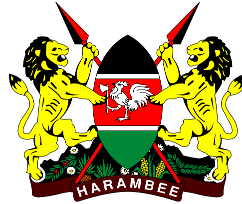

PARLIAMENTARY SERVICE COMMISSION

Parliamentary Budget Office

Evading recessionary pressure under a mounting debt burden

Budget Options for 2021/2022 and the Medium Term

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For more information, contact:
The Director,
Parliamentary Budget Office
Parliament of the Republic of Kenya
Protection House, 10th Floor
P.O. Box 41842 – 00100 GPO
NAIROBI, KENYA

Tel: +254-20-284-8810
Email: pbo@parliament.go.ke

The document can be downloaded from www.parliament.go.ke

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List of Acronyms and Abbreviations

AIA	Appropriations in Aid
ASALs	Arid and Semi-Arid Areas
BPS	Budget Policy Statement
BROP	Budget Review and Outlook Paper
BRT	Bus Rapid Transport
CBD	Central Business District
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CFSP	County Fiscal Strategy Paper
CIDCs	Constituency Industrial Development Centres
CIDP	County Integrated Development Plan
CRR	Cash Reserve Ratio
DMUs	Diesel Multiple Units
ERS	Economic Recovery Strategy
FDI	Foreign Direct Investment
FTA	Free Trade Area
GCP	Gross County Product
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
IFC	International Finance Corporation
IFMIS	Integrated Financial Management System
JKIA	Jomo Kenyatta International Airport
KAM	Kenya Association of Manufacturers
KEMSA	Kenya Medical Supplies Authority
KeRRA	Kenya Rural Roads Authority
KETRA	Kenya Trade Remedies Agency
KIPPRA	Kenya Institute of Public Policy Research and Analysis
KNBS	Kenya National Bureau of Statistics
MOH	Ministry of Health
MPC	Monetary Policy Committee
MSMEs	Micro, Small and Medium Enterprises
MTEF	Medium Term Expenditure Framework
MTP	Medium Term Plan
NHIF	National Hospital Insurance Fund
NPLs	Non-Performing Loans
OVC	Orphans and Vulnerable Children
OVOP	One Village One Product
PAYE	Pay As You Earn
PBB	Programme Based Budget
PBO	Parliamentary Budget Office
PFM	Public Finance Management
PPG	Public and Publicly Guaranteed
PPP	Public Private Partnership

PV	Present Value
SEZs	Special Economic Zones
SGR	Standard Gauge Railway
SMEs	Small and Medium Enterprises
TFP	Total Factor Productivity
TREO	Tax Remission for Export Office
UHC	Universal Health Coverage
UNCTAD	United Nations Conference on Trade and Development
USD	United States Dollars
VAT	Value Added Tax

Acknowledgements

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The following were the key contributors, in alphabetic order: Abdinasir Moge, Dr. Abel Nyagwachi, Ali Salat, Chacha Machage, Danson Kachumbo, Edison Odhiambo, Eric Kanyi, Julie Mwithiga, Millicent Makina, Omar Abdirahim.

Summary of Key Issues and Policy Options

The Kenyan economy is currently facing significant challenges with the COVID-19 pandemic worsening an already dire situation. Indeed, the economy was already showing signs of distress even before the COVID pandemic.

Summary of Key Issues:

i.	**Many companies have closed down over the past two years. According to data by the Registrar of Companies, in 2019 a minimum of 388 companies dissolved.**
ii.	**Revenue collection has been subdued over a number of years**
iii.	**Fiscal indiscipline is rife and medium term projections do not seem to matter. Medium term targets are varied at will without regard to their impact on policy direction.**
iv.	**Issues of fiduciary risk have been devolved to the subnational level**
v.	**Public investment appraisal and management is weak hence new projects are introduced at any stage of the budget**
vi.	**Policy strategizing is not linked to specific targets, programmes and achievements**
vii.	**Weaknesses of the budget challenge function**
viii.	**A reduction i savings and widening of savings-investment gap**
ix.	**Kenya's Foreign Direct Investment declined by Kshs. 31 billion in 2019 and is estimated to have declined by as much as 40 % in 2020.**
x.	**Concerns with regard to debt accumulation, particularly among investors, may also lead to loss of access to cheap external markets.**

The Budget Options for 2021/2022 recognizes these challenges to the economy and proposes some measures to reduce the expenditure pressures and accord the country some fiscal space.

Summary of Options:

Enhancing investments	Re-appraisal of all projects in the budget
	An empowered project management unit (PMU)
	Overhaul of tertiary education syllabus
	Conditional grants to counties for investment in Agriculture
	Address regulatory challenges and barriers to market entry for businesses that may hinder activities of foreign investors.
Fiscal Policy	**Reduce the budget deficit to 3% of GDP immediately and target to balance the budget within the next three financial years** ▪ **Freeze nominal expenditure growth for all spending categories** ▪ **Continue with a work-from-home option for public servants and encourage shift to online platforms for meetings.** T ▪ **Rationalize the expenditure for State Corporations** ▪ **No new projects**
	Allow an increase in development expenditure that is financed through external resources
	Reschedule debt to free more money to finance expenditure in the budget
	Enhance budget challenge function by separating cash management and treasury function from macro-economic forecasting and budget preparation.

	Carry out a web publication of actual expenditure by programme and by project.
External Sector	**Invest in the promotion and marketing of exports of agricultural products such as fruits, which have performed well during the pandemic.**
	Continued Implementation of the duty remission scheme under Tax Remission for Export Office (TREO) will enhance the value of exports for Kenyan manufacturers.
Debt	**Reduce the net domestic borrowing to zero coupled with increase in concessional financing**
	Medium term debt service expenditures must be reduced to no more than 3.4% of GDP as per the BPS 2018
	Revision of an arbitrarily set ceiling
Push towards attainment of Universal Health Coverage in the Country	❖ Make it mandatory for Kenyans aged between 18-65 years are enrolled under the National Hospital Insurance Fund (NHIF) social insurance scheme. The elderly (over 65 years) and the vulnerable persons be supported by the government to enrol under the NHIF cover through a yearly government supported capitation. ❖ The contributory pension schemes be brought on board in terms of providing medical scheme through the NHIF platform to cover the post retirement period for their members. This will expand the pool of resources available for UHC ❖ Fast tracking reforms to enhance efficiency at NHIF and Kenya Medical Supplies Authority (KEMSA) which are two critical institutions at the centre of a successful UHC programme.
	Invest in research and policy formulation on use of alternative (herbal) medicine as a complement to conventional drugs.
Jumpstarting the manufacturing sector for economic recovery	Allocate additional resources to institutions such as the Kenya Industrial Estates that enhance innovation and development of small scale industries.
	Provide funding to Institutions such as brand Kenya that can increase export of goods from Kenya through identification of foreign markets.
Improving delivery of the road and rail network	Re- appraise all roads projects with an aim of maintaining only those major projects in the budget and leaving small roads to CDF and the county governments.
	special allocations be provided to expand provision of affordable, safe and comfortable rail passenger transport in large cities like Nairobi, and building interconnectivity across regions beyond the existing rail line systems.
	The Public Investment Management Unit should prepare annual reports on all new projects detailing value for money, affordability and returns on investment of each new project.

	Information on the process of Public Private Partnerships regarding large projects should be reviewed and approved by the National Assembly given the contingent risks often embedded in such long-term projects.
Social Safety Net Programmes	Scale up the Hunger Safety Net Program which currently focuses on four arid counties to cater for other equally vulnerable persons in the urban informal settlements. This program is mainly donor supported.
	Enhance the amount of monies currently transferred through the "Inua Jamii" program for the financial year 2021/22 by Kshs 6.5 billion to compensate for further loss of income to beneficiaries arising from the containment measures of the pandemic.
Enhancing County budget process	Leverage on Information Communication and Technology for county data management.
	Develop and maintain a compendium of projects for each county
	Project prioritisation should focus on the total project cost not just the annual cost of the project
	Establish a system of sanctions and rewards for availing budget information to the general public.

Chapter One

The State of Kenya's Economy

1.1 Pre-existing Economic Conditions: A Pre-COVID Diagnosis of the Kenyan Economy

1.1.1 **Despite attaining lower middle-income status in 2014, the Kenyan economy is yet to surmount underlying structural inadequacies that continue to hinder broad-based economic development.** In 2014, the size of the Kenyan economy was estimated at $55.1 billion; a 25% increase from a previous estimation of $44.1 billion in 2013. Over the same period, per capita GDP went up by $252 to stand at $1,246 – leading to reclassification of the economy as 'lower middle income'. Over the past decade, the economy has grown by 5.6%, on average. This growth is largely attributed to macroeconomic stability; governance reforms with the advent of the 2010 constitution; increased investor confidence; easing of infrastructure constraints; and increased financial inflows through foreign direct investment and remittances. However, the country continues to face significant challenges such as poverty and rising inequality, weak private sector investment and vulnerability to internal and external shocks. This is largely driven by underlying inadequacies in the key engines driving economic growth that continue to hinder broad-based, inclusive economic development.

1.1.2 **Kenya's economic growth trajectory is underpinned by a large share of consumer spending relative to investments.** As illustrated in Figure 1, Private consumption has been the key driver of economic growth over the past decade, with a contribution to economic growth of 22%, on average. This is in sharp contrast to a 4.7% contribution from the investments (both public and private) component. While consumption-led economic growth is not bad per se, the challenge is that it tends to be significantly weaker and

What are the key drivers of sustainable economic growth and development?

i. Pragmatic Leadership
Entails influencing the development of values including integrity and professionalism in service delivery. Pragmatic leadership ensures that there is a clear roadmap of how to get things done as the country works towards its vision/ development goals.

ii.Efficient Public Service
Entails prioritizing of efficient and effective service delivery to all citizen without coercion; upholding fairness and in a corrupt free environment.

iii. Education as an investment
Skills development can increase competitiveness of labour. Skills development that is fit for purpose particularly in economic growth sectors. Thus, the education system should be oriented towards the world of work.

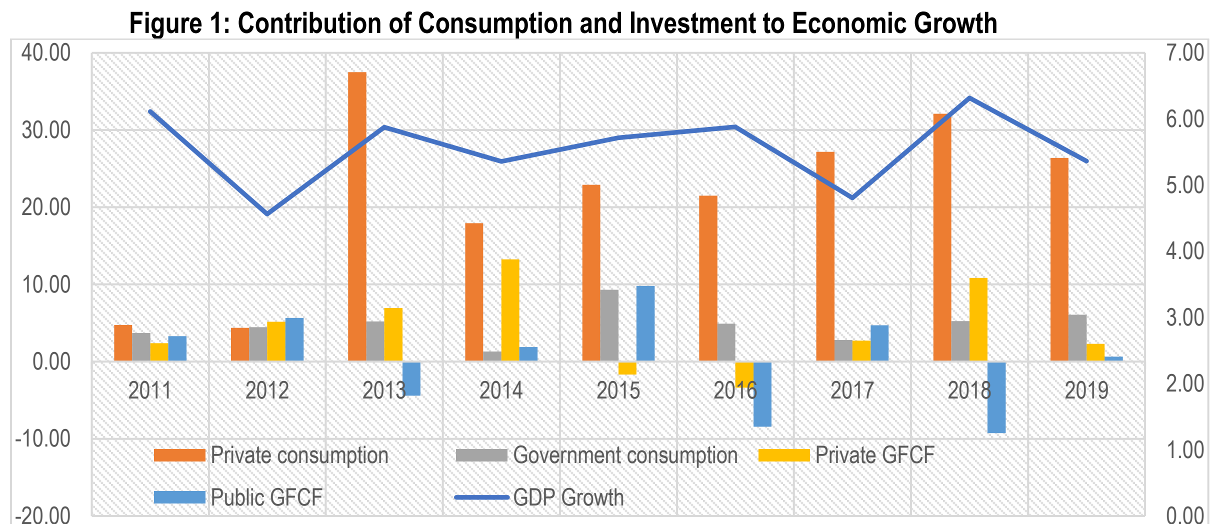
iv. Good governance
Adhering to principles of enhancing corrupt free society where honesty, transparency, efficiency and effectiveness, fairness and accountability are virtues to everyone

v. Policy Strategizing
Having a clear policy direction that is well anchored and that all leaders and citizens collectively work towards.

unsustainable in the medium to long run[1]. The high consumption trend is attributed to the 'middle-class' consumer. A study by Deloitte indicates that Kenya's middle class, estimated at 44.9% of the population, has given rise to **'a thriving shopping-mall lifestyle, a booming housing market, a growing automobile industry, expansion of retail banking and growing domestic tourism'**[2]. The high purchasing power of the middle-class is a significant factor in enhanced consumer spending leading to a higher aggregate demand and therefore higher economic growth. It is important to note however, that the 'middle-class' narrative in Kenya has been put to question by the apparent income uncertainty and instability of the income group, as well as their reliance on credit to smooth consumption[3]. There is a general concern that consumer spending is increasingly being driven by household debt. The rise of short term, high interest digital credit uptake particularly by low-income households has contributed to an increase in household indebtedness. These loans typically solve short-term liquidity problems in households and small businesses but are not significant enough to facilitate long-term investments amongst borrowers[4]. Another concern is the tendency of middle-class expenditure to lean towards imported goods as a mark of quality and stature of the buyer therefore **leaks** a significant portion of national income to another country.

1.1.3 Low investments is a drag on economic growth. As illustrated in Figure 2, over the past decade, the contribution of public and private investment to economic growth has been significantly low and in some instance, negative. Some of the factors adversely affecting private sector investment include limited access to credit, infrastructure deficiencies, shortage of requisite skills, regulatory challenges, barriers to market entry, a large informal sector and rampant corruption[5]. With regard to public investment, concerns abound with regard to choice and quality. Poor project management is the most significant challenge; from design, appraisal, selection, delays in implementation and inadequate monitoring and evaluation.

