Fiddling, While Kenya Burns

By David Ndii

After all the hullaballoo, and the brazen manipulation of the vote on Uhuru Kenyatta's presidential veto of parliaments proposal to defer VAT on fuel for another two years, you would be forgiven to think that the government scored big in the battle to shore up its terrible and rapidly deteriorating finances. It did not. Much to the contrary, the melodrama was an inconsequential sideshow.

Alongside the president's memorandum, the Treasury tabled a supplementary (i.e. revised) budget that which elicited screaming headlines: the government had "slashed" by a whopping 55 billion shillings from Sh. 3.026 trillion to 2.971 trillion. A critical reader would immediately have noticed that a 1.8 percent reduction hardly qualifies to be a "slashing" — trimming would have been accurate. Of note, the supplementary budget the Treasury did not provide a complete budget revision, but only a high level expenditure summary with five budget lines.

But the Treasury also published its regular Budget Review and Outlook (BROP) paper that contains the detailed budget data. As is customary with our National Treasury, the numbers in the two tables are not identical. Even the numbers in different tables of the BROP are not identical, although the differences are not material— it's mostly sloppiness, and occasionally, sleight of hand. I follow the BROP figures (*See table below*) as they are more comprehensive and also the more up to date of the two, if only by two days. Two things to note.

Table 6: Government Fiscal Projections, FY 2018/19-2021/22

	FY 2014/15	FY 2015/16	FY 2016/17	FY 2017/18		FY 2018/19		FY 2019/20		FY 2020/21		FY 2021/22
	Actual	Actual	Prel Actual	Rev. Budget	Prel Actual	Budget	BROP 18	BPS 18	BROP 18	BPS 18	BROP 18	BROP 18
TOTAL REVENUE	**1,108**	**1,233**	**1,423**	**1,660**	**1,487**	**1,949**	**1,853**	**2,118**	**2,074**	**2,424**	**2,382**	**2,731**
Total Revenue as a % of GDP	***19.0%***	***18.4%***	***18.6%***	***19.1%***	***16.8%***	***20.0%***	***18.4%***	***19.1%***	***18.1%***	***19.2%***	***18.4%***	***18.6%***
Ordinary revenue	1,032	1,153	1,307	1,490	1,365	1,769	1,673	1,931	1,870	2,229	2,155	2,479
Ordinary Revenue as a % of GDP	***17.7%***	***17.2%***	***17.1%***	***17.2%***	***15.4%***	***18.2%***	***16.7%***	***17.4%***	***16.3%***	***17.7%***	***16.6%***	***16.8%***
Tax Revenue	958	1,069	1,220	1,370	1,259	1,639	1,561	1,817	1,763	2,103	2,036	2,348
Non-Tax Revenue	74	84	87	120	106	130	111	114	107	126	118	130
AIA	76	80	116	170	122	180	180	187	204	195	227	253
Expenditure	**1,641**	**1,793**	**2,128**	**2,346**	**2,127**	**2,571**	**2,488**	**2,662**	**2,660**	**2,913**	**2,905**	**3,248**
Expenditure as a % of GDP	***28.1%***	***26.7%***	***27.8%***	***27.0%***	***24.0%***	***26.4%***	***24.8%***	***24.0%***	***23.3%***	***23.1%***	***22.4%***	***22.1%***
Recurrent	897	1,031	1,183	1,458	1,324	1,564	1,541	1,621	1,607	1,785	1,799	2,034
Development	511	481	640	556	476	626	574	664	676	741	719	817
Equalization Fund	0	6	6	-	-	9	5	6	6	7	7	7
County Transfer	229	276	305	332	327	376	367	372	372	382	382	392
Contingencies	5	5	-	-	-	5	5	5	5	5	5	5
Budget Balance (Deficit (-) excl Grants	**(532)**	**(549)**	**(687)**	**(670)**	**(624)**	**(608)**	**(622)**	**(530)**	**(573)**	**(475)**	**(509)**	**(503)**
Deficit as % of GDP	***-9.1%***	***-8.2%***	***-9.0%***	***-7.7%***	***-7.1%***	***-6.3%***	***-6.2%***	***-4.8%***	***-5.0%***	***-3.8%***	***-3.9%***	***-3.4%***
Grants	28	30	27	43	28	48	46	52	52	52	52	54
Balance Incl.Grants	(504)	(520)	(660)	(627)	(597)	(560)	(576)	(479)	(521)	(423)	(457)	(449)
Deficit as % of GDP	***-8.6%***	***-7.7%***	***-8.6%***	***-7.2%***	***-6.7%***	***-5.8%***	***-5.7%***	***-4.3%***	***-4.6%***	***-3.3%***	***-3.5%***	***-3.1%***
Net Foreign Financing	217	270	386	375	355	287	272	220	217	165	147	109
Domestic Loan Repayments (receipts)	3	2	2	4	2	4	4	4	4	4	4	4
Domestic Borrowing	251	202	309	249	274	269	300	264	310	259	311	346
Domestic Borrowing % of GDP	***4.3%***	***3.0%***	***4.0%***	***2.9%***	***3.1%***	***2.8%***	***3.0%***	***2.4%***	***2.7%***	***2.0%***	***2.4%***	***2.3%***
Public Debt (net Deposits)	2,601	3,211	3,973	4,530	4,530	4,821	5,097	5,321	5,543	5,712	5,864	5,977
Public Debt to GDP (net Deposits)	***44.6%***	***47.9%***	***51.9%***	***52.2%***	***51.2%***	***49.6%***	***50.8%***	***47.9%***	***48.4%***	***45.3%***	***45.3%***	***40.6%***
Nominal GDP (Ksh. billion)	**5,832**	**6,710**	**7,658**	**8,679**	**8,846**	**9,727**	**10,043**	**11,101**	**11,440**	**12,621**	**12,957**	**14,719**

