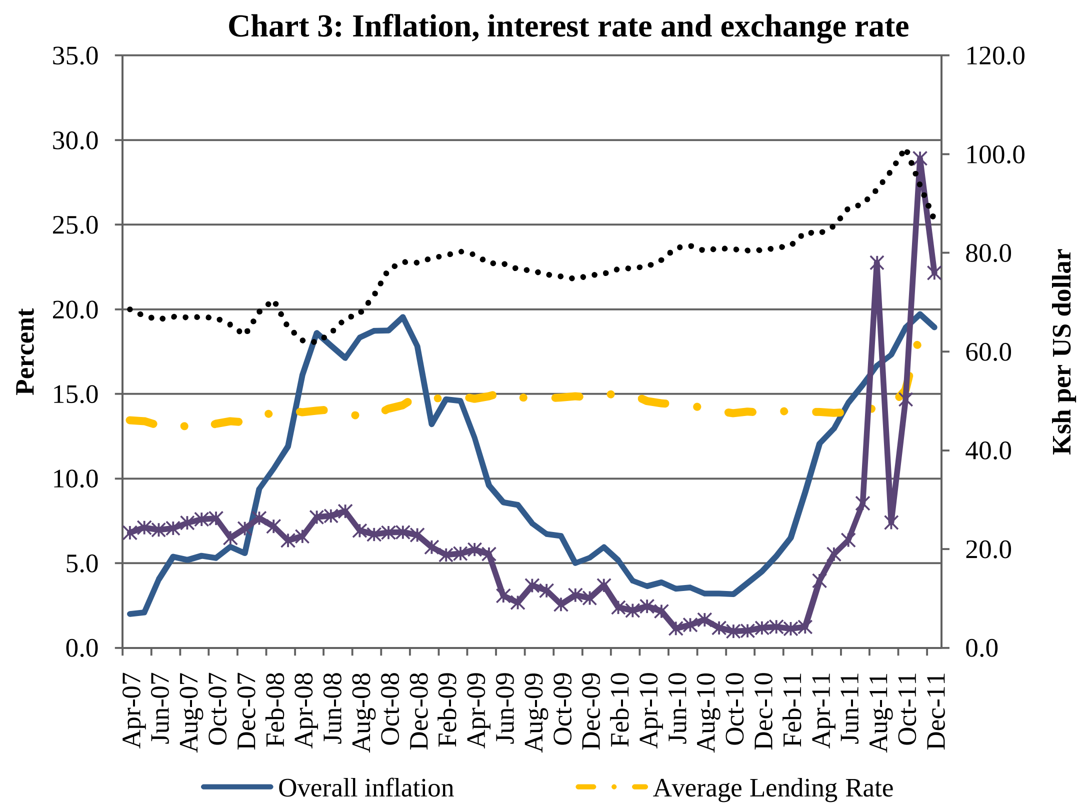


Sectoral activities indicate a good recovery in Agriculture from a decline in 2008-2009



Macro prices—inflation, interest rates, and exchange rate—has exhibited volatility in recent months

- Inflation has risen to double digits—overshooting the policy target—mainly due to:
  - ➢ High food prices
  - ➢ Rising fuel prices due to political crisis in MENA
  - ➢ Shilling weakening
- The shilling exchange rate has weakened but has recently recouped some loses
  - – Increased forex demand
  - – Rising inflation
  - – Expectation of further weakening
- Tight liquidity has started pushing interest rate up



Concerted efforts have been instituted with combination of tighter monetary policy, fiscal restrain, additional IMF resources, and managing expectations

2010/11 Fiscal Outcome

- Fiscal performance for FY 2010/11 was broadly on track, despite challenges
- Ordinary revenue was on target despite VAT withholding challenges, competition in mobile telephony sector, oil supply constraints, changes in taxation of cigarettes, thanks to the strong growth
- AiA is understated with underreporting
- Deficit was broadly in line with previous years
- Domestic borrowing at 3.3% of GDP was well below target of 4.6% of GDP

