POLICY BRIEF

Enhancing Commitment to Contractual Obligations by Government in Payment to Suppliers

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Executive Summary

Micro, Small and Medium Enterprises (MSMEs) play a significant role in Kenya's economy especially in employment creation, contribution to the GDP in terms of national revenue and income, providing market linkages and intermediating the supply of goods and services.This policy brief identifies the challenges faced by MSMEs involved in supply of goods and services as a result of non-payment of the supplies by government. It also highlights some of the effects of government's non-payment for supplies to business and proposals for policy reforms. Our research identified the following key challenges faced by the businesses related to access to non-payment by government to supplier of goods and services:

a) Non-payment by government for goods and services supplied by the private sector including MSMEs;

b) Delayed payment by the government for the goods and services supplied;

c) The government in most of the contracts does not pay part-payment or down payment at commencement of the supply of goods and services;

d) There are MSMEs that have often supplied goods and services to government without the necessary procurement documentation;

e) Non-payment to some of the MSMEs that supply goods and services as subcontracted suppliers by large government suppliers.

And proposes the following recommendations for consideration:

- The National Treasury should initiate the review and amendment of the Public Procurement and Disposal Act, No. 33 of 2015 to provide for:
  - Prompt payment of the full contractual sum upon satisfactory supply of goods and services.
  - Contractors to include prompt payment of 30 days in any subcontract.
  - The functions of the Public Procurement Administrative Board to include determination of interest payable to suppliers on delayed payment.
  - Annual audit of procurement plan and its implementation to ascertain and determine the existence of implied contracts.
- The National Treasury should initiate the review and amendment of the Public Finance Management Act.
- The National Treasury should establish a taskforce to audit and review all pending bills at national and county level.

1. *Republic of Kenya (2015). Public Procurement and Disposal Act, No. 33 of 2015.*

Adopting the proposed policy recommendations will improve business productivity, stabilize the labour market, improve GDP growth, improve business trust in government, enhance stability in monetary sector, reduce non-performing trade credit and enhance government accountability.

Challenges Facing MSME Sector: Payment of Goods and Services Supplied

Whereas the MSMEs have, to large extent, opportunities in supplying goods and services to government, they have faced numerous challenges related payment for goods and services delivered by government. Some of the key challenges are:

a) Non-payment by government for goods and services supplied by the private sector, including MSMEs. The Office of the Controller of Budget (2018) estimates that as at 30th June 2018, the pending bills (Financial obligations that have not been settled at the end of financial year for goods and services delivered) by counties amounted to Ksh. 108.41 billion. The counties with high pending bills were:

Counties with Highest Pending Bills	
Nairobi	Ksh. 64.8 billion
Mombasa	Ksh. 3.705 billion
Kisumu	Ksh. 2.047 billion
Wajir	Ksh. 2.619 billion
Nakuru	Ksh. 2.379 billion
Meru	Ksh. 2 billion
Kwale	Ksh. 1.830 billion
Narok	Ksh. 1.725 billion
Nyeri	Ksh. 1.411 billion
Nandi	Ksh. 1.394 billion
Nyamira	Ksh. 1.349 billion

(Office of the Controller of Budget, 2018)

The Auditor-General estimates that as at 30th June 2016, the national government had accumulated the pending bills totaling Ksh. 20.47 billion with Ksh. 18 billion being recurrent budget and Ksh. 900 million with Ksh. 1.5 billion not classified .The Ministries and Departments that were leading in pending bills were:

2. Office of the Controller of Budget (2018). Annual County Governments Budget Implementation Review Report for FY 2017/18. Nairobi. Available at www.cob.go.ke.