Source: National Treasury

First, the expenditure cuts are less than the revenue forecast which is revised downwards by Sh. 96 billion, while expenditure is revised downwards by Sh. 83 billion. Even though the 10 billion difference is not such a big sum, it's unclear why the government would go to such lengths to table an austerity budget that increases the deficit.

More significantly, the revenue forecast is still unrealistic. The budget was based on revenue growth of 31 percent, comprising of 30 percent and 36 percent increase in tax and non-tax revenues respectively, which has now been scaled down to 25 percent, with tax and non-tax revenue forecast down to 24 and 28 percent respectively. These forecasts are out of touch with reality. Tax revenues increased only three percent and non-tax by 12 percent for a total revenue increase of four percent. This, as we will see shortly, is not an anomaly—it is a significant trend.

> The budget was based on revenue growth of 31 percent, comprising 30 percent and 36 percent increase in tax and non-tax revenues respectively, which has now been scaled down to 25 percent, with tax and non tax revenue forecast down to 24 and 28 percent respectively. These forecasts are out of touch with reality.

In its current financial circumstances, it is not just sensible that the government be prudent, it is imperative. There will be no harm done if revenue exceeds target, but unrealistic revenue forecasts result in government spending money it does not have. This is how the government ends up accumulating pending bills, which, according to the private sector lobby KEPSA, are now in the order of Sh. 200 billion.

Trend growth gives you a revenue forecast of Sh. 1.55 billion. An optimistic one, assuming a most favorable economy and factoring in tax rises, would double the growth rate to 8 percent, still comes to Sh. 1.62 trillion. I would work with Sh.1.6 trillion.

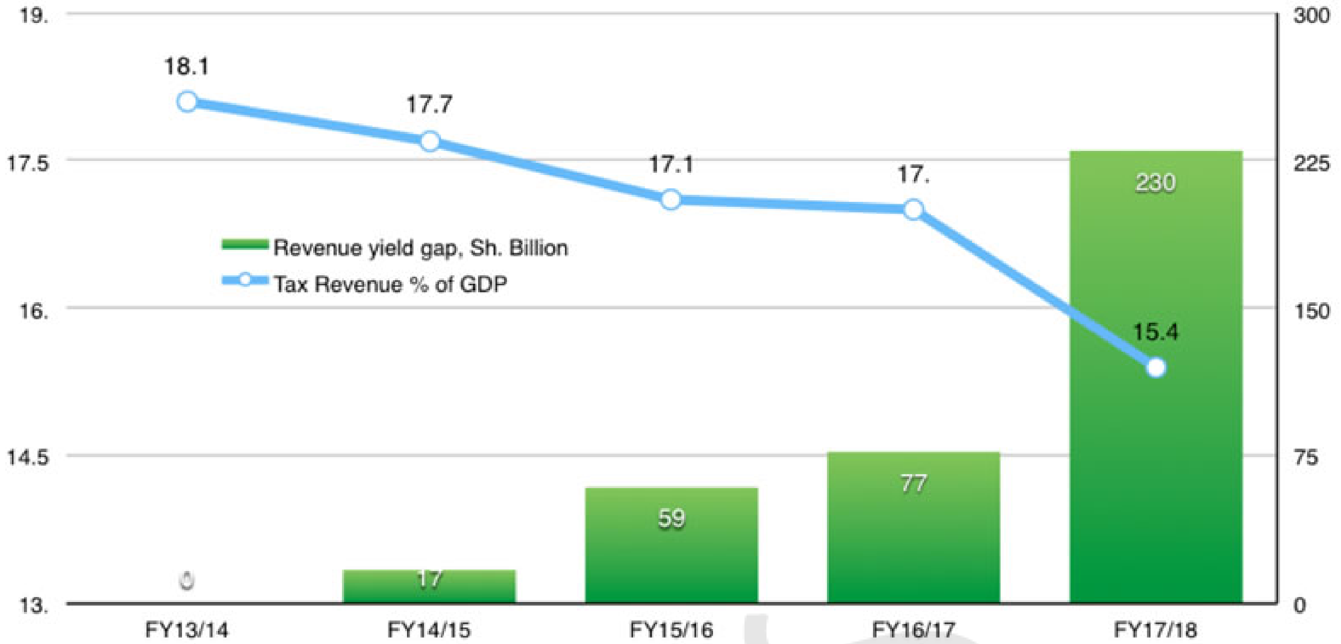
> In its current financial circumstances, it is not just sensible that the government be prudent, it is imperative…Unrealistic revenue forecasts result in government spending money it does not have…The government ends up accumulating pending bills… now in the order of KSh 200 billion.

