KENYA | MACROECONOMIC UPDATE | BUDGET ANALYSIS | INSIGHTS

FUNDAMENTALS

KENYA: FY24 DRAFT BUDGET
A TIGHT BALANCING ACT

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IN BRIEF

- The FY24 draft budget estimates signal an expansionary spending plan (+6.4% y/y to KES 3.6tn) and an ambitious Finance Bill 2023 has telegraphed an aggressive revenue-raising efforts for the next fiscal year.

- With an emphasis on reining in the previous tax exemptions and focus towards widening the tax base, we believe that the Finance Bill 2023 effects policy guidelines contained in the earlier released 2023 Tax Expenditure report and the recently approved National Tax Policy.

- Nonetheless, we expect pushbacks in the ongoing public participation leg of the FY24 budget process on some of the Bill's contentious clauses. Specifically, the proposed 3.0% mandatory housing levy to be borne by both employer and employee, and the requirement for a taxpayer to deposit 20.0% of value amount in a tax dispute before appealing at the High Court sticks out.

- We expect the National Treasury Cabinet Secretary to give direction on the huge domestic arrears as he formally presents the FY24 budget in the National Assembly on 8th June 2023. In addition, the slow Exchequer disbursements in the current fiscal year has not been comprehensively addressed and risks spilling over to the next fiscal year.

- The authorities target a lower fiscal deficit in FY24 at 4.1% of GDP (FY23: 5.7%). The recent proposed legislation to tweak the fiscal rule from the current KES 10.0tn public debt limit to a debt anchor of 55.0% of GDP in present value terms, will give some policy space for implementing the FY24 budget.

- Faced with the maturity of USD 2.0bn KENINT 6.875% 2024, we believe Kenya will muddle through as it executes a liability management operation by 1Q2024. However, a suppressed yield environment in the local rates raises a hurdle for achieving the relatively higher FY24 domestic borrowing target.

Race against time

The draft FY24[1] budget estimates and Finance Bill 2023 were presented in the National Assembly on 27th April and 4th May, respectively. Like previous years, the budget estimates signaled an expansionary spending plan (+6.4% y/y to KES 3.6tn, excluding debt amortizations). Against the backdrop of a lower-than-expected revenue mobilization in the current FY23, the ambitious tax proposals in the Finance Bill 2023 puts the financing of the FY24 budget in a bind.

Nevertheless, the FY24 budget process is in the public participation stage until late May while the National Assembly is in a one-month long recess until 5th June 2023. The Budget & Appropriations Committee is expected to table its recommendation report on the draft FY24 budget estimates, while the Finance & National Planning is to table its report on the proposed Finance Bill 2023. The Cabinet Secretary, National Treasury Prof. Njuguna Ndung'u is expected to formally present the FY24 budget in the National Assembly on 8th June 2023.

Finance Bill, an end-product?

The July 2022 - March 2023 run rate of tax collection at 88.1% points to ordinary revenue miss in the current fiscal year (KES 2.2tn target). Against this backdrop, the FY24 ordinary revenue target of KES 2.6tn (+17.3% y/y) appears aggressive, resulting in ambitious tax proposals contained in the Finance Bill 2023. We would like to think of the Finance Bill 2023 as an end-product of earlier announced overarching tax strategy reforms. The 2022 Tax Expenditure report, released in March 2023, estimated revenue foregone in 2021 calendar year at KES 361.0bn (2.61% of GDP) due to tax exemptions and incentives. The National Tax Policy also mapped out policy guidelines to enhance tax predictability. We understand that the Finance Bill 2023 touches on tax proposals aimed at narrowing tax expenditure and putting into effect some of the tax policy guidelines.

We expect the approval of the proposed higher VAT rate on petroleum products to give fuel inflation a lift and add upside risks to the headline print. The VAT rate on petroleum products is currently at 8.0%, following the assent into law of Finance Bill 2018. This push for a higher VAT rate on petroleum products was first proposed in the National Tax Policy, directing a single standard VAT rate of 16.0% on goods and services. Furthermore, the 2022 Tax Expenditure report singled out the VAT imported fuel as the third highest tax foregone. From this prism, it is less surprising that this proposal is in the Finance Bill 2023.

The tax proposals are also aimed at widening the tax base, more so, the informal sector and the digital economy. A turnover tax rate of 3.0% will apply to businesses with an estimated annual turnover between KES 500k – KES 15mn in the informal sector. The introduction of a withholding tax of 15.0% on digital content monetization and 3.0% digital asset tax, targeting cryptocurrency and non-fungible token transactions, are to widen the tax base of the nascent digital economy. Further, the tax bands under personal income tax are set to increase to four (from the current three) with monthly income above KES 500k proposed to be taxed at a progressive rate of 35.0% (from current 30.0%). That notwithstanding, we believe the estimated number of employees targeted with the upper marginal tax rate is marginal to meaningfully move the needle.

The proposed repeal of annual inflation adjustment of excise duty on select excisable goods will give much needed predictability to alcoholic, tobacco and agro-food manufacturers who bore the greatest brunt with this specific excise rate in previous budget cycles. Another bright spot in the Finance Bill, in our view, is the lowering of the excise duty rate from 20.0% to 15.0% on i). telephone and internet services and ii). fees charged for money transfer services by banks, money transfer agencies and other financial services. We believe these lower excise duty proposals will stimulate digital inclusivity and enhance financial inclusion if approved.