Ministries and Departments Leading in Pending Bills	
State Department for Coordination of National Government	Ksh. 4.52 billion
State Department of Devolution	Ksh. 2.55 billion
State Department of Planning	Ksh. 2.55 billion
State Department of Interior	Ksh. 1.8 billion
Lands, Housing and Urban Development	Ksh. 1.693 billion

However, this was noted to be a 53% decrease from 2015 (which was Ksh. 43.212 billion).

b) Delayed payment by the government for the goods and services supplied. Payments by government for supplies received has been observed to be delayed for period of over 5 years. For example, some of the county pending bills have been carried forward since the inception of county governments in 2013.

c) There are MSMEs that have often supplied goods and services to government without the necessary procurement documentation.This has been occasioned by government entities sourcing goods and services within short timelines where the entities indicate that the appropriate documentation would be issued in the course of the supply of the goods and services where due to expediency of procurement of the goods or services, the provision of necessary documentation may not be available. In many instances, the suppliers may have some of the core documents such as Local Purchase Order (LPO) and Local Service Order (LSO) completed before supply of the goods and services but the government departments may not have followed some of the procedures.This has exposed the MSMEs to risk where the tenders, and subsequent supply, are declared irregular and it is subsequently declared that the suppliers of goods and services should not be paid.

d) The government does not pay part-payment or down payments upon signing the contract, and issuance of LPO or LSO for most contracts.With the exception of infrastructure construction services, the government pays the whole contract amount after the complete supply of goods and services.This is unlike in the private sector where the payments are scheduled according to specific deliverables. Consequently, the suppliers must to use their funds to supply the goods and services throughout the entire contract value chain.

e) Non-payment to MSMEs that supply goods and services as subcontracted suppliers by large government suppliers. Some of the large suppliers are local entities while others are international entities. Some of the large suppliers who subcontract MSMEs fail or delay paying the MSMEs for goods and services supplied to government even where the government has already paid the large suppliers for the goods and services supplied.

3. Office of Auditor-General (2017). Summary of the Report of the Auditor-General on the Financial Statements for National Government for the FY 2015/2016. Available at www.oagkenya.go.ke

Impact of Non-Payment by Government on Business

As a result of non-payment by government to suppliers and risk exposure faced by subcontracted MSMEs:

a) There are businesses that have collapsed or faced severe growth constraints due lack of working capital or adequate cash flow as most of their funds have being held by government as a result of non-payment of supplies.As noted above, with pending bills amounting to Ksh. 128.88 billion for both national and county governments, businesses that supply the government can experience financial difficulties.The Central Bank of Kenya report noted above indicated that businesses were not able to repay loans due to delayed payments by government an indicator of businesses facing cash flow or working capital difficulties

b) Suppliers who had supplied goods and services without all necessary documentation remain exposed to risks of non-payment for the goods and services supplied.This implies that the businesses would have to write off the debts owed by government, even if they have some of the documentation in their possession but the documentation may not be complete e.g. where a supplier has a contract but does not have the Local Services order or Local Purchase Order or where there is correspondence between the government agency and supplier to the effects that the supplier has formally been requested to supply the goods and services.

c) Many workers employed by MSMEs, whose payments have not been paid by government, were laid off due to the constrained financial challenges facing those businesses.This has also inhibited the MSMEs ability to hire new workers and hence create more jobs.

d) The numbers of non-performing loans in the banks have risen due to inability of MSMEs to repay loans taken to finance businesses.The non-performing loans portfolio in the banks from private sector was Ksh. 234.5 billion in 2017 which was a 54.3% increase from 2016 (which was Ksh. 191.2 billion) .The high non-performing loans are partly attributed to delayed payments by private and public sector, Central Bank of Kenya (2017). Non-payment to suppliers by government has ripple effect in terms impact on other businesses dealing with government suppliers who also have taken up loans to finance their businesses.

e) Many business assets (capital) that were offered as collateral for security to access bank loans have been auctioned by banks and other financial intermediaries.This has led to closure of businesses or slowed business growth due to capital inadequacy.As noted above, the non-performing loans portfolio implies that banks had to repossess the collaterals issued in most cases so as to recover the loans issued.

f) Businesses that have failed to repay the loans, as a result of non-payment by government, have ended up being listed with credit reference bureaus as loan defaulters.This has negatively affected their ability to finance their businesses through access to credit.