Herein lies the problem. The Sh.1.6 trillion revenue forecast is Sh. 250 billion short of the revised recurrent budget. Interest cost (Sh. 400 billion), pensions (Sh. 90 billion) are non-discretionary (i.e. mandatory) and the wage bill (Sh. 444 billion) which does not give you much room to manoeuvre already add up to Sh. 930 billion. This leaves a balance of Ksh. 660 billion to fund counties (Sh. 367) and the national government's operations and maintenance (O&M) outlays (Sh. 530 billion) totaling Ksh. 960 billion.

The only question here should be where the axe falls. There are only two options either the axe falls on the national government, or to share the cuts with the counties. The latter is obviously more sensible than the former. The equitable way of doing this is to net out the counties wage bill which is about Sh.140 billion, and share the balance proportionately. This math works out to 33 percent of the national governments O&M budget and the transfer to counties net of wage bill which translates to national government O&M budget of Sh. 202 and counties Sh.78 which means that the transfers to counties reduce from Sh. 376 to Sh. 218 billion. This is the reality that the government has refused to face. It should also be readily apparent that the tax measures that the government rigged through parliament are not a solution to its financial woes.

The Jubilee administration bet the farm on mega-infrastructure projects to expand the economy and has borrowed heavily to finance them. Infrastructure investments are supposed to crowd in productive private investment which in turn expands the tax base, which in turn generates the revenue to pay the debts. But far from increasing, the tax take is falling. The preliminary data treasury has published shows a sharp decline to 15.4 percent last financial year, down from 17 percent in the previous one. A 1.6 percentage-point decline in a year looks improbable— it is more likely that they have over-estimated GDP. This and the reason why, will be confirmed shortly. Still even the one percentage-point decline from 18 to 17 percent in five years is itself a serious problem. It translates to a forgone revenue of Sh. 77 billion in FY16/17 (*see chart below*). If we assume that the 15.4 figure is an underestimate and instead apply a revenue yield of 17 percent last year, the revenue yield gap drops to a more plausible Sh. 80 billion. Why?

Revenue to GDP ratio, % (LHS) and implied revenue gap Sh. billion (RHS)



First, a lot of the borrowed money was stolen outright and many, perhaps all the projects have been done at highly inflated costs. We still do not have any physical evidence of what we spent the proceeds of the first eurobond, Sh.190 billion (US$ 2.2 billion) proceeds of the first eurobond issue on. Government claims that the money was channeled into the development budget and absorbed in one financial year. Not only is it simply not possible to build things at that rate, the funding for all the projects done for that year is accounted for without the eurobond money. This is the reason that the special audit of the eurobond has never come out.

> A lot of the borrowed money was stolen outright and many, perhaps all, of the projects have been done at highly inflated costs. We still do not have any physical evidence of what we spent the proceeds of the first Eurobond on…

The national investment rate has remained stagnant at about 18 percent of GDP, against a requirement of 25-30 percent of GDP. We also know that credit to the private sector collapsed suddenly three years ago, and has been comatose since. The credit market has become a pyramid scheme, where interest on government securities is re-invested in government securities. As with all pyramid schemes, this one too will come to grief.

In short, the reason why the revenue yield has declined is because the productive base of the economy has not expanded. The Jubilee administration bet the farm on a state of the art milking machine, even built a brand new shed to go with it, and now expects the cows to produce more milk. It is the same cows. And now the debt repayments and electricity bills are eating into the working capital forcing the farmer to cut back on feed. They now lament that the milkman (KRA) has a new machine but is still unable to produce more milk.

