THE PUBLIC FINANCE CONFERENCE

2024 | SETTING THE AGENDA

SESSION PAPER NO. 1

Financing Budgets in the Context of Fiscal Constraint

With increased taxation becoming arder and harder and the level of public debt rising to unsustainable levels, the question of alternative financing strategies arises. However, the government's options are limited; Kenyans are saying no to taxation, they are demanding that the government stop borrowing and are questioning its use of Public-Private Partnerships (PPPs). How then can the government finance its budget and at the same time pursue fiscal consolidation?

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Background

Kenya faces multiple challenges in financing its national and county budgets amidst rising public debt, limited revenue generation, and the need for fiscal consolidation. Fiscal consolidation-(gradual reduction of fiscal deficits and debt accumulation)—has become increasingly relevant as the country grapples with the need for sustainable public finances. These challenges threaten to jeopardize the country's ability to provide essential services and maintain economic stability.

In response to the above challenges, the government has implemented aggressive tax reforms to increase revenues and there is a fact that Kenya's tax revenue performance has been on an upward trajectory in terms of revenue growth for example an average of about ten percent in ordinary revenue (tax and non-tax revenue). Even with that, these measures/ reforms have not yielded sufficient revenues as projected by the government, evident in missed revenue targets of an average of four percent annually in the last decade. For instance, the government missed its revenue target for the FY 2023/24 by over Ksh 200 billion, with ordinary revenue accounting for Ksh 172 billion of this shortfall. This was despite a growth of 14.5 percent that resulted in total revenue of Ksh 2.7 trillion. Notably, Appropriations-in-Aid (A-i-A) increased by 30 percent to Ksh 414 billion in FY 2023/24 from Ksh 313 billion in FY 2022/23. Part of this increase is attributed to an upward revision of some fees and charges charged by the national government on non-taxes.

Any shortfall in revenue means there is a path to challenges related to the expenditure part of the budget. Notably, the expenditure side of the budget has also continued to bulge at almost similar rates to revenue.

Even with sustained growth in revenue, revenue performance in Kenya remains below its estimated potential. The International Monetary Fund (IMF) estimates that Kenya can collect up to 25 percent of GDP in tax revenues, which also coincides with the EAC region's macroeconomic convergence benchmark for the achievement of the EAC Monetary Union. This translates to a revenue gap of above 10 percent of GDP based on the FY 2023/24 ordinary revenue performance of 14.4 percent of GDP.

In a bid to close this revenue gap, the government has implemented raft policies and legal reforms. In 2023, the government released its maiden National Tax Policy. Shortly after, the government of Kenya finalized its first Medium-Term Revenue Strategy (MTRS) for FY2024/25–FY2026/27 which outlined key revenue reforms for the medium term. In addition, the government has maintained its tradition of releasing an annual finance bill, which in FY 2023/24 introduced an array of new revenue-raising measures. The government had intended to introduce new measures in the FY 2024/25, however, with Kenyans feeling the rising burden of taxation, demonstrations erupted, and the government was forced to withdraw the Finance Bill, 2024.

The situation at the county level is not different as counties have continually missed their revenue targets. County governments in FY 2023/24 jointly collected Ksh 59 billion in Own Source Revenues (OSR). This represented a growth of 55 percent; however, the collected revenue remains below the estimated potential of Ksh 216 billion.

With increased taxation becoming harder and harder and the level of public debt rising to unsustainable levels, the question of alternative financing strategies arises. However, the government's options are limited; Kenyans are saying no to taxation, they are demanding that the government stop borrowing and are questioning its use of Public-Private Partnerships (PPPs). How then can the government finance its budget and at the same time pursue fiscal consolidation?

Objectives of the Session

This session will serve as a vital platform to explore how Kenya's government funding mechanisms are evolving and the long-term implications for the country's fiscal health. Key areas of discussion will include tax and non-tax revenue, public debt management, the role of foreign aid, and own-source revenue generation at the county level. The specific objectives of the session will be to:

- **Critically assess the effectiveness of the government's revenue mobilization plan**
- **Review the government's borrowing strategy and map out alternative strategies for funding public budgets in Kenya**
- **Explore the role of fiscal discipline in Kenya's fiscal sustainability journey**

Key Themes to be Discussed

THEME ONE: Effectiveness of the government's revenue mobilization plan: How well is it working, and what adjustments are needed?

Revenue is primarily very important for the development of the country both in terms of building infrastructure and continuing the delivery of the services, even with such importance, sometimes it is important to ask, even with this where is every coin allocated to?

Kenya's tax collection continues to lag behind expectations while showing gradual signs of improvement. Year in, year out the government has introduced new revenue reforms; both administrative and policy reforms. This means expansion of the tax base to net more taxpayers is important for purposes of enhancing revenue collection to help mitigate budgetary deficits, however, it is good to understand how the taxation burden is distributed among the population.

These strategies have aimed at generating additional revenues, through such avenues as expanding the tax base, increasing administrative efficiency and increasing tax compliance. However, their effectiveness has seen mixed results, with some successes alongside ongoing challenges, most notably underperformance in revenue, the most contentious Finance Bill of 2024.