Figure 1: Contribution of Consumption and Investment to Economic Growth

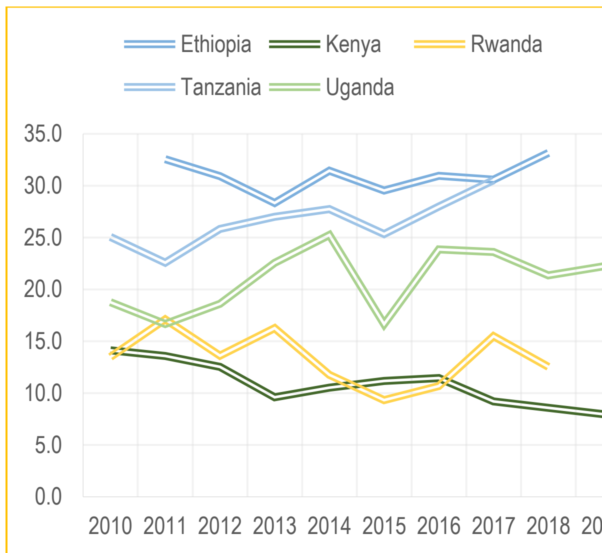


Source: PBO, Macroeconomic Diagnostics

[1] Kharroubi and Kohlscheen, Consumption led Expansions, BIS Quarterly Review, March 2017
[2] Deloitte, 2016. Kenya: Grounding Africa's Economic Growth
[3] Neubert, 2019
[4] Wamalwa, P;Rugiri, I & Lauler, J (2019), Digital Credit, Financial Literacy and Household Indebtedness. WPS/08/19, Kenya Bankers Association
[5] IFC, 2019: Creating Markets in Kenya. Country Private Sector Diagnostic

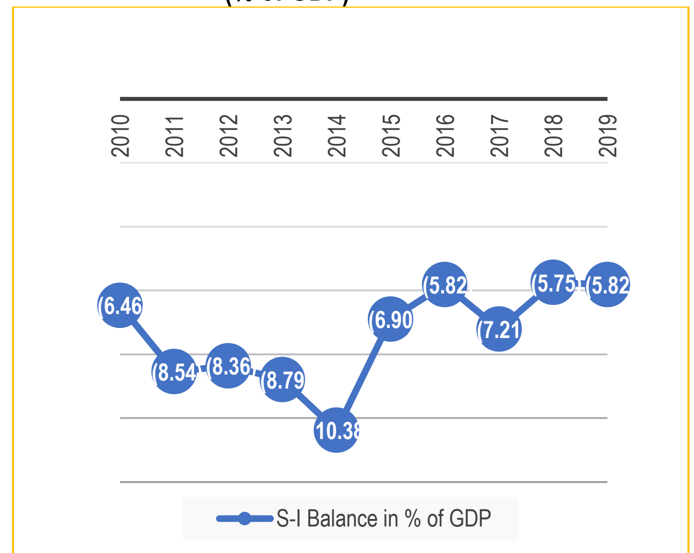
1.1.4 **At 10.9% of GDP over the last decade, Kenya's level of savings is significantly lower than that of its peers which partly explains its low investment efforts.** A wide savings- investment gap is partly the reason for the moderate growth rates experienced over the last decade despite the intentions by the government to achieve higher growth levels. The low level of savings means that the country is unable to invest adequately due to lack of resources and is therefore unable to comprehensively develop the 'value-producing' engines of growth such as manufacturing and exports. While consumer demand can boost growth, it does not necessarily translate to value adding activities and employment as investment would. Such growth is therefore weak and unsustainable.

Figure 2: Gross savings (% of GDP)



Data Source: World Development Indicators, World Bank

Figure 3: Savings – Investment Balance (% of GDP)



Source: Macroeconomic Diagnostics

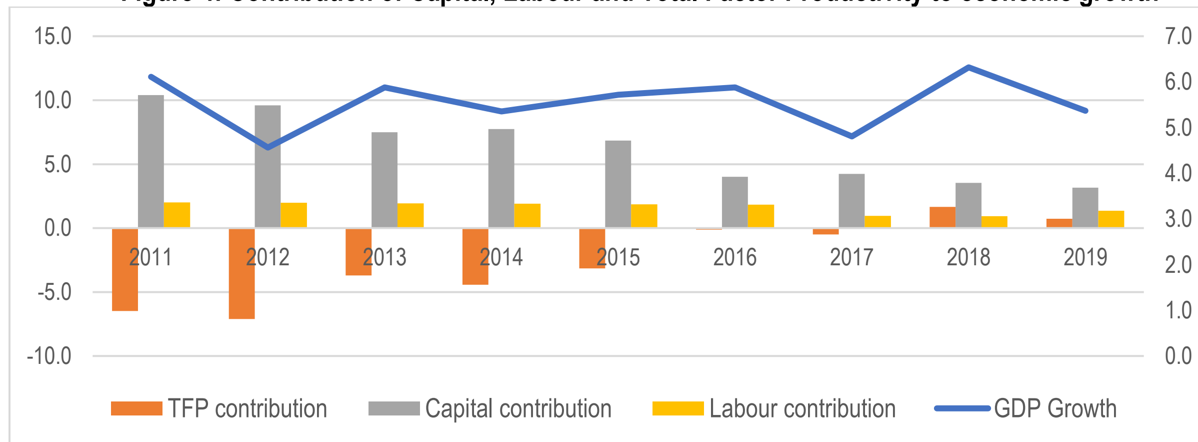
1.1.5 **The low level of investments has negatively affected the country's level of productivity.** As illustrated in Figure 5, the contribution of capital to GDP growth has declined steadily over the past decade; attributable to use of obsolete technology, low innovation and poor adoption of technological advancements. Investment is generally approached from a narrow perspective, for instance, there has been significant investment in roads infrastructure but very little focus on industries that would benefit from such investments. According to a World Bank study[6], though the innovation rate is high in Kenya, **the 'degree of innovativeness' is low**. Most Kenyan firm-level innovations are hardly new to the market and are mainly small improvements on existing concepts/products/processes. As such, their impact on overall productivity is 'statistically insignificant'. This could explain the low contribution of total factor productivity to economic growth. The weak link between innovation and productivity has been attributed to limited knowledge capital investments; and inadequate education within the labour-force, which inhibit adequate transformation of innovations to productivity gains[7].

Savings and Capital Formation: The case of Singapore

Singapore has a compulsory savings programme which mandates every employed citizen to save 20% of their net income in the Central Provident Fund. These contributions vary with age, with younger employees contributing higher amounts than older employees; and employers also make contributions on behalf of the employee. The fund was established in 1955 as a compulsory national social security savings plan to ensure financial security for all citizens particularly when retired or unable to work. Each member holds 3 accounts: Ordinary, Special and Medisave, and contributes different amounts to each account.

The objectives of the CPF are to help its members accumulate enough savings to own a home, pay for healthcare, provide insurance protection for the family, finance retirement and enhance assets for future consumption. Thus, using these savings, members can buy residential properties as well as diversify their financial portfolio through purchase of shares, loan stocks unit trusts and gold for investment purposes. As a result, Singapore's savings rate and investment is significantly high. In addition, these savings have been used to fund public sector development.

Figure 4: Contribution of Capital, Labour and Total Factor Productivity to economic growth



Source: PBO, Macroeconomic Diagnostics Model, 2020

[6] Cirera, 2016, Catching up to the technological Frontier? Understanding Firm level innovation and Productivity

[7] Country Private Sector Diagnostic

1.1.6 **The contribution of labour to GDP growth appears to have stagnated over the past decade with significant decline within the last three years.** Indeed, labour is concentrated in low productivity sectors, notably in the agriculture sector, which accounted for 55% of total employment in 2019[8]. Such low productivity sectors offer low income and little job security. There is a high incidence of youth unemployment, estimated at 15.5% in the 15-34 age bracket[9], which implies that Kenya is not reaping enough demographic dividends from its highly youthful population. Skills constraint is also a significant factor limiting labour productivity with basic skills proficiency among workers considered generally low. Furthermore, the cost of labour in Kenya is considerably higher than that of its peers; relative to labour productivity which is reportedly lower in Kenya compared to many of its African peers[10]. **Thus enhancing labour productivity will require a targeted approach to educational investment in order to enhance skills and innovation.**

	Minimum Wage $	PPP $
Kenya	140	349
Ethiopia	25	77
Uganda	2	5
Tanzania	50	132
Rwanda	3	8

Data Source: International Labour Organisation

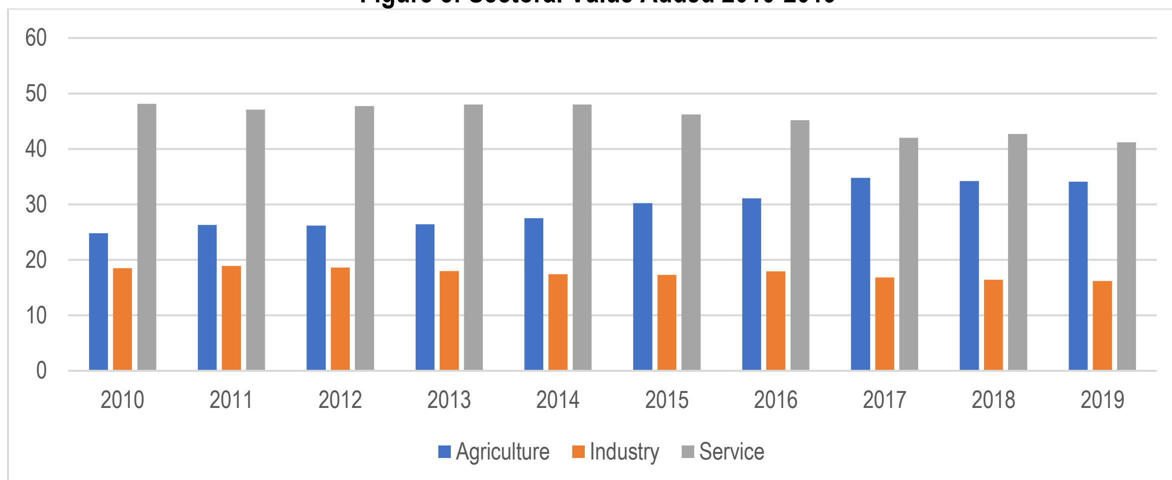
1.1.7 **In terms of sectoral contribution to GDP growth, the service sector has been the main contributor to economic over the past decade.** This includes accommodation and restaurants; information and communication; transport and storage; financial and insurance services; and real estate services among others. In 2020, the sector experienced significant contraction because of the COVID pandemic and this had had a significant adverse impact on economic growth. The most affected sub-sectors include accommodation and restaurants as well as transportation and storage.

1.1.8 **The agricultural sector is the second largest contributor to growth even though the sector is still weather dependent** and continues to be adversely affected by erratic weather patterns as well as low level of investments both at the national and county level. The sector however continues to play a significant role in the economy. In 2020, the sector shielded the economy from further decline during the second quarter of 2020 by registering reasonable growth even as many other sectors experienced growth contraction – notably the Services sector. Thus, any meaningful growth strategy has to prioritize agricultural investments.

1.1.9 **The industrial sector is yet to pick up and its contribution to economic growth has been lagging behind.** In particular, the contribution of manufacturing to GDP has been declining steadily, denoting a reduction in the manufacturing capacity of the country. Food and beverages accounts for the largest share of manufacturing products implying the dependence of the industry on agriculture whose productivity has remained significantly low. Key challenges facing the sector include inadequate skills, barriers to entry, insufficient FDI, low innovation, high cost of doing business, bureaucracy and corruption among others. To diversify manufacturing to other sectors beyond agriculture, serious innovations are required in order to compete effectively on a global scale. Indeed, the non-agro-based manufacturing sector is highly dominated by the informal sector whose main outputs include furniture and metal works and the production is domestically oriented. Manufacturing is among the key pillars of the big four agenda but unless there is enhanced project prioritization and implementation is carried out decisively and aggressively, the outcome for the sector and the economy will remain poor.

[8] KIPPRA (2019).
[9] KNBS Quarterly Labour Force Report, Quarter 2 2020
[10] World Bank STEP Household survey, 2018

Figure 5: Sectoral Value Added 2010-2019



Data Source: Kenya Economic Update, KIPPRA

Table 1: Point Contribution to Economic Growth, 2010 - 2019

Sector	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Agriculture, forestry and fishing	2.1	1.6	1.2	1.6	1.5	1.7	1.8	1.7	2.1	1.8
Manufacturing	0.9	0.7	0.5	0.6	0.5	0.5	0.5	0.4	0.5	0.4
Mining and quarrying	0.1	0.1	0.0	0.1	0.0	0.1	0.0	0.0	0.1	0.0
Construction	0.4	0.3	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Wholesale and retail trade	0.6	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.5	0.4
transport and storage	0.6	0.4	0.4	0.5	0.5	0.5	0.5	0.4	0.5	0.5
Accommodation and food services	0.1	0.1	0.1	0.1	0.0	0.0	0.0	0.0	0.1	0.0
Information and communication	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Financial and Insurance activities	0.5	0.3	0.3	0.4	0.4	0.4	0.4	0.3	0.4	0.3
Real Estate	0.7	0.5	0.4	0.5	0.4	0.4	0.4	0.3	0.4	0.4
Education	0.5	0.3	0.2	0.3	0.3	0.3	0.3	0.2	0.3	0.2
Human Health and social work activities	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Activities of Households as employers	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Others	0.6	0.4	0.3	0.4	0.4	0.4	0.4	0.3	0.4	0.3
GDP growth	**8.4**	**6.1**	**4.5**	**5.9**	**5.4**	**5.7**	**5.9**	**4.8**	**6.3**	**5.4**

Data Source: Economic Survey (Various Issues)

Options:

- **Re-appraisal of all projects in the budget-** This will weed out all non-performing projects where the country is not getting value for money and redirect funds to high-returns projects.

- **An empowered project management unit (PMU)-** Improve the choice and quality of investments by subjecting projects to extensive appraisal and strict selection process. selection of projects tied to addressing specific needs as opposed to 'feel-good' projects are more likely to enhance private sector output. The PMU should carry out regular monitoring and evaluation and ensure all projects are finalized within the stipulated timelines.

- **Overhaul of tertiary education syllabus -** reorient tertiary education to practical, 'for-the-job' training as opposed to theoretical approach.

- **Conditional grants to counties for investment in Agriculture –** These funds will be used for agricultural extension services and agricultural innovations to enhance quantity and quality of agriculture and livestock produce.

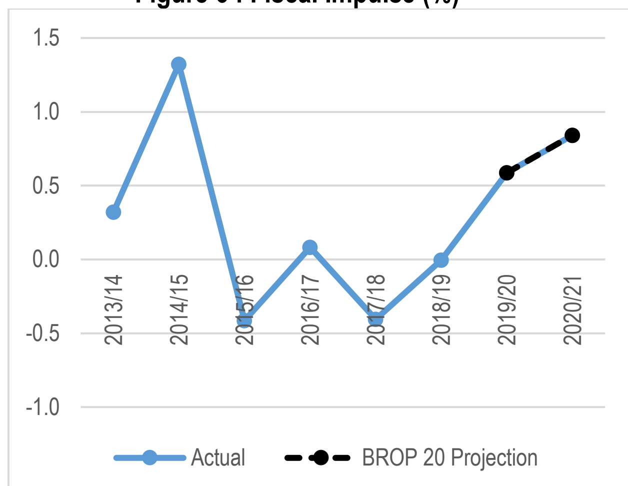
- **Address regulatory challenges and barriers to market entry for businesses that may hinder activities of foreign investors.**

1.2 Fiscal Policy Dynamics

1.2.1 **Kenya's Fiscal Policy has been on an expansionary path since FY 2013/14 as indicated by a positive fiscal impulse[11] (Figure 6).** Over the past years, government development spending has been increasing especially on mega infrastructure projects in road, rail and energy; with the aim of supporting economic growth hence the expansionary fiscal policy. On the downside, the revenues have been underperforming and hence this expenditure has over time, been financed through increasingly expensive debt. This has led to the pursuit of fiscal consolidation as a key government policy.