But the National Treasury's growth projections are as panglossian as ever. In the original budget forecast, the nominal GDP expands from 7.7 trillion in FY16/17 (the latest actual data) to Sh. 12.6 trillion in FY20/21 a growth of 64 percent or 17 percent per year. Nominal GDP is the denominator used to calculate budget financial ratios. This translates to a real economic growth rate of 7.4 percent per year (this is obtained by applying an inflation adjustment known as GDP deflator. I have applied the average deflator for the last five years). Average growth rate for the last five years—5.56 percent. Growth has topped seven percent only once in the last thirty years— 2007. Now comes the remarkable part. In the revised projections, nominal GDP has been adjusted upwards to just under

Sh. 13 trillion in FY20/21. It is conceivable that the mandarins are factoring higher inflation— one hopes so because otherwise it translates to a delusional eight percent per year growth rate. The reason for the sharp fall in the revenue ratio last year is now clear— GDP has been inflated on purpose.

What is this fantasy in aid of? Their purpose is to reduce the budget financial ratios without budget cuts. This way, they are able to “get away” with fiddling with the actual budget figures and still achieve “fiscal consolidation.” This year, the deficit in the revised budget is adjusted upwards by 14b from 603 to 622 billion but it as a ratio to GDP it declines from 6.3 to 6.1 percent on account of GDP being adjusted upwards by 321 billion. In FY21/22 the nominal GDP projection is jerked up 17 percent which excluding an inflation surge, brings the real growth rate for the period to 8.4 percent. This enables the mandarin to “bring down” the budget deficit 3.4 percent, even as expenditure grows by Sh.750 billion. A serious sensible projection would have projected 5 percent real growth. A 3.4 percent of GDP deficit based on this would have required expenditure to be adjusted downwards by Sh. 400 billion, or revenue to rise by similar amount or a combination of the two.

The budget, both the original and supplementary one, is best summed as “do nothing” strategy. If you are not up to changing reality, change the numbers.

We are compelled to wonder who this tomfoolery is meant for? It is not the public, they don’t get to see these numbers, let alone read and understand them. It cannot possibly be the IMF, the credit rating agencies or the markets. If anything, this is nothing short of showing the markets a middle finger. That to my mind, leaves only one constituency— their political bosses. The mandarins are telling them what they, the political bosses, want to hear.

My first column calling out the Jubilee’s administration fiscal recklessness, published in August 2014 was subtitled “Lessons from Ghana”.

Three days ago, the Ghanaian government announced that it was planning to issue $50 billion “century bonds” over the next few years, starting with a five to ten billion issue by the end of the year. A “century bond” is a bond with a hundred year maturity. Only three developing countries—China, Mexico and Argentina_ have sold century bonds. Ghana’s issue will be the biggest. A 10 billion dollar issue is a fifth of Ghana’s GDP and would cost a billion dollars in interest a year. The markets did not like the news. Immediately, the yields on Ghana’s eurobond yields shot up (which is another way of saying the value of its bonds fell) and the Cedi fell 2.6 percent. The Financial Times summed it up thus: “In capital market terms, this is no this is not just a moon shot, it’s a mission to Mars.” The FT story was headlined, “Someone tell Ghana this it isn’t 2017 anymore.”

> If you are not up to changing reality, change the numbers. We are compelled to wonder who this tomfoolery is meant for? It is not the public, they don’t get to see these numbers, let alone read and understand them. It cannot possibly be the IMF, the credit rating agencies or the markets. If anything, this is nothing short of showing the markets the middle finger. That to my mind, leaves only one constituency— their political bosses. The mandarins are telling them what they, the political bosses, want to hear.

Argentina issued its century bond last May. The issue was oversubscribed four times. A year down the road, Argentina is in the grip of another financial meltdown. Inflation is raging at 3.5 percent a month, the Central Bank has raised the benchmark interest rate to 60 percent and the Peso, down 52 percent on the dollar this year, is still falling. What changed? In 2015 Argentina elected a new president who promised to impose macroeconomic discipline. Argentina's legendary fiscal laxity has led to eight debt defaults, including the biggest sovereign default in history in 2002. The markets took the new president seriously. Earlier this year, he showed signs of backtracking — revising inflation target upwards and lowering interest rates. Market sentiment turned. Argentina had plenty of foreign exchange reserves, but within weeks it was looking for lifelines everywhere including its perpetual nemesis the IMF which it has approached for a US$ 50 billion bailout.

Someone needs to tell Jubilee this isn't 2017 anymore.

Published by the good folks at The Elephant.

The Elephant is a platform for engaging citizens to reflect, re-member and re-envision their society by interrogating the past, the present, to fashion a future.

Follow us on Twitter.