FISCAL OUTTURN, 2009/10 - 2010-11

	2009/10		2010/11			
	Act.	% of GDP	Rev Bgt	Act.	Dev.	% of GDP
Total Revenue and Grants	617.6	25.1%	721.4	671.7	-49.7	24.3%
Revenue	586.4	23.9%	686.4	652.9	-33.5	23.6%
Ordinary	549.2	22.3%	618.8	621.3	2.5	22.5%
AiA	37.1	1.5%	67.6	31.6	-36.0	1.1%
Grants	31.2	1.3%	35.0	18.8	-16.2	0.7%
Total Expenditure	725.2	29.5%	876.5	791.5	-85.0	28.7%
Recurrent	510.5	20.8%	603.7	566.1	-37.6	20.5%
of which:						
Interest payments	63.5	2.6%	74.2	76.2	2.0	2.8%
Wages	172.6	7.0%	202.3	195.9	-6.4	7.1%
Development	214.7	8.7%	272.8	225.4	-47.4	8.2%
of which:						
Domestically financed	140.8	5.7%	177.3	155.9	-21.4	5.6%
Foreign financed	71.7	2.9%	93.0	67.0	-26.0	2.4%
Deficit excl. grants	-138.8	-5.6%	-190.1	-138.6	51.5	-5.0%
Deficit incl. grants	-107.6	-4.4%	-155.1	-119.9	35.3	-4.3%
Domestic borrowing	133.5	5.4%	125.0	90.4	-34.6	3.3%
Nominal GDP	2458.3	100.0%	2705.4	2761.5	56.1	100.0%

2011/12 Budget—A recap

- Key Highlights
  - Underlying assumptions
    - *Continued strong growth strong, with global recovery in US/Euro and sub-region*
  - *Fiscal discipline*
    - *Gradual consolidation to ensuring sustainable public finances as we implement decentralization system*
    - *Continue with efficient allocation of resources and value for money*
- Addressing Current Policy Challenges
  - *Sustaining Growth, Reducing Unemployment and Poverty, Addressing Food Insecurity, and Dealing with High Oil/Food Prices*
- Priority Public Service Delivery
    - *Removing binding constraints to growth;*
    - *Staying on course on Vision 2030 priorities;*
    - *Implementing the new constitution; and*
    - *Strategic intervention to deal with recurrent drought, high food and fuel price*

Emerging Fiscal Challenges

- Shortfall in revenue collection – By Dec. 2011 it was about Ksh. 17 billion
  - Weaker-than-envisaged growth
  - Challenges in the withholding mechanisms
- Expenditure pressures from:
  - Drought mitigation measures
  - Salary awards
  - Implementation of new Constitution
  - Security operations
  - High cost of service delivery with inflation
  - Increased debt servicing with weaker shilling and higher interest rates

- Shortfall in domestic borrowing—As at end-Dec. 2011 dom. borrowing was Ksh 14 bn against a target of Ksh 87 bn or Ksh 119.5 bn for the FY—due to:
  - Volatility in money market leading to undersubcription
  - Rising inflation and weakening of the shilling

Revised budget reflecting the current situation and rationalization of expenditure will be tabled in Parliament shortly

Progress with GoK's economic program supported by the IMF under ECF arrangement

- 31st January 2011: Three-year Program approved for amount totalling US$ 509 million, with US$ 100 million disbursed immediately.
- June 2011: First Review completed – second tranche of US$ 70 million disbursed
- Dec 2011: Second Review Completed and Augmentation approved—Third tranche of US$ 70 million plus additional US$ 75 million disbursed
- Feb/Mar 2012: Scheduled Third Review.
- The objectives of the programme will enable us to:
  - Transit smoothly to sustainable debt levels;
  - Spend on our investment programme without causing undue pressure on the exchange rate with increased imports; and
  - Maintain fiscal discipline during implementation of a decentralization system.

III. MACROECONOMIC OUTLOOK/POLICIES FOR 2012 AND MEDIUM-TERM

Global scene

- The pace of economic activity is weakening, and the risks for Europe and the world are high
- *Sep' 11 WEO projections* indicate that global growth will moderate to about 4% percent through 2012, from over 5 percent in 2010. Now, downside risks becoming real.
  - Growth will continue to be uneven—with BRICs growing strongly but slowing, while advanced countries still weak
- At regional level, real GDP growth in the SSA region is projected to average 5.2 -5.7 percent during 2011-2012 compared to growth of 5.4 percent in 2010

Growth prospects

- Still favorable but there is need for caution with:
  - Weaker-than-expected global economy
  - Recurrence of higher fuel and food prices with geopolitics
- As such, we have revised real GDP growth down to 5.3% in 2012 from 5.7% earlier, before picking to around 5.5%-6.0% over the medium-term. The growth will be underpinned by:
  - Continued expansion in Agriculture; Tourism; ICT/tranport and Communication; Construction; and
  - Exports to the sub-regions.
- While these projected growth are significantly lower than the Vision 2030 targets, the fiscal framework is premised on the need to be cautious