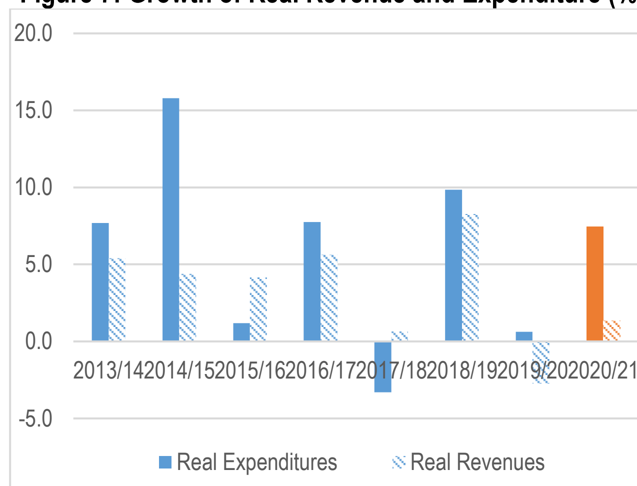
[11] Fiscal impulse is the change in the primary budget balance that has been adjusted to remove cyclical components of the business cycle. A positive fiscal impulse signals an expansionary fiscal policy while a negative fiscal impulse signals a contractionary fiscal policy.

Figure 6 : Fiscal Impulse (%)



Source: PBO

Figure 7: Growth of Real Revenue and Expenditure (%)



Source: PBO

1.2.2 **Over the last four financial years, the National Treasury has set increasingly unrealistic revenue targets**. The deviation between actual tax revenue and printed revenue estimates increased from 5 % in 2016/17 to 21 % in 2019/20 (see Table 2). Overambitious revenue targets during budget preparation have contributed to numerous in-year revisions of expenditure plans, which result in unrealised fiscal policy objectives.

Table 2: Budgeted and Actual Revenue

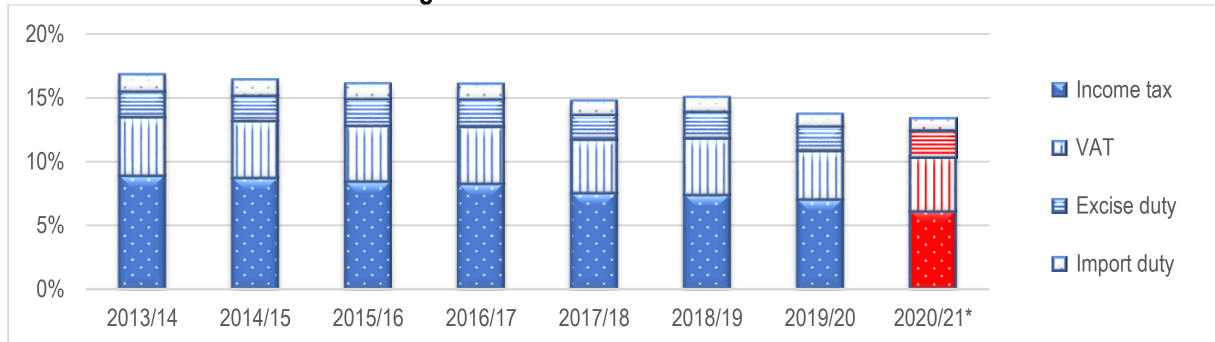
Revenue (Ksh billion)	2016/17			2017/18			2018/19			2019/20		
	Printed	Actual	Dev %	Printed	Actual	Dev %	Printed	Actual	Dev %	Printed	Actual	Dev %
Revenue & grants	**1,573**	**1,467**	**(6.8)**	**1,763**	**1,551**	**(12.1)**	**1,998**	**1721**	**(13.8)**	**2,155**	**1,753**	**(18.6)**
Total Revenue	**1,501**	**1,440**	**(4.1)**	**1,705**	**1,523**	**(10.7)**	**1,949**	**1702**	**(12.7)**	**2,116**	**1,734**	**(18.1)**
Ordinary Rev	**1,376**	**1,307**	**(5.1)**	**1,549**	**1,365**	**(11.9)**	**1,769**	**1500**	**(15.2)**	**1,877**	**1,573**	**(16.2)**
Tax revenue	**1,282**	**1,220**	**(4.9)**	**1,449**	**1,259**	**(13.1)**	**1,639**	**1,401**	**(14.5)**	**1,758**	**1,384**	**(21.3)**
Income tax	671	625	(6.9)	766	641	(16.3)	837	685	(18.1)	884	707	(20.1)
VAT	346	339	(1.9)	384	357	(6.9)	464	414	(10.8)	496	384	(22.6)
Import duty	96	90	(6.6)	102	94	(8.5)	119	107	(10.5)	135	98	(27.6)
Excise duty	169	165	(2.3)	197	168	(15.0)	219	194	(11.3)	242	195	(19.4)
Other	94	87	(7.5)	100	106	5.5	130	99	(23.8)	119	189	59.0
Appropriation-in-Aid	124	133	7.2	155	158	1.7	180	202	12.2	239	160	(32.9)
Grants	**73**	**27**	**(62.9)**	**59**	**28**	**(53.1)**	**48**	**20**	**(59.4)**	**39**	**20**	**(48.9)**
As a % of GDP												
Revenue & grants	**20.7**	**19.3**	**(1.4)**	**20.7**	**18.2**	**(2.5)**	**21.4**	**18.5**	**(3.0)**	**21.1**	**17.2**	**(3.9)**
Total Revenue	**19.8**	**19.0**	**(0.8)**	**20.0**	**17.9**	**(2.1)**	**20.9**	**18.3**	**(2.7)**	**20.8**	**17.0**	**(3.7)**
Ordinary Rev	**18.1**	**17.2**	**(0.9)**	**18.2**	**16.0**	**(2.2)**	**19.0**	**16.1**	**(2.9)**	**18.4**	**15.4**	**(3.0)**
Tax revenue	**16.9**	**16.1**	**(0.8)**	**17.0**	**14.8**	**(2.2)**	**17.6**	**15.0**	**(2.6)**	**17.2**	**13.6**	**(3.7)**
Income tax	8.8	8.2	(0.6)	9.0	7.5	(1.5)	9.0	7.4	(1.6)	8.7	6.9	(1.7)
VAT	4.6	4.5	(0.1)	4.5	4.2	(0.3)	5.0	4.4	(0.5)	4.9	3.8	(1.1)
Import duty	1.3	1.2	(0.1)	1.2	1.1	(0.1)	1.3	1.1	(0.1)	1.3	1.0	(0.4)
Excise duty	2.2	2.2	(0.1)	2.3	2.0	(0.3)	2.4	2.1	(0.3)	2.4	1.9	(0.5)
Other	1.2	1.1	(0.1)	1.2	1.2	0.1	1.4	1.1	(0.3)	1.2	1.9	0.7
Appropriation-in-Aid	1.6	1.8	0.1	1.8	1.9	0.0	1.9	2.2	0.2	2.3	1.6	(0.8)

Grants	1.0	0.4	(0.6)	0.7	0.3	(0.4)	0.5	0.2	(0.3)	0.4	0.2	(0.2)

Source: National Treasury

1.2.3 The trend in declining Tax Revenue relative to economic output persisted long before the pandemic. Despite indications by the National Treasury that the Covid-19 pandemic was the main reason for revenue underperformance in the second half of 2019/20, Tax Revenue as a share of GDP has been declining from 17 % in 2013/14 to 14 % in 2019/20. The largest decline is in Income Tax and VAT.

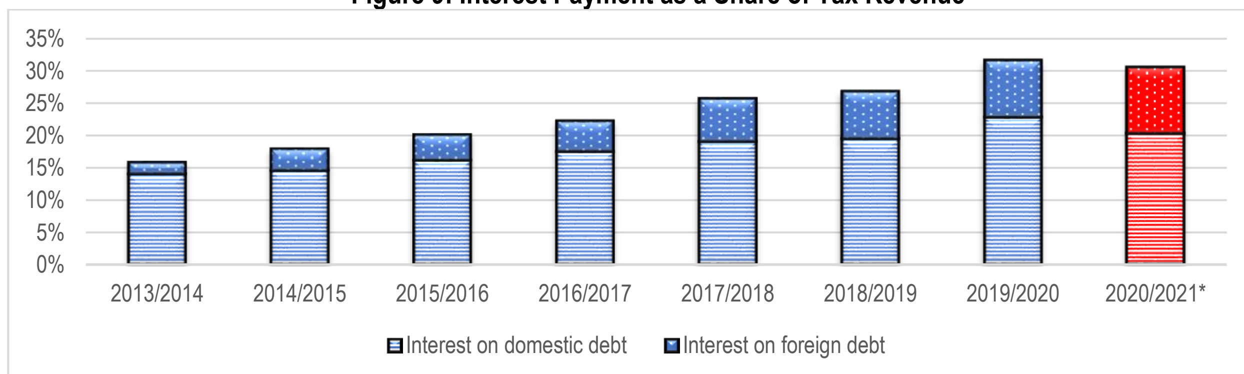
Figure 8: Tax Revenue as a Share of GDP[12]



Source: National Treasury

1.2.4 Recurrent expenditure has been on an upward trend even as tax revenue has dwindled. Recurrent expenditure as a share of GDP increased from 14.8 % in 2013/14 to 16.3 % in 2019/20 whereas, development expenditure as a share of GDP declined slightly from 6.2 % to 5.9 %. One of the main components of increasing recurrent expenditure was interest payment on domestic and external debt. Interest payment on debt as a share of tax revenue doubled between 2013/14 and 2019/20. Over this period, interest payment on domestic debt as a share of tax revenue increased from about 14 % to 23 %. On the other hand, interest payment on external debt increased from about 2 % to 9 % - partially driven by higher borrowing costs as Kenya gradually borrowed more commercial external loans.

Figure 9: Interest Payment as a Share of Tax Revenue



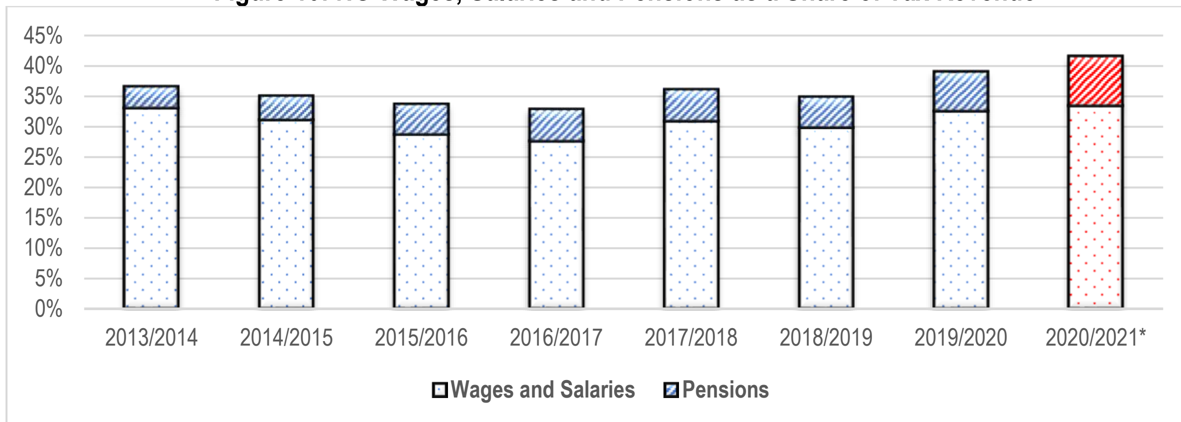
Source: National Treasury

1.2.5 Debt repayment has been rising even as other major expenditure categories such as the national government wage bill remained relatively unchanged (see Figure 10). Total expenditure and net lending as a share of GDP in 2019/20 was similar to the 2013/14 level even as interest payments increased significantly. Notably, whereas development spending as a share of GDP decreased, other

[12] The asterisk * refers to National Treasury's estimates for FY 2020/21 as indicated in the BROP 2020

major expenditure categories such as expenditure on wages and salaries of national government employees, expenditure on operation and maintenance, pensions and transfers to counties remained relatively unchanged between 2013/14 and 2019/20. Consequently, debt repayment may be crowding out development expenditure.

Figure 10: NG Wages, Salaries and Pensions as a Share of Tax Revenue



Source: National Treasury

1.2.6 The government's goal of having a fiscal deficit (inclusive of grants) at 3 % of GDP by 2021/22[13], has remained elusive due to the overly optimistic revenue forecasts as well as expenditure pressures resulting from poor planning and budgeting. The fiscal deficit as presented in the Budget Policy Statement has been a moving target. The actual fiscal deficit including grants averaged 7.6 % in the period FY 2013/14 to FY 2019/20 compared to an average target of 4.0 % during the same period, representing a 3.6 % deviation. This captures the inability of realistically forecasting future revenues and fiscal deficits and implies that the decisions in the overall budget are not being guided by reality but rather by the need to indicate a favourable fiscal position. In addition, the principles of Medium-Term Budgeting where the projected expenditure limitation should be a guide to current decisions is also not being respected.

1.2.7 A continued expansionary fiscal policy given the limited fiscal space in the current state of the economy may result in fiscal unsustainability. If there is no significant change in the implementation of policy interventions geared towards enhancing revenue collection and reducing non-core spending, then expenditure as a share of GDP is likely to rise and revenue as a share of GDP decline in the medium-term. The risk here is that increased spending at a time when revenues are underperforming, interest payments are rising and the economy's ability to incur more debt is narrowing, will render the economy vulnerable to fiscal unsustainability.