4. Central Bank of Kenya (2017)The Central Bank of Kenya Annual Report, 2016.Available at www.centralbank.go.ke.

g) Reduced realization of government revenue due to limited taxes collected from the businesses that have not been paid by government and hence not being able to make revenue.

h) Increase in unpaid trade credit portfolio, which has affected the businesses that supply government suppliers with the goods or services on credit with anticipation that once government pays for the goods, the suppliers would pay back for the goods supplied. Industry players estimate trade portfolio to be approximately Ksh. 500 billion, which includes non-performing trade credit.

i) Reduced business trust in government supply chain management, which has to an extent resulted in credible and good suppliers of goods and services shunning away from continued business with county due to non-payment for goods and services, especially for Business to Government (B2G) transactions. This may result in government having suppliers, which would not provide value for money and quality supply of goods and services.

j) High pending bills have contributed to slow growth in the GDP, which was 4.90% as at 2017. As noted above, the total pending bills is Ks. 128.88 billion, which is 2.86% of the real GDP prices (which is estimated to be Ksh. 4.510 trillion. This implies that Ksh. 128.88 billion is not being utilized into productive economic activities by business since government holds that amount of money.

Policy Gaps: Government Payment to Suppliers

Government payment to suppliers is anchored on various legal and regulatory frameworks key among them the Public Procurement and Disposal Act, Cap No. 33 of 2015 and the Public Finance Management Act, Cap 412C. There are some policy gaps in the legal frameworks that predispose the MSMEs to government non-payment for goods and supplies received. The main policy gaps are –

a) Under section 146 and 147 of the Public Procurement and Disposal Act, advance payment is only permitted under exceptional circumstances. This limits the government agencies ability to pay suppliers commitment fees, which is capped at not more than 20% of the contract sum. Non-payment of advance payment reduces business's cash flow and working capital where government delays payment of the contract sum upon completion of the contract.

b) The Public Finance Management Act does not provide for mandatory requirement for government to factor or provide for payment of pending bills within the following year's budget as well as Budget Policy Statement for National Government and County Fiscal Strategy Paper for county governments.

5. Central Bank of Kenya (2018). The Annual GDP Report. Available at https://www.centralbank.go.ke/annual-gdp/.

c) There is inadequate legal obligation on government for mandatory prompt payment for the contract sum upon successful delivery of goods and services.This has resulted in delays by government in procurement of goods and services without any recourse for suppliers except through court enforcement. It is not appropriate for government to only pay suppliers upon court's enforcement of contracts, yet business would seek to establish long-term contractual relations with government devoid of litigation unless where necessary.

d) There is no legal protection for suppliers of goods and services who genuinely supply goods and services to government and receive necessary documentation where some of the documentation or procedure may not be compliant with the Public Procurement and Disposal Act.The law does not recognize implied contracts where the government receives fair value of goods and services, especially where government entities formally request for supply of goods and services within short notices and urgent circumstances.The suppliers are exposed to the risk of government repudiating the contractual obligations on the reason that some aspects of procedure may not have been followed.fair value of goods and services, especially where government entities formally request for supply of goods and services within short notices and urgent circumstances.The suppliers are exposed to the risk of government repudiating the contractual obligations on the reason that some aspects of procedure may not have been followed.

d) Whereas section 140 of the Public Procurement and Disposal Act provides for interest to be payable on delayed payments, the Act does not provide for the mechanism of determining the amount of interest payable.This leaves the suppliers with court process as the only recourse for claiming the interest payable.

Policy Recommendations

In order to address the policy gaps described above, the following policy measures should be adopted

a) The national treasury should initiate the review and amendment of the Public Procurement and Disposal Act, No. 33 of 2015 to provide for:

   i) Prompt payment of the full contractual sum upon satisfactory supply of goods and services and invoicing within 30 days or maximum 60 days. In addition, the Act should provide for interest payable upon the expiration of the due date.

   ii) Contractors to include in any subcontract prompt payment of 30 days as provided in the contract between the contractor and government.

   iii) The functions of the Public Procurement Administrative Board to include determination of interest payable to suppliers on delayed payment.This should also include the procedure for lodging of claims for such determination by suppliers.

iv) Annual audit of procurement plan and its implementation to ascertain and determine the existence of implied contracts where goods and services have been satisfactorily supplied by MSMEs to government without all necessary documents for purposes of paying for the supplies while government takes necessary administrative measures against government officers who may have flouted the rules.

b) The national treasury should initiate the review and amendment of the Public Finance Management Act to provide for:

i) Establishment of project bank accounts by each government entity engaged in infrastructure development for management of project funds of determined threshold e.g. Ksh. 10 million and above. Funds should be credited to the account during each disbursement of the money to the entity from the National Treasury. This would ensure that funds for procurement of goods and services are available upon the procurement of goods and services and reduce occurrence of pending bills.