Sustaining Growth and Employment and poverty reduction

- *We recognize that despite the achievements in revitalizing economic activity,* the number of jobs generated has not been adequate to absorb the influx of labour entrants, which is now estimated at 500,000 per annum
- To address unemployment problem while at the same time reduce poverty, our economy would have to expand at a faster pace and on sustainable basis.
- We therefore need to nurture the current economic recovery, while putting in place measures to accelerate it to level envisioned under Vision 2030 so as to create at least one million new jobs each year

Macroeconomic Outlook

- **Inflation**: Current pressures on prices and the exchange rate are expected to subside in line with the reduction in oil prices, and normal supply of food;
  - Appropriate policies expected to bring down inflation to single digit level in an year's time and stabilize at 5% in MT.
- Stability in **interest rates and exchange rates** are also expected to be restored.
- On external front, the **balance of payments position** expected to strengthen, allowing the CBK to gradually build foreign exchange reserves

Fiscal Outlook

- **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 below 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 24%
  - Keep budgetary expenditures consistent with M-T priorities and continue with rationalization to improve efficiency and reduce wastage

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
- 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 help:
  - accelerate reforms in public financial management
  - strengthen cash management system and improve resource management
- Fully implement the **IFMIS** across government Ministries and Departments, and eventually rolled out to country governments

Deficit financing policy

- Continued borrowing from domestic and external sources, with the latter being largely on concessional terms.
- Non-concessional financing will be accessed cautiously, utilized for productive investment, and limited to the set ceiling in the Medium term debt strategy.

Medium-Term Macroeconomic Framework 2012/13-2014/15

	2010/11	2011/12	2012/13	2013/14	2014/15
	Est.	Proj.	Proj.	Proj.	Proj.
	Annual percentage change				
National account and prices					
Real GDP	5.3	5.2	5.5	5.8	6.3
GDP deflator	7.4	13.1	10.5	6.5	5.4
CPI Index (eop)	14.5	8.9	7.9	5.6	5.0
CPI Index (avg)	6.8	15.1	9.5	6.3	5.0
Terms of trade (-deterioration)	-4.9	-1.1	-0.3	-0.2	0.7
	In percentage of GDP				
Investment and saving					
Investment	22.1	22.3	22.5	24.4	25.1
Gross National Saving	12.6	13.2	15.5	18.7	20.7
Central government budget					
Total revenue	24.0	23.5	24.0	24.2	24.4
Total expenditure and net lending	29.2	29.5	29.9	29.4	29.5
Overall balance (commitment basis) excl. grants	-5.2	-6.0	-5.9	-5.2	-5.1
Overall balance (commitment basis) incl. grants	-4.5	-4.7	-4.6	-3.9	-3.7
Nominal public debt, net	48.6	45.6	44.1	43.4	42.6
External sector					
Current external balance, including official transfers	-9.6	-9.1	-7.0	-5.7	-4.5
Gross international reserve coverage in months of imports	3.1	3.1	3.3	3.5	4.0

Source: Ministry of Finance

Risks to the Outlook

- Further weakening in the global economy
- Unfavorable weather condition(should there be another round of dry spell in 2012) could weaken agriculture
- A reversal in the current easing of international oil prices may fuel inflation
- Unsuccessful transition to decentralized system of Government could weaken investor confidence

IV. 2012/13 BUDGET FRAMEWORK

2012/13 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 first updated Vision 2030 MTP.
  - Real GDP is expected to increase by 5.5 percent in FY 2012/13 underpinned by continued good performance across all sectors of the economy.
  - Inflation is expected to ease gradually to 7.9 percent by end-June 2013
  - Gross international reserves are expected to increase to 4 months of current import cover by June 2013.

2012/13 BUDGET FRAMEWORK (cont..)

Revenue projections:

- Target revenues including AiA of 24 percent of GDP (or KShs. 922.6 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

2012/13 BUDGET FRAMEWORK (cont..)

Expenditure forecast:

- Overall expenditures are projected at 29.9% of GDP (or Kshs. 1,147.5 billion), more or less the same level of 29.6 percent in 2011/12.
- The key policy document guiding the Government's funding allocation decisions is the updated first MTP of Vision 2030 (www.planning.go.ke) , which provides the overarching development priorities.

2012/13 BUDGET FRAMEWORK (cont..)