Policy Options

i) **Reduce the budget deficit to 3% of GDP immediately and target to balance the budget within the next three financial years –** Tough times call for tough decisions. A reduction in the budget will enable

[13] Fiscal Deficit target under the East Africa Monetary Union Protocol

the country to live within its means. This will require significant expenditure reduction particularly for non-core recurrent spending. Public expenditure reduction can be achieved by exploring the following options:

a. **Freeze nominal expenditure growth for all spending categories –** In particular, spending in growth supportive sectors such as energy and infrastructure can be maintained at prevailing levels but recurrent expenditure should be rationalized as much as reasonably possible. Infrastructure spending should be limited to major road networks only.
b. **Continue with a work-from-home option for public servants and encourage shift to online platforms for meetings.** This will reduce demands on Operations and Maintenance.
c. **Rationalize the expenditure for State Corporations -** A merger of State Corporations may lead to reduced government spending but this should be implemented in a way that reduces operation costs and absorbs a large portion of the current workforce to avoid costly litigation due to loss of jobs
d. **No new projects** - defer all projects by one year especially where no commitments have been entered

ii) **Allow an increase in development expenditure that is financed through external resources**: This may be achieved by pushing for the highest level of commitment since the government will have to pay a fee for committed but non-disbursed loans.

iii) **Reschedule debt to free more money to finance expenditure in the budget:** This will likely reduce the domestic borrowing and lead to less crowding out of the private sector. More credit available for local businesses.

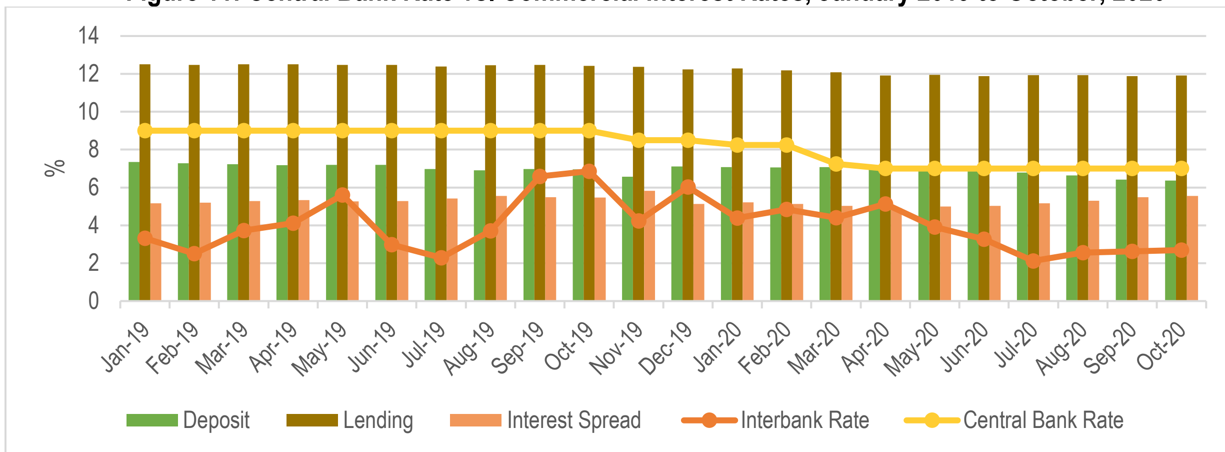
iv) **Enhance budget challenge function by separating cash management and treasury function from macro-economic forecasting and budget preparation.**

v) **Transparency in public spending** – carry out a web publication of actual expenditure by programme and by project.

1.3 Monetary Policy Dynamics

1.3.1 **In the last three years, the government has pursued expansionary monetary policy as evidenced by lowering of the Central Bank Rate (CBR) by 300 basis points, however credit uptake by the private sector continues to be sluggish.** In the wake of the Covid-19 pandemic restrictions in March, 2020, the MPC lowered the CBR rate to 7 % so as to enhance liquidity and mitigate any adverse effects of the pandemic. Cash Reserve Ratio (CRR) was also lowered by 100 basis points to 4.25 per cent in order to avail Kshs. 35.2 billion to commercial banks to support their distressed customers. As a result, liquidity in the economy increased by 16.7 % as at the end of November 2020 compared to the previous year. Furthermore, both the deposit rate and the lending rate declined to 6.37 % and 11.92 % respectively as at end of October 2020. However, the interest rate spread continues to widen (Figure 11). The interbank rate has also risen from 4.39 % at the beginning of the year to 6 % in December 2020 denoting tight liquidity in the market.

Figure 11: Central Bank Rate vs. Commercial Interest Rates, January 2019 to October, 2020



Source: CBK, 2020

1.3.2 Credit to the private sector has marginally improved and was estimated at 7.7 % as at the end of September 2020. It is worth noting however that despite the credit growth, private sector credit uptake has declined by 0.7 % implying either low demand for credit in the private sector or 'cautious lending' by commercial banks. Non-performing loans are a key factor in the cautious approach of banks. The ratio of gross non-performing loans (NPLs) to gross loans stood at 13.6 % in September, 2020 compared to 12.0 % in December, 2019[14]. Commercial banks have been able to restructure total loans amounting to Kshs. 1.38 trillion. This represents 46.5 % of the total banking sector loan book.[15]The non-performing loans are dominant in the real sector, transport and communication and personal due to a subdued business environment. According to Fitch, it is projected that non- performing loans will rise to 15 % as at the end of 2020 and the trend may continue in 2021.[16] **Furthermore, the incessant government borrowing in the domestic market continues to have a negative impact on credit to private sector.**

Table 3: Private Sector Credit to various sectors of the economy, July 2019 to June 2020

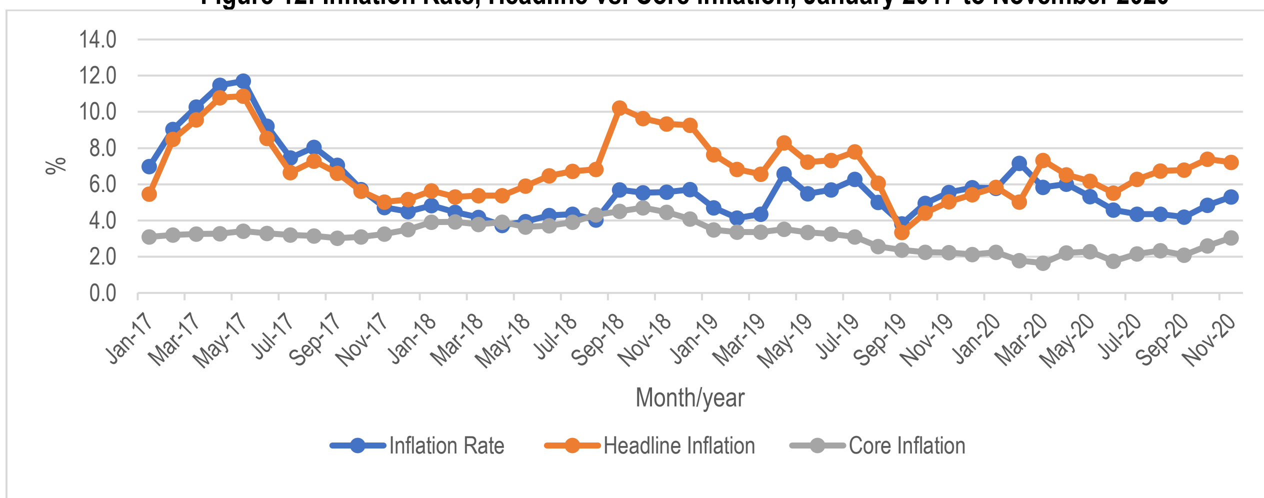
	Jul-19	Aug-19	Sep-19	Oct-19	Nov-19	Dec-19	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20
Credit to private sector	**6.1**	**6.3**	**7.0**	**6.6**	**7.3**	**7.1**	**7.3**	**7.7**	**8.9**	**9.0**	**8.2**	**7.7**
Agriculture	7.6	6.6	5.5	2.1	-6.1	-2.4	-4.8	0.2	1.4	2.8	2.6	2.2
Manufacturing	10.3	7.5	7.5	5.3	7.5	9.2	12.7	10.4	15.3	20.1	18.2	11.1
Trade	8	8.4	7.6	8.5	8.8	8.9	6	9.5	9.4	10.3	8	9.4
Building & Construction	-5.4	-6	-5.3	-5.2	-6.1	1.6	4	-0.5	9.5	7.7	5.7	4.6
Transport & Communication	6.4	5.8	5	4.3	9.8	8.1	9.9	7.4	7.1	9.1	5	14.9
Finance & Insurance	5.3	8.2	14.5	15.1	15.8	0.4	-1.1	1.9	6.6	3.1	8.4	3.2
Real Estate	0.5	2.4	2.2	0.3	1.9	1.5	3.5	3.4	2.2	4.8	4.4	4.9
Mining and Quarrying	-13.5	-10.8	-5.1	-6.6	-3.2	-5.8	-9.4	-14.6	3.9	11	5.8	10
Private Households	7.1	8.6	8.8	6.9	6.1	5.6	5.6	5.9	3.4	2.2	3.2	3.6
Consumer Durables	23.6	23	28.4	28.6	25.9	26	21.4	20.6	24.1	19.6	16.7	15.2
Business Services	1.6	-0.1	3.2	-0.8	-0.3	2.4	1.5	2.4	3.3	1.2	2.7	5.3
Other Activities	-17.2	-14.4	-13.6	14.9	30.9	16	24.4	33.4	36.8	14.3	16.9	-3.7

Source: CBK, 2020

[14] Various MPC press release
[15] MPC press release, November 2020
[16] Coronavirus Impact on Kenyan Banks 2020, Fitch Ratings

1.3.3 **Inflation has remained fairly within the government target range of 5 ± 2.5 % and was estimated at 5.62 % as at the end of December, 2020.** Current inflationary pressures are due to higher electricity prices and transportation costs. High electricity prices are as a result of the depreciation of the Kenya Shilling against the US dollar leading to an upward revision of the foreign exchange fluctuation adjustment component[17]. In addition, the government revision of excise duty for petroleum products increased fuel costs. Crude oil prices have also risen due to increased global demand. As at the end of December, 2020, Murban crude oil price stood at USD 51.23[18] per barrel as compared to USD 38.87 as in the month of October. On the other hand, core inflation has remained stable but has been steadily rising and is currently estimated 3 %. This steady rise is indicative of increased demand for money as the economy slowly opens up.

Figure 12: Inflation Rate, Headline vs. Core inflation, January 2017 to November 2020



Source: KNBS & Macroeconomic Diagnostics Model, 2020

[17] Gazette Notice No. 9323
18 CBK Weekly Bulletin, 31st December 2020

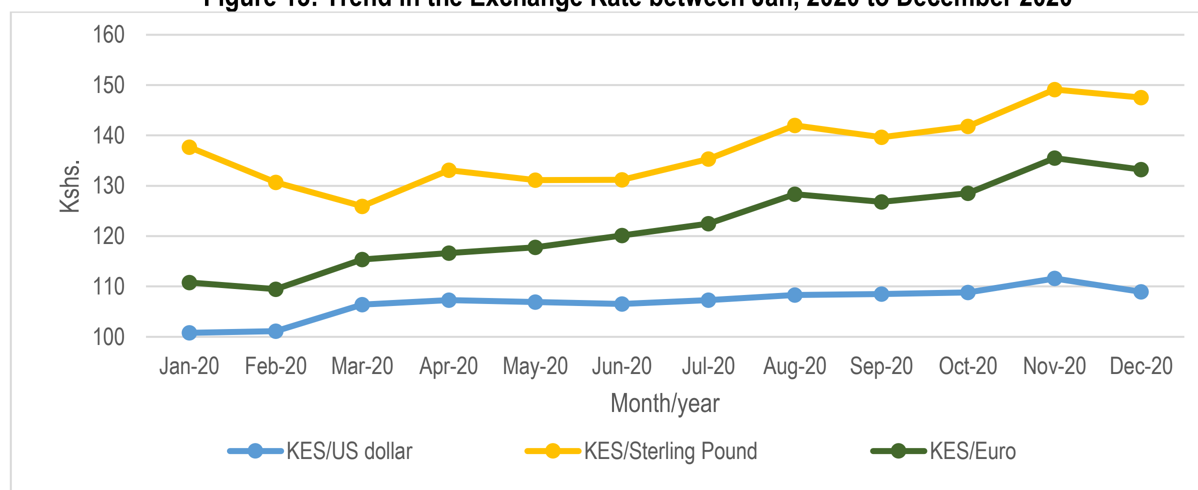
Table 4: Contribution to Inflation, January to November, 2020

Category	Jan-20	Feb-20	Mar-20	Apr-20	May-20	Jun-20	Jul-20	Aug-20	Sep-20	Oct-20	Nov-20
Food & Nonalcoholic Beverages	67.54	59.38	71.55	69.39	67.53	67.66	52.91	42.58	42.50	41.05	41.26
Alcoholic Beverages, Tobacco & Narcotics	5.75	5.86	4.66	4.29	5.16	5.70	4.77	3.99	3.59	3.02	2.47
Clothing & Footwear	1.14	1.36	1.15	1.04	1.48	1.98	1.51	1.45	1.33	1.61	2.01
Housing, Water, Electricity, Gas and other Fuels	8.31	11.32	11.98	5.99	7.25	5.20	3.76	7.35	7.94	8.92	7.97
Furnishings, Household Equipment and Routine Household Maintenance	0.87	0.89	1.31	1.31	1.23	1.25	1.02	1.07	1.31	1.77	1.92
Health	0.74	0.63	0.54	0.50	0.76	0.83	1.26	1.60	1.28	1.92	2.50
Transport	8.58	12.43	9.75	9.59	9.76	16.77	26.06	30.05	31.15	28.29	25.57
Information & Communication	0.32	0.24	-9.99	0.71	0.92	-7.85	0.17	1.48	0.62	0.71	1.63
Recreation, Sports & Culture	0.13	0.14	0.33	0.29	0.51	1.28	1.17	1.18	1.23	1.10	1.05
Education Services	1.96	2.57	1.65	1.44	1.10	1.58	2.62	2.16	2.16	2.24	2.54
Restaurants & Accommodation Services	4.02	4.43	4.99	4.06	2.95	3.90	2.99	5.50	5.61	7.26	8.72
Personal Care, Social Protection and Miscellaneous Goods & Services	0.64	0.76	1.29	0.97	0.81	1.03	1.15	1.15	1.12	1.03	1.07
Insurance and Financial Services			0.79	0.44	0.55	0.65	0.61	0.45	0.16	1.09	1.29
TOTAL	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Source: Macroeconomic Diagnostics Model, 2020

1.3.4 The Kenya Shilling has continued to sharply depreciate against major currencies. Since the beginning of the year, the Kenya Shilling has depreciated by 10 %, 12.7 % and 21.7 % against the US Dollar, Sterling Pound and Euro respectively. This is attributed to strengthening of the US dollar in the global markets, and decreased export earnings including tourism receipts. Furthermore, increased demand for foreign currencies by importers as well as external debt servicing, is exerting pressure on the Kenya Shilling. Going forward, given the economic underperformance, low credit to private sector, depreciation of Kenya Shilling, high debt service; the focus should be to maintain stable inflation, minimizing the depreciation of the Shilling and exploring measures to increase credit to the private sector.