Hot potato issues in the Bill

We expect pushbacks during the ongoing public participation leg of the FY24 budget process on some of the contentious clauses. The requirement of 24hours turnaround time in remitting withholding taxes might increase compliance costs for the target taxpayers. There is also a proposal that for a taxpayer in a tax dispute against Kenya Revenue Authority (KRA), they will be required to deposit 20.0% of the disputed claim with the tax agency before filing an appeal at the High Court. This requirement will reduce liquidity on the taxpayer's part as they await determination of their tax appeal. The proposed 3.0% mandatory housing levy by both employer and employee to the National Housing Development Fund will meet stiff resistance. First introduced in the Finance Bill 2018 at a lower rate of 1.5%, it was challenged in Courts and the previous regime shelved the plan. Although the government has packaged the housing levy as funding for its affordable housing programme, the enforceability of a mandatory contribution plan will be a hard sell.

[1] July 2023 – June 2024

BUDGET, KES BN's

	Revised FY23 budget	Draft FY24 budget
National Government	2,116.9	2,227.7
Executive	2,044.1	2,164.3
Judiciary	22.0	23.0
Legislative	50.7	40.4
Counties equitable revenue	399.6	385.4
Consolidated Fund Services	867.8	986.2
Interest	675.8	775.1
Others	192.0	211.0
Total Expenditure [A]	**3,384.3**	**3,599.3**
Debt redemptions	685.2	850.1
Total Revenue	2,528.8	2,893.7
Ordinary Revenue	2,192.0	2,571.2
Appropriation-in-Aid	336.8	322.5
Grants	31.4	42.2
Total Revenue + Grants [B]	**2,560.2**	**2,935.9**
Budget Deficit [A] - [B]	**824.1**	**663.4**
External Financing	395.9	131.4
Domestic Financing	428.2	532.0
Nominal GDP	**14,521.6**	**16,290.3**
Deficit, % of GDP	5.7%	4.1%

SOURCE: THE NATIONAL TREASURY

Unaddressed fiscus underbelly

The FY24 budget has slightly expanded targeted social assistance programs to cushion the most vulnerable. Cash transfers have been maintained at KES 27.2bn whereas the Constituency Development Fund – for discretionary spending by MPs in their constituencies – has a higher allocation of KES 53.5bn. There are budgetary provisions to curb the periodic drought in the country. However, the rolling back of subsidies for fuel and maize flour and scaled down fertilizer subsidy programme implies some upside to inflationary pressures. With no meaningful change in public sector earnings, the 11.2% uptick in the wage bill to KES 600.0bn in FY24 pre-empts bloated public sector workforce.

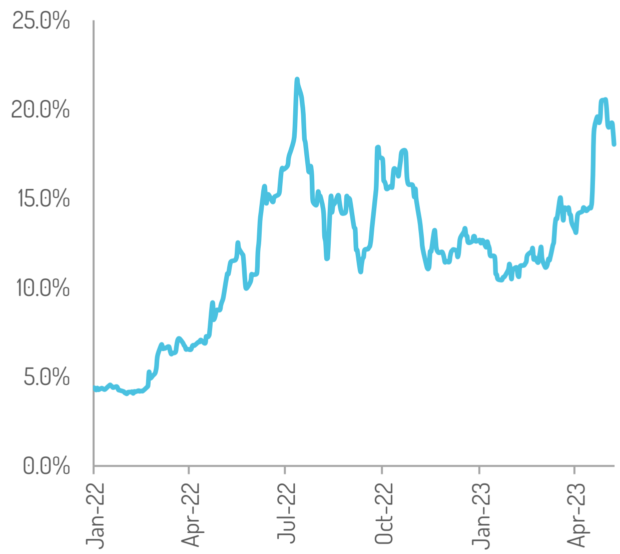
Broadly, the FY24 budget fails to address some underbelly of recent public finance outturn. The sense we have is that settlement of domestic arrears (KES 481.0bn; 3.6% of GDP) have not been prioritized in the budget. The roads ministry recently announced a halt in new roads projects, weighed down by a staggering KES 150.0bn domestic arrears to contractors and suppliers. With our expectation of a much more subdued Finance Bill 2023 in its final form, this will exacerbate a lower-than-expected revenue outturn in FY24. In turn, the slow disbursement of revenue from the Exchequer in the current FY23 runs the risk of spilling over into the next fiscal year. We are of the view that Finance Minister, Prof. Ndung'u, will give guidance on these risks as he formally presents the FY24 budget statement on 8th June.

A USD 2.0bn maturity awaits

Interest servicing costs (KES 775.1bn; 4.8% of GDP) will be the largest expenditure item in the FY24 budget, with domestic interest chalking up 81.0% of the total interest payments. We like the government's proactiveness in announcing a potential liability management operation of its USD 2.0bn KENINT 6.875% 2024. With FX reserves at low levels, we doubt a drawdown on the external buffers for a bond repurchase (at current discounted prices) will be the base case. Furthermore, the 10.0% maximum repurchase level does not tip the apple cart. We thus opine that the most appropriate liability management operation will take the form of a tender offer and a new bond offering, with a possible execution date by 1Q2024.

The authorities target a lower fiscal deficit at 4.1% of GDP in FY24 (FY23: 5.7%). The recent proposed legislation to tweak the fiscal rule from the current KES 10.0tn public debt limit to a debt anchor of 55.0% of GDP in present value terms, will give some policy space for implementing the FY24 budget. Public debt in present value terms is at 65% of GDP, but the 55.0% debt anchor has a sunset of FY27 target. Yield suppression in the current FY23 has led to a dearth in demand at primary auctions, denting the domestic borrowing outturn. Therefore, the pain point in the next fiscal year will be achieving the relatively higher domestic borrowing target of KES 532.0bn (3.3% of GDP) amidst the suppressed yield environment.

YIELDS ON KENINT 6.875% 2024



SOURCE: BLOOMBERG

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