Updated Vision 2030 MTP:

- The updated MTP is the first since implementation of the first Vision 2030 MTP in 2008 and takes into account the revised macroeconomic framework.
- The policy priorities therein have been recalibrated and should guide the budgetary framework over the next two years, as we implement a decentralized structure of government and prepare the Second MTP for 2013-2018.

2012/13 BUDGET FRAMEWORK (cont..)

Overall Deficit and Financing:

- The overall budget deficit (including grants) in 2012/13 is projected to be about KShs 177.7 billion (equivalent to 4.6% of GDP).
- Net external financing amounting to KShs. 100.1 billion (2.6% of GDP) is expected to cover part of this budget deficit, leaving about KShs 77.6 billion (2.0% of GDP) to be financed through domestic borrowing.

V. RESOURCE ENVELOPE AND SECTOR CEILINGS

2012/13 Resource Envelope

Total Available resources	**1,147.5**
– Revenue (incl. AiA)	922.6
– External Grants	47.2
– External Loans (net)	100.1
– Privatization proceeds	0.0
– Net Domestic Borrowing	77.6
– External Commercial Financing	0.0
Total Expenditure	**1,147.5**
– Recurrent	782.7
– Development	364.8

2012/13 Resource Envelope (Cont…)

- From the above, it is clear that the total available resources in 2012/13 amount to **KShs. 1,147.5 billion**

- This resource envelope forms the **basis for setting the sector ceilings**

- The table above reflects **finite amount of resources** that is to be allocated in the most efficient way possible in order to achieve the desired outcomes at least cost and remain within a sound fiscal framework.

- Any additional request over and above these ceilings will not be accommodated. SWGs must budget within the allocated ceiling.

2012/13 Resource Envelope (Cont…)

As usual Treasury receives request s for additional funding. 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;
- ⇨**Borrow more from domestic financial market**—with risks of continued raising interests rates and crowding out private sector investments and growth.
- ⇨**Create fiscal space** by cutting/rationalizing other expenditures

Resources allocation criteria

- The Government has updated its main priorities going forward in the context of **first MTP update** and **budget consultations** at County level.
- As such, resource allocations are expected to reflect these prioritization with:
  - The priority social sectors (education and health) will continue to take a large share of total resources
  - Economic sectors of agriculture and livestock also allocated adequate resources;
  - Resources for physical infrastructure such as roads (including feeder roads), energy, and water and irrigation continue to increase.
  - Resources for internal security, rule of law, youth and development of Arid lands will continue to receive adequate allocation

Judiciary and Parliament

- **Judiciary** has been allocated adequate resources to enable it implement programmes and strategies geared towards full implementation of the new Constitution;
- **Parliament** has also be allocated enough resources to enable it continue to play the important role of strengthening democratic space and good governance.
  - ***Their resource allocation are incorporated in their respective Sector Ceilings***

Devolved Funds

- The BROP Sector Ceilings incorporates the cost of delivering devolved functions under the new Constitution
- Costing of Devolved functions is ongoing and estimates by Sector will be incorporated in the next BPS
- Various options are being considered on how to present the 2012/13 budget in view of the County Government coming on board in the course of the FY. These will be elaborated in the next BPS

CONCLUSION

- **First**, let me reiterate the importance of *prudent fiscal policy* in helping sustain macro-stability.
  - 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.

- **Secondly**, the *scarcity of resources* calls for the need to prioritize these resources to best achieve Gov't stated policy priorities as well a the implementation of the new constitution.

CONCLUSION (Cont...)

- **Thirdly**, need to contain expenditures while at the same time re-allocating towards the key social/economic sectors as envisioned under the updated Vision 2030 MTP.
- **Finally**, should additional resources become available in the course of finalization of Sector budgets in line with prioritized programmes and firming up of the resource envelope, the Government will utilize these resources to enhance the baseline ceilings covering:
  - ✓ Implementation of the new Constitution
  - ✓ Strategic intervention in the area of education, health, infrastructure (especially rural/feeder roads), tourism, internal security and agriculture (especially irrigation programmes and other food security enhancing programmes),
  - ✓ Specific consideration to job creation for the youth

Next Steps

- Incorporate the comments from the Sector Hearings and the Accounting Officers to finalize the BROP
- Finalize on the supplementary budget to incorporate measures to deal with the highlighted challenges in budget implementation
- Preparation of the 2012 Budget Policy Statement incorporating firm Sectoral and Ministerial Ceilings
- Preparation of detailed itemized and programmed budget for submission to Parliament by end-April’12

THANK YOU