Figure 13: Trend in the Exchange Rate between Jan, 2020 to December 2020

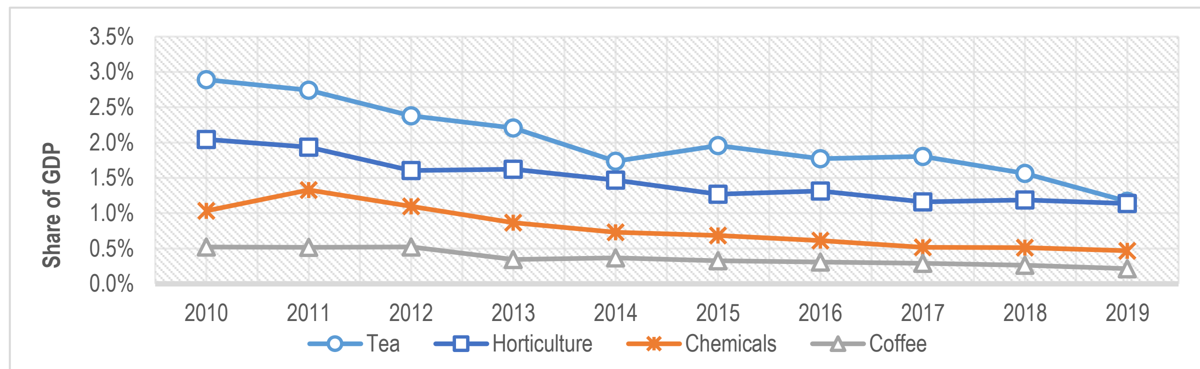


Source: CBK, 2020

1.4 The External Sector

1.4.1 **Kenya's exports have been on a steady decline over the past decade,** from 13 % (share of GDP) in 2010 to 6 % in 2019. This reduction is driven by the relatively slower growth in the value of all the principal domestic exports. Between 2010 and 2019, the GDP share of tea and horticulture exports, which accounted for about 36 % of Kenya's domestic exports decreased by 1.7 %age points and 1 %age point respectively. Exports of coffee and chemicals which accounted for 12 % of exports also had a similar downward trend over the same period (see Figure 14).

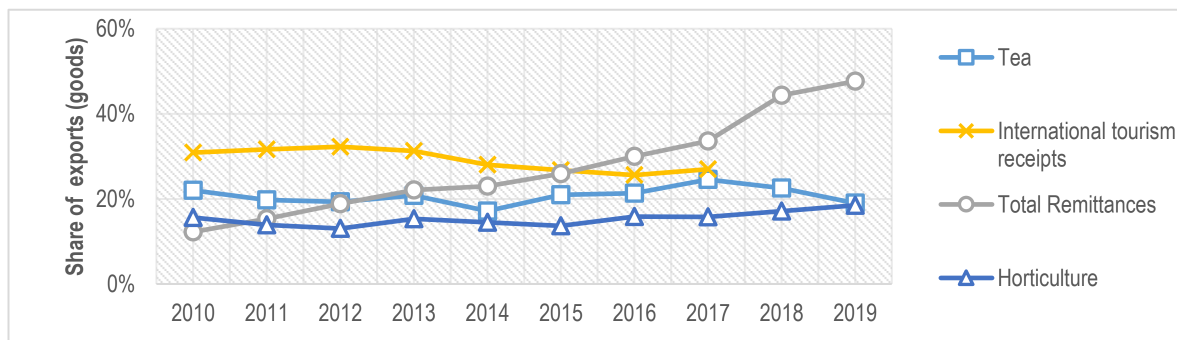
Figure 14: Value of Selected Domestic Exports as a Share of GDP



Source of Data: CBK and KNBS

1.4.2 **Remittances have replaced underperforming principal domestic exports such as tea and international tourism as Kenya's main source of foreign exchange.** In addition, they have had a significant impact on the expenditures of poor households by contributing to poverty alleviation and reduced inequality[19] as well as improved household savings[20] and human capital development in Kenya[21].

Figure 15: Major Foreign-Exchange Earners as a Share of Total Exports (Goods)



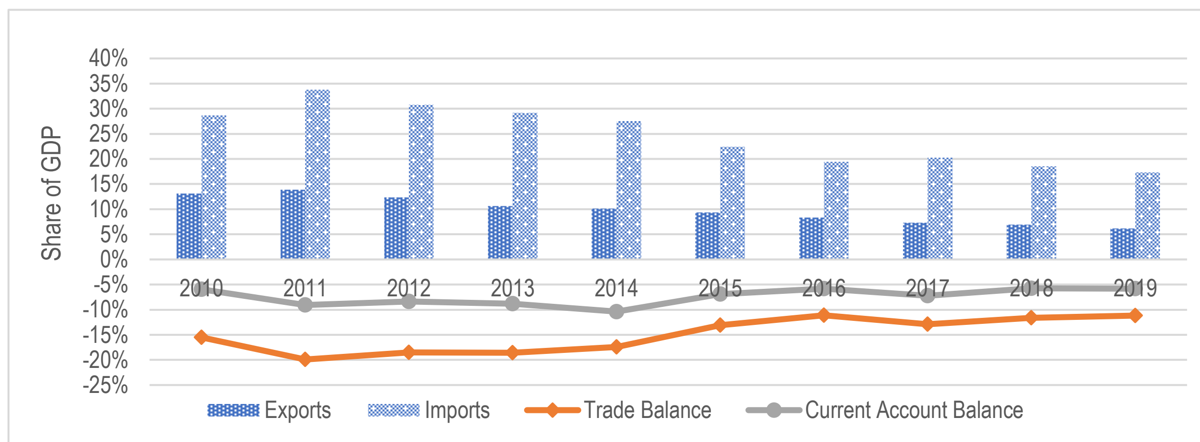
Source of Data: CBK, KNBS, World Bank

[19] Bang JT, Mitra A, Wunnava PV. Do remittances improve income inequality? An instrumental variable quantile analysis of the Kenyan case. Economic Modelling. 2016;58:394–402.
[20] Dendir S. Saving out of Remittances: Evidence from Ethiopia and Kenya. International Migration. 2017;55(4):118–140.
[21] Hines AL, Simpson NB. Migration, remittances and human capital investment in Kenya. Economic Notes: Review of Banking, Finance and Monetary Economics. 2019;48(3):e12142.

1.4.3 **An increase in remittance and declining imports have contributed to the narrowing of both the trade and current account deficits over the past five years.** Decreasing imports have been driven by the falling import value of Machinery, transport equipment, fuels and lubricants as major infrastructure projects were finalized. Local manufacturing may have been hampered by declining imports of intermediate inputs which are critical for export production and creating linkages to international value chains.

1.4.4 **The narrowing of the current account deficit may not be sustainable due to reliance on remittances as a major source of foreign exchange.** The volatility of foreign exchange earned through remittances is tied to the economic conditions and policies of the source countries. In the two years after the 2007-2008 financial crisis that affected countries in North America and Europe - the source of about 80 % of Kenya's remittances - the share of remittances to GDP fell from 2.2 % to 1.6 %. Going forward, uncertainty relating to the impact of Covid-19 pandemic on economic activity in developed countries, coupled with tougher anti-immigration policies in the United States of America and many European Union countries may dampen remittances to Kenya.

Figure 16: Current Account Balance a share of GDP



Source of Data: KNBS

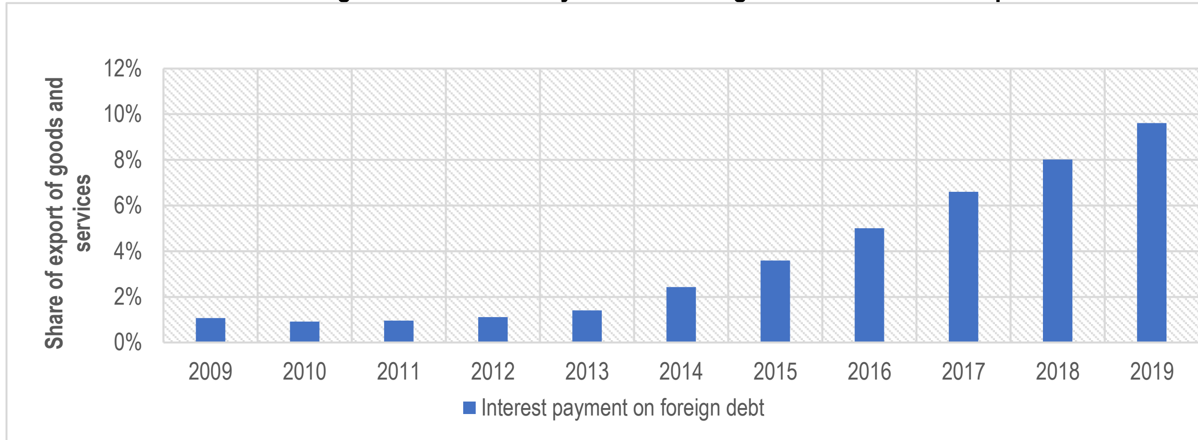
1.4.5 **Reviving exports will positively contribute to growth, and enhance foreign exchange receipts.** Exporting also contributes to the increased productivity of exporting firms and domestic suppliers in the value chain[22]. Policies such as Kenya's duty relief and exemptions scheme on imported intermediate inputs for exporting firms have been found to boost the value of exports of firms that had access to the scheme[23]. Consequently, expanding access to such programmes may contribute to an increase in the value of aggregate exports.

[22] Buturac G, Mikulić D, Palić P. Sources of export growth and development of manufacturing industry: empirical evidence from Croatia. Economic Research-Ekonomska Istraživanja. 2019;32(1):101–127.

[23] Chacha P, Edwards L. Imported inputs, Government Support and Performance of manufacturing exporters. 2018.

1.4.6 **Enhanced foreign reserves are needed to cover the increasing foreign debt repayments.** Over the past decade, growth in interest payments on foreign debt has outpaced growth in exports of goods and services. Interest payment on foreign debt has increased from about 1 % of exports of goods and services to close to 10 %. The increase in the share of revenue used to pay both external and domestic debt may also hamper efforts to reduce the expanding fiscal deficit.

Figure 17: Interest Payment on Foreign Debt as Share of Exports



Source of Data: KNBS and QEBR

1.4.7 **The expansion of the fiscal deficit may be linked to future deterioration of the current account balance.** The twin deficit hypothesis posits that budget deficits lead to an increase in domestic interest rates, which may encourage capital inflow leading to an appreciation of the real exchange rate and a worsening current account balance[24]. The causality may also flow from reduced revenue from exports contributing to a budget deficit. In some instances, there may be a bidirectional relationship between the two deficits i.e. fiscal deficits contribute to worsening current account deficits and vice versa[25]. There is evidence that in the Kenyan context, the two deficits are linked. That is, current account deficits cause worsening fiscal deficits[26] as well as the possibility of bidirectional causality between the two deficits[27]. Consequently, during policy formulation, both deficits should be considered concurrently.

1.4.8 **Fiscal consolidation has been proposed as a policy measure aimed at curbing Kenya's fiscal deficit.** However, the short-run benefits of reducing the budget deficit through fiscal consolidation may be offset by slower economic growth in the long run[28]. Therefore, the targeted expenditures in the fiscal consolidation effort must be carefully considered in light of their possible long-term effects on growth and poverty alleviation.

[24] Banday UJ, Aneja R. Twin deficit hypothesis and reverse causality: a case study of China. Palgrave Communications. 2019;5(1):1–10.
[25] Senadza B, Aloryito G. The twin deficits hypothesis: Evidence from Ghana, 2016.
[26] Egwaikhide FO, Oyeranti OA, Ayodele OA, Tchokote J. Causality between budget deficit and the current account balance in African countries. West African journal of monetary and economic integration. 2002;2(2):1–28.
[27] Ahmad AH, Aworinde OB. Revisiting the twin deficits hypothesis: new evidence from nonlinear tests. Applied Economics Letters. 2019;1–5.
[28] Ng'ang'a W, Chevallier J, Ndiritu S. Primary balance dynamics and public debt sustainability in Kenya. HAL; 2019

Policy Options

i) **The Government should invest in the promotion and marketing of exports of agricultural products such as fruits, which have performed well during the pandemic.** Access to new export markets and value addition by small and medium-sized fruit farmers will promote diversification of agricultural exports and improve living standards in rural areas.

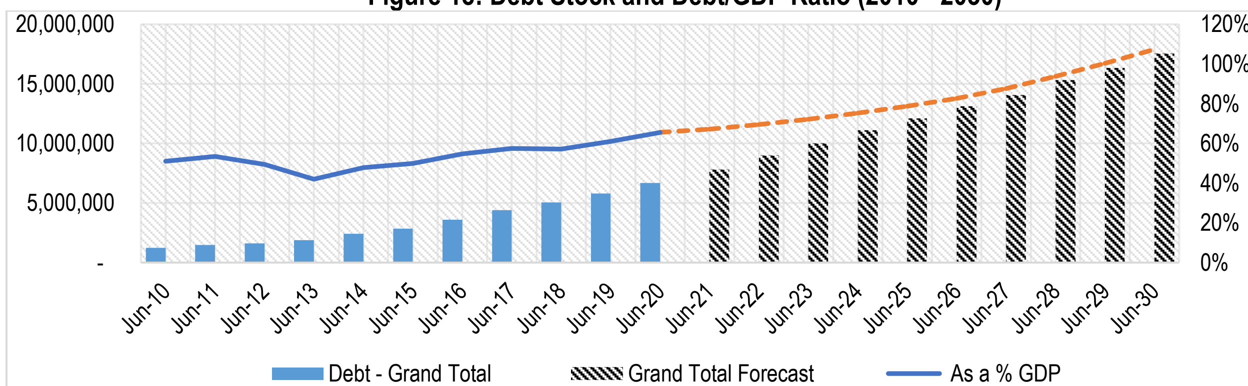
ii) **Continued Implementation of the duty remission scheme under Tax Remission for Export Office (TREO) will enhance the value of exports for Kenyan manufacturers.** However, the government should also invest in a comprehensive review of the impact of the policy to enhance its effectiveness in export promotion.

iii) In the medium-term, public investments in key enablers such as access to cheaper uninterrupted electricity supply, efficient and cheap transport system and creation of a favourable business environment will enhance the competitiveness of Kenya's exporter.

1.5 Debt Stock Analysis & Forecast

1.5.1 Public debt stock amounted to Kshs. 7.12 trillion as at the end of September 2020[29], accounting for 65.6% of GDP and 79% of the PFM debt ceiling. This is on account of expenditure pressures related to infrastructure and debt servicing, coupled with decline in revenue generation. This trend is projected to continue over the medium term as the expansionary economic blueprint, the need for fiscal stimulus and debt servicing obligations continue to drive expenditures even as revenue generation remains low and the economy continues to underperform. In the current financial year, debt is forecasted to reach Kshs. 7.8 trillion and will account for approximately 69% of GDP and 87% of the total debt ceiling. Indeed, the debt stock is projected to double by June 2030 and could account for over 100% of GDP.