Also, in formulating and implementing taxation policies, equity is key. But sometimes, the tax systems lack this component and tend to over-rely on specific tax heads. In 2022, the International Monetary Fund (IMF) estimated Kenya's potential of tax revenue to GDP to be 25.0 percent which is consistent with the EAC region's macroeconomic convergence benchmark for achievement of the EAC Monetary Union. In FY 2022/23, Kenya's tax gap was estimated at 11.5 percent of GDP. Over the medium term, Kenya's government intends to robustly scale this up from Ksh. 3.0 trillion in 2023/24 to Ksh. 4.4 trillion.

Therefore, this session will seek to diagnose key gaps in the government's revenue mobilization plan and make recommendations on key areas that the government can target for increased domestic revenue mobilization. Specifically, the session will answer the following questions.

1. Ongoing Reforms in Revenue Mobilization and Alternatives

- What is Kenya's revenue mobilization problem? What are the merits of some of the proposed and actioned policy measures? e.g. tax incentives/expenditure, non-tax revenue. What are alternative priority areas of tax reform?
- Is the current tax structure fair and sustainable in the long term?

2. Improving Sub-national Budget Financing

- o What avenues are there for counties to generate more revenue locally?

- How can counties improve their OSR collection? What good practices or models currently in place exist that counties can adopt?

THEME TWO: Outlook on public debt- Can Kenya manage its debt more effectively? What alternative strategies exist for financing?

It is no longer news that Kenya is under a constrained fiscal space and high debt burden environment. There has been a heated debate about whether Kenya has a revenue or spending problem, even with revenue growth, the budget deficit has perennially remained pressuring the government to continue plunging into debt and potentially surging the debt repayments each financial year. To further explore, this deficit issue which has a direct impact on public debt, the budget deficit has often increased in years as a result of supplementary budgets and the issue could be as a result of an ambitious revenue target. For example, between FY 2017/18 and 2022/23, the actual deficit was above 750 billion annually.

Public debt in Kenya has continually surged; gross public debt stood at Ksh 10.6 trillion as of June 2024. The government in FY 2023/24 alone borrowed Ksh 818 billion (5.1 percent of GDP) and plans to borrow Ksh 769 billion (4.3 percent of GDP) in FY 2024/25. This is despite continued public pronouncements that the government will slow down on borrowing.

The increased borrowing has also come at an increased cost with both bills and bonds fetching interests above 15 percent. This has then pushed the cost of borrowing up with projected interest payments amounting to Ksh 1,009 billion in the FY 2024/25. This means that 35 percent of the projected ordinary revenue will go to interest payments. This then leaves little resources for the rest of government expenditures and creates the need for a rethink of how the government funds its budget. This session will seek to answer the following key questions:

3. A Reflection on Public Debt Management in Kenya

- Has there been value for money for public debt in Kenya?
- Where has Kenya gone wrong in its approach to borrowing strategy?

4. Alternatives for Deficit Financing.

- What are some key learning points from Kenya's experience with public debt management?
- What are some alternative borrowing strategies that Kenya can employ?
- Are public-private partnerships (PPPs) a viable alternative to financing development in Kenya?

THEME THREE: Budgeting for the Future?

As Kenyans went to the streets to pressure the government to rethink its taxation decisions, the conversation quickly shifted to a broader call for enhanced transparency and accountability in the use of public resources. This was in part triggered by budget lines (such as the office of the first lady, the office of the second lady, and the office of the spouse of the prime cabinet secretary) that Kenyans felt were a waste of government resources and opulence displayed by senior public officials. The call for fiscal discipline was seen as critical to addressing rising public debt, high fiscal deficits, and growing demands for public services.

These sessions will attempt to answer the following questions:

5. Connecting Financing and Service Delivery

- Is there wastage in government? What can be done to reduce wastage in government? Is zero-based budgeting the solution?

- What criteria should the government use to prioritize spending under a constrained budget? Should some sectors like health and education be protected in period of fiscal constraint?
- What steps can the government take to improve transparency and accountability in government spending? Could this trigger voluntary compliance with taxation?

6. Public Participation in Budgeting

- What role can citizens, civil society and media play in promoting accountability and public trust in government?

Importance of the Topic in Today's Context

Kenya has continually grappled with increased borrowing to fund its development agenda. Kenyans continue to demand better services from the government but do not want to be taxed more. Therefore, the topic provides an opportunity to explore alternative funding to government budgets, entrench accountability, and foster fiscal sustainability. The session will critique the government's approach to taxation and offer recommendations on growing revenues from alternative sources.

The session will also review Kenya's approach to debt management and tackle the controversies around Public-Private Partnerships (PPPs) and whether they can help reduce reliance on borrowing, ensuring development continues without overburdening citizens.

From the perspective of expenditures, the session will answer the question of whether there is wastage in government and explore whether zero-based budgeting is a solution to this challenge.

Expected Outcomes of the Session

Participants will gain valuable insights into financing budgets through effective taxation, managing public debt and reducing budget deficits while ensuring sustainable economic growth. They will develop a deeper understanding of innovative financing solutions, such as Public-Private Partnerships (PPPs), and explore effective revenue mobilization strategies, such as tax-base expansion, particularly through taxation of the informal sector and the digital economy and enhancing tax compliance. The session will also emphasize the importance of transparency and accountability in public finance management, equipping participants particularly government officials with strategies to improve governance for increased public trust.