ii) Provision of mandatory requirement for government to factor of provide for payment of suppliers in the cash flow plans and quarterly transfers/disbursement from National Treasury in each quarter during the financial year.

iii) Provision of mandatory requirement for government to factor or provide for payment of pending bills within the following year's budget as well as Budget Policy Statement for National Government and County Fiscal Strategy Paper for county governments.

iv) Increase of budget and expenditure control by the controller of budget on implementation and compliance with procurement plan by ensuring that no approvals shall be issued by controller of budget on procurement of goods and services that are not provided for in the procurement plan.

v) Requirement for each government entity at both national and county level to include in the quarterly and annual report, the amount of money spent on procurement, the pending bills for the respective quarter and the proposed payment plan for the pending bills.This would enhance budget discipline and accountability.

vi) Provide for midterm-review and amendment of the procurement plan to allow for alignment of procurement with revenue actually received, especially actual national government transfer of an equitable share of revenue; incorporation of changes in environment in which the respective government entity is operating.This would enable government entities to be realistic in their procurement and expenditures. However, this would be allowable so long as procuring entities stay within their allocated or approved budget ceilings so that they would only be dealing with reallocation of funds within their budget and programmes and subject to approval by the county executive committees.

5. Central Bank of Kenya (2017). The Central Bank of Kenya Annual Report, 2016. Available at www.centralbank.go.ke

b) The national treasury should establish a taskforce to audit and review all pending bills at national and county level.The taskforce should be mandated to also recommend short and medium-term measures for reducing the pending bills and completion of all payments pending for more than two years before end of 2019.

Potential Impact of Adopting the Proposed Policy Measures

By adopting the above proposed policy measures the following is the anticipated impact on MSMEs sector:

a) **Improved business productivity** as a result of access to the locked business funds.

b) **Improved stability of businesses** as a result of increased working capital made available by releasing the amount owed by government to businesses. Businesses that may be considering shutting down due to financial constraints would be salvaged from closure.

c) **Stabilization of the labour market** as employers who were owed money by government would be able to sustain the employment levels or hire more employees to grow the businesses.

d) **Improved GDP growth** as a result of the government releasing money owed under the pending bills into productive activities into the economy.

e) **Improved business trust on government** in terms of government being a trusted business partners, especially for Business to Government (B2G) transactions.

f) **Enhanced stability** in monetary sector as a result of reduction in non-performing loans in the banks.

g) **Reduction in non-performing** trade credit where the trade credit is related to pending bills.

h) **Enhanced government accountability** in relation to public procurement and payment of suppliers.

Best Practice: Case of UK Government Payment to Suppliers

The United Kingdom policy and legal framework for government payment to suppliers provide best practices that may be adopted in Kenya.These are –

- **a)** (Government contracting authorities are required to provide in the contracts for payment of valid and undisputed contracts within 30 days upon submission of the valid and undisputed invoice.
- **b)** Invoices for payment submitted are verified in a timely manner and undue delays are not regarded as sufficient justification for failing to regard an invoice as valid.
- **c)** Contractors are required to include in any subcontract prompt payment terms of payment within 60 days.
- **d)** Government suppliers sign a voluntary Prompt Payment Code to pay subcontractors within 60 days, which acts as a soft mechanism for ensuring compliance with the code and contractual commitments.
- **e)** Government contracting authorities establish a project bank account for managing construction projects funds.This facilitates timely and efficient payment of contractors.
- **f)** Large government contractors are required to report on payment practices, which acts as a soft enforcement mechanism for compliance.
- **g)** This has improved payment of suppliers by government, payment of sub-contractors by the main government contractors and increased openness and accountability in relation to payments for governments contracts.

Conclusion

In conclusion, nonpayment by government to suppliers of goods and services has impeded business operations and growth among the suppliers.This has also had ripple effects such as nonperforming bank loan portfolio as well as business closures. County governments have been noted to have the highest level of pending bills compared to the national government. By adopting the proposed policy measures, the government will enhance business to government business relationship and increase private sector participation in supplying goods and services to government.

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