Figure 18: Debt Stock and Debt/GDP Ratio (2010 - 2030)

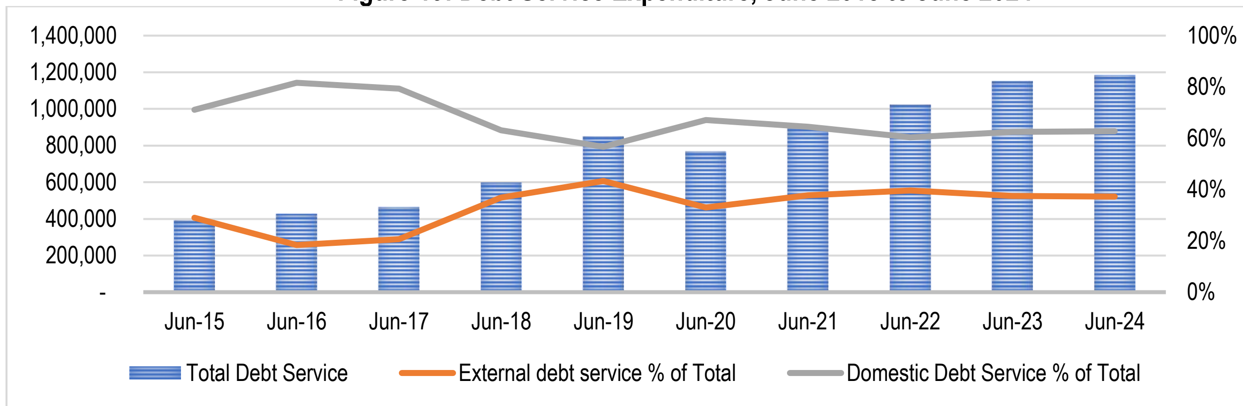


Source: PBO Forecast

[29] Central Bank of Kenya, Weekly Bulletin (December 31 2020)

1.5.2 Debt service (Debt principal and interest payments) will cross the Kshs. 1 trillion mark in FY 2021/22 and will be domestically driven. Debt repayment expenditure, estimated at Kshs. 925 billion in FY 2020/21, will reach 1.023 trillion by the end of FY 2021/22. To manage this situation, lengthening the maturity of existing securities may be necessary even though this will transfer debt to future generations.

Figure 19: Debt Service Expenditure, June 2015 to June 2024



Source: National Treasury

1.5.3 Refinancing risk and interest risk positions have improved but the exchange rate risk remains. The debt stock reflects an improved risk position from the previous financial year i.e.

a) Refinancing risk position has improved with the broadening of the maturity period from 7.4 years to 8.9 years, which is greatly supported by the concessional component of external debt;

b) Interest risk has also improved, with the reduction of the Weighted interest rate from 7.7% to 7.2% and the increase of the Average time to Re-fixing from 7.3 to 8.2, indicating a low interest rate volatility environment; and

c) Exchange rate risk will have a marginal increase given the increase in external debt. Risks will remain on the downside and - given the high level of debt and debt service - any movement of the risk indicators could have a large impact.

Table 5: Cost and Risk Indicators of Existing Debt

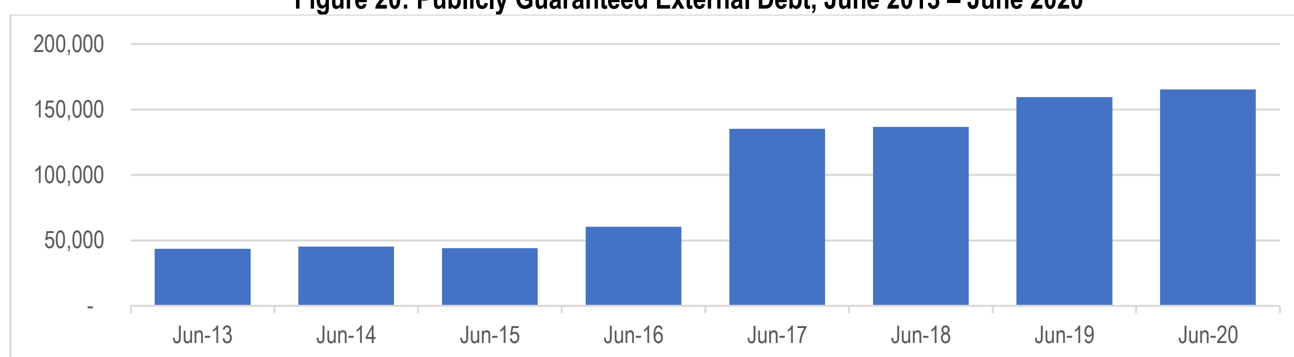
Indicator		19-Jun	20-Jun
Cost of debt	Weighted interest rate (%)	7.7	7.2
	Interest Payment (% of GDP)	3.9	4.3
Refinancing risk	Debt Maturing in 1yr (% of total)	27.4	11.6
	Debt Maturing in 1yr (% of GDP)	13.8	8.6
	ATM External Debt (Years)	10.1	11
	ATM Domestic Debt (Years)	4.7	5.5
	ATM Total Debt (Years)	7.4	8.9
Interest rate risk	Average Time to Re-fixing (Years)	7.3	8.2
	Debt re-fixing in 1 year (% of Total)	32.4	29.2
	Fixed re-fixing in 1 year (% of Total)	91.9	85.8

Exchange rate risk	FX debt as % of Total	52	53

Source: National Treasury

1.5.4 **Guaranteed debt is a significant risk to the country's debt position.** As of June 2020, guaranteed debt amounted to Kshs. 165.2 billion, reflecting a 276% increase since June 2015. This increase is as a result of increase in commercial debt – Kshs. 79.9 billion (guarantee provided to Kenya Airways) and bilateral credit Kshs. 80.6 billion (guarantees to capital projects undertaken by Ken-Gen and the Kenya Ports Authority). Debt Guarantees are given subject to Article 213 of the Constitution and Section 58 of the PFM Act. Given its stock level, strict adherence to legal provisions will be key in minimising this contingent liability risk and maximising the economic impact of debt guarantees. This will be of importance given the broadening loan guarantee spectrum with the introduction of the Credit Guarantee Scheme.

Figure 20: Publicly Guaranteed External Debt, June 2013 – June 2020



Source: National Treasury

1.5.5 **Even though Kenya's overall stock of debt stock is considered sustainable, other debt sustainability indicators indicate otherwise**. At 63.4% Kenya's PV of debt to GDP ratio remains within it threshold, and indicates that the debt stocks solvency conditions are thinly met. Other sustainability indicators on the other hand, have breached their thresholds and appear to be deteriorating over the medium term. These include the *i)* PV of public debt to revenue and grants ratio, *ii)* debt service to revenue and grants ratio, *iii)* PV of debt to exports ratio and *iv)* PPG debt service to exports ratio. These are mainly driven by lower exports and revenues. Following the impact of the COVID-19, the outlook forecast is expected to worsen with a possibility of breaching all the thresholds in the medium term.

Table 6: Debt Sustainability Indicators (2020 - 2024), June 2020

Indicator	***Threshold***	***2020***	***2021***	***2022***	***2023***	***2024***
PV of debt to GDP ratio	70	61.3	63.4	63.9	63.6	62.2
PV of Public debt to revenue & grants ratio	300	338.1	356.6	357.4	351.3	341.2
Debt service to revenue & grants ratio	50	53.8	68	74.5	71.5	78.6
External Debt Sustainability	***Threshold***	***2020***	***2021***	***2022***	***2023***	***2024***
PV of Debt to exports ratio	240	288	260.6	258.5	255.2	249.2
PPG Debt service - to - exports ratio	21	27.5	25.9	25.5	24.4	36.1
PPG Debt Service - to - Revenue ratio	23	14.5	15.9	15.9	14.8	22.0

Source: IMF & National Treasury

1.5.6 The role of the debt ceiling in debt management is weak. This is because the Kshs. 9 trillion debt ceiling is not considered a sustainability indicator but a legal limit. It is a numerical limit, arbitrarily set, and delinked from macroeconomic factors that determine the debt carrying capacity of a country, alongside other factors. Furthermore, it limits the regulatory role of the public debt management office given that there is a single regulatory parameter, which is already fixed. Choice of ceiling will promote transparency and use of better sustainability measures.

Policy Options

i) **Reduce the net domestic borrowing to zero coupled with increase in concessional financing** – this will reduce the incremental effect of domestic borrowing on debt and concessional external debt be used to replace/buyout expensive domestic/external debt.

ii) **Medium term debt service expenditures must be reduced to no more than 3.4% of GDP as per the BPS 2018**–Debt servicing expenditures are set to cross the Kshs. 1 trillion mark in FY 2020/21. Targeted reduction of debt servicing expenditure alongside reduction of non-core recurrent expenditures, will have a higher effect of easing fiscal space. This should however be guided by a clearly laid out policy.

iii) **Revision of an arbitrarily set ceiling:** the debt ceiling as designed creates a regulatory flaw as it is delinked to the rest of the economy. Choice of a ratio would provide a debt limit that is more responsive to both liquidity and solvency concerns and lead to prudent debt management practice.

1.6 Medium Term Economic Outlook and Prospects

Under the prevailing circumstances and assuming no significant change in policy, the economy is estimated to grow by 0.5% in 2020, increasing to 1.3% in 2021 and 4.3% in 2022.

Risks to the macroeconomic outlook

i. **The depth and duration of the COVID-19 pandemic:** Even though successful vaccine trials have been reported by several pharmaceutical companies, how effective they are in bringing the pandemic to an end will depend on a number of factors. Firstly, acceptability is a concern in some regions due to fearmongering and misinformation. Secondly, there may be challenges in terms of scaling up production and distribution of the vaccine on a global scale. Already, equity concerns are emerging in terms of who gets the vaccine first and at what cost, with concern that these vaccines may not be available to developing economies at least until end of 2021.

ii. **Political uncertainty:** History has shown that economic growth tends to be muted during electioneering periods. This is attributed to a rather challenging business environment and a wait and see approach by investors pending the outcome of the elections. In this particular instance, the election fever has hit rather early on account of the Building Bridges Initiative (BBI) referendum drive as well as various by-elections. Thus the political environment will continue to be a key driver affecting growth until end of 2022.

iii. **Erratic weather patterns:** According to the Famine Early Warning Systems Network, the general performance of the October to December short rains is expected to be below average and this will have an adverse impact on crop production. Though, Western, Central and Eastern Kenya have

received normal rainfall but the northwest, northeast, southeast and coastal parts have received only 55-70% of normal rainfall. Thus on average, rainfall performance is expected to be below average. Indeed, some regions such as Meru North are reported to have experienced a late rainfall start causing them to replant. This combined with limited access to seeds could adversely affect harvests. The March to May 2021 long rains outlook is expected to be average with tendency to below average. Thus crop production is expected to be moderate.

iv. **Fiduciary risk:** Poor planning, misapplication and misappropriation of funds continue to be a risk to budget implementation and achievement of policy objectives both at the national and county level. Fiduciary risk can be attributed to corruption, inefficient procedures and weaknesses in monitoring of the budget. The budget ends up not achieving the intended results.

Chapter Two

Economic Recovery: Leveraging Tax Policy Innovation and Expenditure Prioritization

2.1 Taxation and Sectoral Policy in a Changing Economy

Overview

2.1.1 Apart from general weak growth of revenue since about 2014/15, the buoyancy parameters for income tax and VAT appear to be of great concern. Notably, the tax-to-base ratios (tax to GDP ratios) have fallen from 8.2% in 2016/17 to 6.9% in 2019/20 for the income tax. VAT relative buoyancy fell from 4.5% in 2016/17 to 3.8% in 2019/20, while that of import duty declined from 1.2% to 1% over similar period. Excise duty similarly declined from 2h.2% to 1.9% over the same period. Legislative repeals appear to have had only temporary, one year, benefit in terms of revenue growth. The Excise duty law was repealed in 2015, while the VAT Act was repealed in 2013 with the hope of strengthening revenue yield, but the effects have since dissipated. The Tax Procedures Act was also enacted to streamline administration and enforcement of tax laws. In the case of VAT, the benefits of removing extensive tax exemptions and zero-rating during the review of the Act in 2013 would later be diminished by subsequent Finance Acts that helped return a large number of tax exemptions following persistent stakeholder lobbying.

2.1.2 This situation was getting dire particularly on the face of COVID-19 pandemic, which precipitated the removal of some of the VAT tax waivers through the Tax Laws (Amendment) Act of 2020. For example, following the changes in the Tax Laws Act, zero-rated products have greatly been limited official and diplomatic supplies. Given the tax rate reduction on both VAT tax rate (16% to 14%), personal income tax and corporate income tax (top rate reduced to 25%), the general decline in revenue worsened further. The first quarter QBER strongly supports this fact. While the excise duty and import duty collections are below first quarter 2019/20 by about Kshs. 2.5 billion each, the PAYE alone fell by Kshs. 26.64 billion by the first quarter 2020/21 (three months) relative to the first quarter of 2019/20. VAT collected from local sources was similarly negatively affected by the health pandemic and tax rate reduction with the collections falling by Kshs. 18.311 billion in the first three months of 2020/21 financial year.

2.1.3 Notwithstanding the extreme COVID-19 shock, the five-year revenue trends indicate unusual loss of potential revenue likely attributable to administrative weaknesses and changes in the economic structure. Given income tax and VAT tax heads are the largest, this decline is quite notable. Income tax and VAT alone contribute 78% of total tax revenues collected annually in Kenya. Therefore, these two are the mainstay of tax collection and therefore an indicator of our revenue sufficiency. Continued underperformance as indicated above can be attributed to several factors among them: administrative weaknesses, tax evasion, corporate losses, and job losses. Some of these factors are briefly discussed below.

Emerging Economic Shifts

2.1.4 An underlying factor in the corporate job losses' impact on income tax and VAT is the fast paced change in the economic structure. Some of these changes include weak physical capital accumulation; increase in labor-saving technologies such as automation which directly affect PAYE; the rapid growth of digital and e-commerce trade and payment systems; the rise in digital capital and intangible capital assets; and, job shift towards digital jobs, among other technology mediated economic changes.

2.1.5 Responding to the rise in digital commerce, the Government enacted provisions to facilitate taxation of digital trades and transactions. The tax, known as Digital Services Tax is levied at 1.5% of gross transaction value of any payment made electronically or via digital platforms. Together with taxation of gambling activities in Kenya, the digital tax proposals represent a real response to changes in the economy which are being facilitated by the deep penetration of internet and mobile telephony. This shift will get more drastic with rising application of artificial intelligence, automation, and machine learning, further squeezing physical labour and distorting the return to traditional factors of production labour and capital. The rising labour squeeze in production is largely due to technology, and new forms of capital physical such as intangible capital or assets (computer and mobile applications). Intermediate labour squeeze in the production systems, and overall economic shifts will see job losses at least in the medium term, but could spawn other effects especially possible worsening of income distribution.

2.1.6 While technological changes are not new, the current digital and technological changes hold mixed promises in terms of benefits and losses and the national and individual level. Briefly some of the notable transitions in the economic and business organization sphere include the following: migration of payments to digital platforms such as mobile money and digital, application and internet based payments; emergence of firms with large network monopolies due to miniscule marginal costs associated with replication of a service to the masses; large scale cross-border digital trades with limited reporting and accountability. The issue of network monopolies or near-monopolies is becoming evident with rising number of firms enjoying super-normal profits owing to access to limitless number of consumers via mobile or computer applications, without proportionate rise in overall expenses. This distortion may appear inconsequential without addressing the impact of such economies of scale on job losses and competition.

2.1.7 Research perspectives are mixed on whether digital disruptions will hurt labour (Pathways for Prosperity Commission, 2018[30]). It is generally agreed that technological innovations, though disruptive, eventually bring broader and improved economic outcomes over time. Given the benefits of digital innovations in Kenya's economy, the question should be how to promote innovative progress while also ensuring that such progress does not generate irreversible income inequalities and unemployment. Unemployment problem, particularly among the youth, is already dire. The unemployment among the youth exceeded 35% prior to the COVID-19 shock, but recent anecdotal information indicates that work layoffs may have worsened the situation.

2.1.8 Paradoxically, the changes in the digital and technology sector have accelerated during the health-related adverse economic shock and some of these changes may persist for the foreseeable future. Thus, the combined effect of digital technology transformation and prevailing economic shocks could help shape income distribution, influence relative factor returns in the economy, affect access to waged labour,

[30] "Charting Pathways for Inclusive Growth: From Paralysis to Preparation", Pathways for Properity Commission, 2018

change profit profiles of various companies, and affect government ability to collect planned domestic taxes to pay for planned expenditure including meeting public debt obligations.

Sectoral and Tax Policies

2.1.9 Digital technological changes are not limited to ICT sector but span nearly all fields including manufacturing (automation, robotics) and agriculture (digital agricultural information, digital enabled market access). The ICT sector whose GDP share is only 1.3% therefore does not fully capture the full impact of the interconnected impact of these technologies on the overall GDP. The tax and public policy system is lagging these changes, affording various entities loopholes to evade tax or reap supernormal profits with limited contribution to government revenue. The broad nature of technology driven changes therefore requires guided, supportive and at times counteractive policy interventions to ensure the benefits of technological transformation are shared well. The role of public policy intervention can span taxation and sectoral level measures.

2.1.10 Ideal policy interventions should seek to address any negative externalities through targeted interventions at say providing unemployment benefits, but also to help restore or preserve revenue losses caused by structural shifts in the economy. Briefly the tax and non-tax sectoral policies could comprise the following:

- Checking monopoly power and abuse of network economies of scale: This problem has been cited with the rapid growth of digital economies – e-commerce, mobile aided digital transactions, and trade. Competition and tax policies need to be realigned to respond to fast-paced changes with the goal of promoting fair competition and progressive taxation of super normal profits.
- Broad based social safety nets: undesirable changes in income distribution can be countered through broad and targeted social welfare programs. These programs should include introduction of unemployment benefits for displaced workers and vulnerable youth.
- Public supported work programmes: non-discriminative work programmes providing work opportunities in the lines of incipient *Kazi mtaani* for low income earners and unemployed persons aged 18 to 64 years.
- Focus on manufacturing and agriculture: agriculture good at job retention. Not about the money but government services -- interventions, markets. Increase the funding from -- for extension, research, innovation fund, quality control.
- Consider designing a differentiated mass market digital services tax rates based on the variations between marginal cost and marginal revenue. Companies that have very low marginal costs (and low employment) and unlimited revenue from the general public need should proportionately contribute more to government revenue. The design of such a tax should ensure that it does not blunt innovation and fair return to innovation and investment. The revenues so collected under such a program should be channeled to offering essential public services, social protection, unemployment benefits, and supporting innovation.
- Address digital enabled base erosion and transfer pricing with focus on intangible assets.
- Design tax and fees to help monetize the large-scale use of personal data by corporates for business and advertisement. This can serve to correct emerging externalities evident in the uncontrolled use of private data by companies in the digital for profit.

2.2 Expenditure Prioritization and Policy Options

Overview

2.2.1 There has been significant progress in the program based approach to budgeting. However incremental budgeting especially in year changes often reverse the initial focus. Thus expenditure orientation of the government has remained largely incremental. The program-based budget approach demands that Results and outputs be the focus when making decisions on priorities and in particular in year adjustments.

2.2.2 However, the success of current program budget system is constrained by poor design of monitorable targets, weak linkage between the set output targets and the underlying expenditure allocation, lack of verifiable unit costs per individual targets, and lack of a strong monitoring and evaluation system for the set targets. As a result, many agencies miss targets, underestimate targets, and over budget with limited action in terms of budget withdrawal or other measures. The implication of these weaknesses is that Ministries and agencies can continue to receive resources to achieve similar targets as in the previous year. Similarly, the absence of proper costing of planned targets implies lack of progress towards prudency and cost efficiency.

2.2.3 As Kenya's fiscal story shows, previous spending reforms have failed to permanently stop the proclivity for expenditure incrementalism and wastage. Budget negotiations through the Sector Working Group planning approach often do not help contain inexplicable expenditure demands nor has it engendered the needed unit cost reduction approach to budgeting. Once an expenditure baseline is set, the current planning and expenditure approval system is biased towards incrementing the base in subsequent spending years. Urgent expenditure reforms are therefore required to make Kenya's fiscal program sustainable and flexible to negative shocks over the long term.

Broad Proposals for Expenditure Reform

2.2.4 Designing an expenditure reform package during a serious economic downturn like we have today runs the risk of worsening the crises. But, carrying on without expenditure reforms could deepen the fiscal side driven crisis, resulting in a prolonged economic recession. It is clear that debt repayment obligations are taking a large share of tax and borrowed resources from the total resource basket, which would otherwise be used for economic recovery. Paradoxically, the government needs a great deal more resources to cope with the current downturn and lay a foundation for stable medium term economic recovery.

2.2.5 With the low growth, low revenues, high expenditure, and high debt service pressure the design of expenditure policy should shift towards extracting maximum value from each tax shilling collected or debt shilling incurred. Over the years, the growth in expenditures has been tilted towards the growth supportive infrastructure sectors majorly on roads, energy, and ICT. These are growth supportive sectors whose public spending should be protected or preserved at prevailing levels to support any incipient economic recovery. However, these are equally the areas where there is the highest leakage of resources.

2.2.6 The large project portfolio in the infrastructure is also an indication that prioritization is also an issue. Many small projects are added without a proper appraisal and costing is done and essentially the final outcome is major delays in completion of projects and substantial resources. There are over one thousand projects of which over seventy % are in infrastructure. There is need to re-appraise these projects with an aim of rationalizing them so as to free sources for major projects to be completed within the shortest period.

2.2.7 Debt driven fiscal risks also pose significant danger to the expansion of public social welfare programs which broadly should include subsidized health spending, education subsidy systems, and social safety net programs for the elderly, orphaned, and disabled persons. Due to ongoing economic disruptions, there is strong anecdotal information of rising unemployment household level poverty. Lack of new resources means that the government should at least preserve the current social subsidy program as it is but improving its design and reducing wastage.

2.2.8 Given the unprecedented macroeconomic and fiscal constraints, the logical solution is to undertake a combination of fiscal restructuring measures including and not limited to the following options: (i) implement substantial cost saving expenditure cuts under recurrent and dropping superfluous development spending; (ii) for the coming financial year, keep spending at the same level or lower as the previous year; (iii) freeze nominal expenditure growth for all spending categories; (iv) reprioritize the limited public spending to the most productive areas by halting certain spending categories such as foreign travel and less critical training spending.

2.2.9 The range of fiscal stabilization tools under the prevailing economic constraints are limited, but long-term rules and regulations can be put in place to protect future growth. Desired fiscal reforms should therefore include a fiscal tool set to deal with future negative economic shocks. This tool set should include regulations to allow automatic stabilizers such as a freeze on expenditure and wage growth when certain fiscal and debt thresholds are breached.

2.3 Push Towards Attainment of Universal Health Coverage in the Country

2.3.1 At the beginning of 2018, the national government identified Universal Health Coverage (UHC) as part of the big four agenda. The goal of the programme is to ensure access to affordable healthcare by all by 2022. The outbreak of the COVID 19 pandemic has further hastened the need to deliver affordable healthcare through the UHC. The journey towards having affordable health cover began with the rollout of a one-year pilot programme in four counties. According to the Ministry of Health, one million Kenyans received health care services in the four pilot counties. This represented a 44% increase in access to healthcare services in the four pilot counties. This increase is an indication that one factor that hinders access to healthcare is the cost associated with seeking healthcare services. This increase amplified the need to put in place a robust healthcare system in the country.

2.3.2 Though UHC is a key government agenda to be achieved by 2022 and the pilot phase having been implemented successfully, there are still certain challenges to be overcome to ensure the expansion of the affordable health programme to all counties. Notably, the current approach lacks a guiding policy for coordination of UHC and to enable its monitoring and evaluation. Further, inefficiencies in designing a complete rollout and proper costing of the programme appear to slow down implementation of the programme.

Policy options

i) Development of a comprehensive UHC policy. It is critical that the government finalizes putting in place a UHC policy to guide the implementation of this programme. Options under this policy for a successful UHC rollout are:

- Making it mandatory that all Kenyans aged between 18-65 years are enrolled under the National Hospital Insurance Fund (NHIF) social insurance scheme. The elderly (over 65 years) and the vulnerable persons be supported by the government to enrol under the NHIF cover through a yearly government supported capitation.
- The contributory pension schemes be brought on board in terms of providing medical scheme through the NHIF platform to cover the post retirement period for their members. This will expand the pool of resources available for UHC;
- Fast tracking reforms to enhance efficiency at NHIF and Kenya Medical Supplies Authority (KEMSA) which are two critical institutions at the centre of a successful UHC programme.

ii) Invest in research and policy formulation on use of alternative (herbal) medicine as a complement to conventional drugs. This is a key component of the **natural products initiative** which is part of vision 2030. The initiative advocates for investment in building capacity for value addition to the enormous bio-diversity in the country, estimated to have high medicinal, cosmetic and nutritional value.

2.4 Jumpstarting the Manufacturing Sector for Economic Recovery

2.4.1 Manufacturing is critical for the growth and development of Kenya's economy. The sector by creating activities further along the value chain, from raw materials to finished products creates employment opportunities. The sector holds key to Kenya's export expansion mainly by supporting value addition in agriculture. Kenya aims to have a robust, diversified and competitive Manufacturing Sector to transform the country into a middle-income economy by 2030. But, historically the goal of achieving industrialization is still elusive. The import substitution policies of 1960s-80s, The Economic Recovery Strategy (ERS) of 2003 - 2007 and its successor Vision 2030 put emphasis on improving the performance of the manufacturing sector.

2.4.2 The influx of imported goods in the country presents cheap alternatives to consumers and this has inhibited the manufacturing sector from thriving. The country therefore requires a manufacturing transformation programme that will improve the quality of locally produced goods in order for these to compete effectively with imports. Unfortunately, the country is yet to properly invest in niche products nor identify the key frontier institutions that can be supported through development and finance. Indeed, key institutions such as the Kenya Industrial Estates have not been allocated adequate resources over the years yet this is an institution that is critical to the advancement of MSMEs.

2.4.3 The MSMEs sector is the bedrock of Kenya's industrialization presenting large opportunities for employment creation. It is estimated that the sector employs 14.9 million with most of the firms mainly

domiciled within the wholesale and retail trade, and repair of motor vehicles and motor cycles. These three sectors account for about 50% of the jobs created. Manufacturing, accommodation and food service activities also account for 11.8 % and 11.1 % of all persons employed in MSMEs respectively. [31]

2.4.4 The sector however faces challenges to its growth. Many studies have shown that enterprises in this category face similar problems. As explained above, they are under-capitalized and face very poor transformation prospects (Kimuyu, 2010). In addition, they have limited access to financial services exacerbated by lack of collateral for credit (KNBS, 2017) and inadequate capacity to meet quality and standards requirement. 80% of the MSME sector in Kenya comprises unlicensed enterprises collectively known as the Jua Kali sector who get minimal support from the stimulus packages offered by the government. Such packages mostly benefit the MSMEs in the formal sector.

2.4.5 Support to the Kenya Industrial Estates will ensure that MSMEs are supported through business incubation programmes to enable them develop the necessary capacity to produce quality products through skills development as well as training programmes to strengthen their capacity for financial planning and risk management.

Policy Options

i) Allocate additional resources to institutions such as the Kenya Industrial Estates that enhance innovation and development of small scale industries.

ii) Provide funding to Institutions such as brand Kenya that can increase export of goods from Kenya through identification of foreign markets.

2.5 Improving delivery of Road and Rail Network

Road Network

2.5.1 During the period 2013/14 – 2019/20, the government constructed 6,622 kilometres s of new roads, exceeding the target of 5,790 KMs. The government spent Kshs. 367,629 million to deliver this level of infrastructure, building 946 KMs of new roads annually at an average cost of Kshs. 56 million per kilometre. Total spending on rehabilitation and maintenance of roads and bridges amounted to Kshs. 305,081 million and Kshs. 294,987 million during the period 2013/14 – 2019/20, respectively. This clearly indicates the relative cost of maintaining and rehabilitating roads relative to building new ones. The table below shows spending on road construction rose rapidly by 70% between 2018/19 and 2019/20. Road maintenance spending rose by an impressive 50% in the same period, but rehabilitation budget rose by 16%. Overall, the trends in spending on road construction and maintenance reflects significant shift compared to spending on rehabilitation.

Table 7: Actual Expenditure, Target vs Achieved KMs accomplished for FY 2013/14- 2019/20

Sub-Programme		2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	Totals for the Period

[31] KNBS 2018

Construction of roads and bridges	Target	283	200	374	534	1,062	1,645	1,692	5,790
	Achieved	260	471	463	725	1,200	2,014	1,489	6,622
	Actual Expenditure - Millions	**31,568**	**48,022**	**33,218**	**58,224**	**52,029**	**54,219**	**90,349**	**367,629**
Rehabilitation of roads and bridges	Target	379	200	152	44	140	143	230	1,288
	Achieved	227	174	122	138	99	208	35	1,003
	Actual Expenditure - Millions	**30,867**	**33,873**	**41,570**	**47,866**	**40,869**	**50,880**	**59,156**	**305,081**
Maintenance of roads and bridges	Target	67,897	41,671	51,338	35,074	32,505	41,204	32,222	301,911
	Achieved	60,363	58,737	30,505	51,103	32,161	41,212	28,812	302,893
	Actual Expenditure - Millions	**27,215**	**22,448**	**31,915**	**40,554**	**43,632**	**51,708**	**77,515**	**294,987**
Design of roads and bridges	Target	234	243	173	265	2,628	1,484	1,644	6,671
	Achieved	240	301	184	1,780	1,653	1,786	1,216	7,160
	Actual Expenditure - Millions	**698**	**770**	**932**	**1,000**	**750**	**921**	**635**	**5,706**

Source: National Treasury (Sector reports, various Issues)

2.5.2 The lack of proper screening of projects through project appraisals before committing resources in the budget creates an opportunity for parachuting small roads related projects hence leading to spreading resources among small projects which may not have an immediate impact on the economy. The problem is not entirely how the projects are identified but how the projects enter the project pipeline, essentially displacing incomplete and probably more viable ongoing projects and creating financing challenges. It is notable that the proliferation of small road projects across the country with allocations ranging from Kshs. 5 million to Kshs.15 million is partly attributable to the informal way the projects enter the public projects pipeline. The major demerit of these "equity" projects is the loss of economies of scale and efficiency. The technical and administrative cost of building tiny road projects around the country for agencies like KeRRA can be significant.

2.5.3 While geographical distribution of road projects is quite reasonable given varied developmental factors in the country, the process of identification of these road projects should be enhanced, including requiring some feasibility assessments before the projects are designed and funded. Critically, the problem of pending bills is more serious in roads subsector. The amount payable to road contractors is currently estimated at Kshs. 50 billion. Together with improved project identification, it is critical to determine optimal

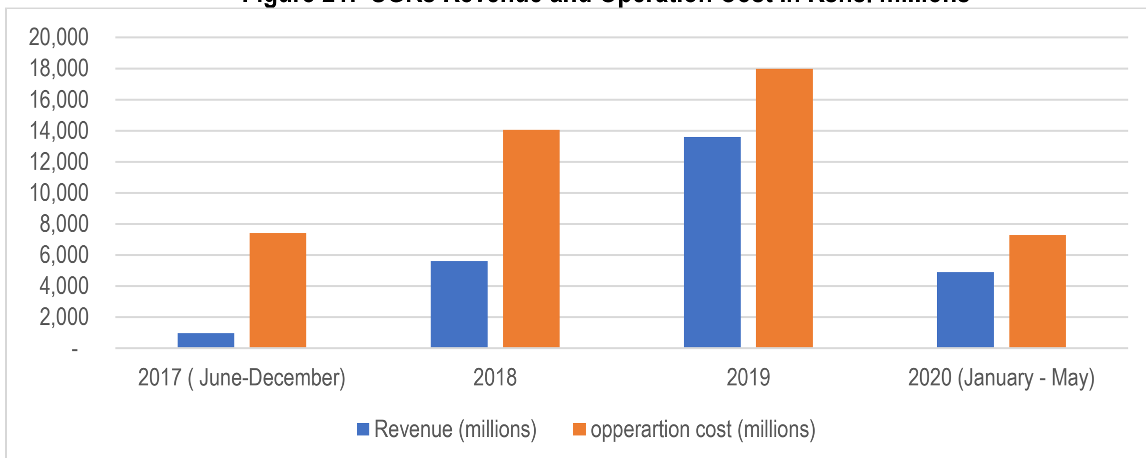
road projects and size relative to total available funding per year and in the medium term. This approach will help streamline road projects and ensure efficient financing and delivery of the road projects

Rail and urban transport

2.5.4 Besides the expansion of the road network, the growing urban population (for example in the Nairobi Metropolitan) worsening congestion and lack of safe, comfortable and available commuter rail services has necessitated the need to modernize urban mobility. The government has therefore identified 5 corridors leading to Nairobi CBD for commuter rail and Bus Rapid Transport (BRT). In this regard the government has rehabilitated Nairobi Commuter rail which was reported to be 25% complete as at June 2020 and acquired 11 Diesel Multiple units (DMUs).

2.5.5 With regard to cross country rail transport, the SGR is contributing greatly by hauling cargo and passengers between the coast of Kenya and Nairobi. However, the operational cost of the SGR has been a challenge, negatively affected by the COVID-19 related economic downturn and three month lockdowns. Further, the financial health of the project continues to be weak with accumulating pending bills often paid for through mid-year budgetary reviews, and project running costs relative to revenue. Rail transport is still the best alternative for cargo haulage and long-distance passenger travel if the network is modernized and extended. Rehabilitation of the Nairobi-Nanyuki rail line is a significant step in the rail modernization process. The potential for rail transport lies in in providing safe and comfortable passenger transport in large cities like Nairobi, and building interconnectivity across regions beyond the existing rail line systems.

Figure 21: SGRs Revenue and Operation Cost in Kshs. millions



Source: Ministry of Transport, Infrastructure, Housing and Urban Development

Financing of Infrastructure through Public Private Partnerships

2.5.6 Infrastructural projects are usually capital intensive which is beyond the capabilities of most governments including Kenya. Such a demanding capital outlay often calls for mobilization of resources through borrowing from both the foreign and domestic market. Foreign borrowing comes with the risk of debt repayment if revenue from the projects is inadequate or if the economy fails to raise enough revenue and

foreign currency. Other risks include foreign exchange risk and currency mismatch related with external loans.

2.5.7 Faced with constrained tax resources and unfavourable debt levels, the government has in recent years tapped into the private sector as an alternative source of funding to meet the funding gap. This has largely been done through the Public Private Partnership (PPP) systems provided for in the PPP Act. One of the major projects being implemented through partnership with the Private is the JKIA – James Gichuru Express Way aimed at easing traffic to and from the Jomo Kenyatta International Airport (JKIA), and the planned Nairobi – Mau Summit dual carriageway. Both projects are designed to be built by the contractors at their own cost with the cost recovery and profit being paid for through toll fees over at least 20 years. With regard to the Expressway, it is expected to run the road for at least 20 years with revenue drawn from toll fees.

2.5.8 Whilst financing projects through the Private alleviates fiscal pressure it comes with certain risks which include weak oversight, embedded contingency risks integrated in the contracts, most commonly government guarantees and deemed demand clauses. With possible weak and opaque negotiations, certain contingencies during project development, and the fact that it is not entirely possible to fully account for all future risks, these projects should be handled with great care to protect the countries long term fiscal sustainability.

Policy Options

i) Re- appraise all roads projects with an aim of maintaining only those major projects in the budget and leaving small roads to CDF and the county governments.
ii) To harness the potential for rail transport, special allocations should be provided to expand provision of affordable, safe and comfortable rail passenger transport in large cities like Nairobi, and building interconnectivity across regions beyond the existing rail line systems.
iii) **To enhance transparency in identification and selection process of projects, the Public Investment Management Unit (**should prepare annual reports on all new projects detailing value for money, affordability and returns on investment of each new project. This report should be submitted to the National Assembly together with the Budget Policy Statement (BPS) of every financial year.
iv) Information on the process of Public Private Partnerships regarding large projects should be reviewed and approved by the National Assembly given the contingent risks often embedded in such long-term projects.

2.6 Enhancing Social Safety Net Programmes

2.6.1 The ongoing health pandemic has been associated with job losses, income losses, rising poverty and unemployment, and put more pressure on the already vulnerable population. Before the close of the last financial year, the government issued a wide ranging fiscal and monetary side stimulus package to ease the burden arising from the economic impact of the pandemic. The fiscal stimulus measures, included

allocation of Kshs 10 billion to the elderly, orphans and other vulnerable members of the society through cash transfers to cushion them from the adverse effects of the pandemic.

2.6.2 Alongside tax income tax, VAT reliefs, and reduction in certain financial transaction fees, the government allocated a Kshs 53.7 billion in the estimates for 2020/21 which includes Kshs. 5 billion for hiring local labour across the country to assist in the rehabilitation of various works. This and other measures provided for a short term solution to cushion the most vulnerable group against the immediate economic impact to households.

2.6.3 Unemployment numbers escalated due to the direct effects of the pandemic. Even in the absence of the pandemic, social protection provisions have been in place covering various groups in the country. Notably, social protection objective is to ensure that all Kenyans live in a dignified way and exploit their human capabilities for their own social and economic development. Cognizant of this, the government has over the years invested in "Inua Jamii" for the cohort of beneficiaries including orphans and vulnerable children, older persons, Persons with Severe Disabilities and to address persons affected by hunger from time to time. The transfer program comprises regular and reliable bi-monthly cash transfers to the beneficiaries or households.

2.6.4 In the FY 2020/21 the National Social Safety Net programme was allocated Kshs. 26.00 billion through the cash transfer project with the following targets;

a. 833,000 households with older persons supported with cash transfers.
b. 390,500 households with OVC supported with cash transfer
c. 47,000 households with PWSD supported with cash transfers

2.6.5 This program has been particularly vital in providing for a minimum income protection to the poor and vulnerable population by enhancing their resilience and social status. The vulnerability of this group has however worsened with the upsurge of the corona virus pandemic and the local measures put in place to contain the spread of the virus. The economic situation remains weak particularly for the vulnerable groups identified above but also among the people living in the informal settlements of major urban centers in Kenya. Given the large negative impact of the ongoing economic downturn on households and unemployed, the vulnerable cohort should be expanded to reach poor households in urban areas, unemployed youth and chronically unemployed and poor job seekers. It is therefore imperative that the budget for the National Social Safety Net programme be enhanced.

Table 8: National Social Safety Net Programme (Kshs Billion)

	Base Year 2020/21	2021/22	2022/23	2023/24
National Safety Net Program	26	32.5	40.63	50.63

Source: PBO Estimate, PBB budget

Policy Options

The following policy recommendations to be considered while formulating the budget for the financial year 2021/22 for the State Department of Social Protection under the Ministry of Labour and Social Protection:

i) The numbers of vulnerable population have increased with the upsurge of the corona virus. Therefore, the Hunger Safety Net Program which currently focuses on four arid counties should be up scaled to cater for other equally vulnerable persons in the urban informal settlements. This program is mainly donor supported.
ii) Enhance the amount of monies currently transferred through the "Inua Jamii" program for the financial year 2021/22 by Kshs 6.5 billion to compensate for further loss of income to beneficiaries arising from the containment measures of the pandemic. Other emerging costs of medication arising from contracting the virus will also be accounted for under this.
iii) Given economic vulnerabilities are deeper than the reach of the current social safety net, additional resources, estimated at about 25% more allocation above the base should be allocated to reach poor households in urban areas, provided a small stipend to unemployed youth and chronically unemployed and poor job seekers.

Chapter 3

Taking the Economy to a new growth pattern through support to devolution

Why are allocations to counties not adequately contributing to economic growth?

1. **The level of fiduciary risk in counties** – Leakage and misapplication of resources has constrained the economic impact of resources allocated to counties as the budget is unable to achieve intended results.
2. **Lack of an institutionalized process of actualizing the Medium Term Expenditure Framework (MTEF)** – The three year rolling framework for budgeting ensures fiscal discipline by setting out medium term expenditure priorities against hard budget constraints and monitoring performance of targets/outcomes.
3. **Inadequate resource allocation** – expenditure needs in counties continue to be higher than resource allocations. This is worsened by the fact that counties have been unable to adequately boost own source revenue collection.
4. **Socio-economic and political risks** – some counties have been plagued with governance concerns pertaining to county leadership and this hinders service delivery.

3.1 Background

3.1.1 With the advent of devolution, resources were devolved to the grassroots level to bring services and development closer to citizens who were expected to play a greater role in development of their regions. However there have been major drawbacks in the way decisions are made and funds utilised.

3.1.2 There are weak internal controls in the use of funds by county governments due to the following;

a) Un-automated systems in the counties

An analysis of the Auditor General and the Controller of Budget reports indicate that IFMIS connectivity challenges continue to affect revenue collection. Whereas revenue collection should be fully automated and use of manual financial systems avoided at all times, more than ten (10) counties still have challenges in IFMIS connectivity with some of them resorting to manual financial systems that are subject to abuse. E-payment systems ensure higher compliance and reduce pilferage of resources as evidenced by the improved revenue collection performance in Nairobi City County due to adoption of the e -payments system.

b) Utilization of revenue at source

Reports from oversight institutions further indicate that some counties are still utilizing revenue at source contrary to Section 109 (2) of the PFM law. This has sometimes led to revenue loss and other accountability issues. It also affects planning and prioritization of activities; and prevents accuracy in data collection to inform future policy.

c) Non-establishment of Audit committee

More than ten (10) counties have not yet established Audit committees as per the reports from oversight offices. Audit committees provide oversight of financial reporting processes, ensure compliance with laws and regulations, monitor the processes and inform the management early enough to provide the necessary remedial actions. Lack of Audit committees hinders transparency and accountability. The committee would be of great value to the counties by identifying opportunities for improvement and actions necessary to enhance service delivery.

d) Weak adherence to public procurement laws

A study by KIPPRA in 2019, established that in some counties, the county procurement plans and the contracts awarded are not made public. This limits the participation of many people who would have taken part had the procurement information been made public thereby encouraging competition, efficiency and

effectiveness in service delivery. This would limit issues of unaccounted/unsupported expenditure among other audit issues raised by the Auditor general every year.

Table 9: Unsupported /Unaccounted Expenditure for 2013/14-2015/16

Items	FY 2013/14	FY 2014/15	FY 2015/16
1: Unsupported Expenditure	6,582	16,899.7	37,109.7
2: Unaccounted Expenditure	1,587	-	2,859.1
Total(1+2)	8,170	16,899.7	39,968.8
% Share to Total Revenue	**4**	**7.0**	**14.5**
Total Equitable Revenue Allocation	**210,000.0**	**242,418.6**	**276,373.0**

Source: Auditor General Report-Various Issues

As shown in Table 11, the share of unsupported and unaccounted expenditure has been increasing through the years. Indeed, by 2015/16, for every Kshs. 100 allocated to counties, 14.5 % could not be accounted for. This is detrimental to economic growth and development.

e) Capacity gaps in prioritisation of projects

The budget framework used in both the national and county budgets, though comprehensive, does not guarantee efficient resource allocation and prioritization. Project prioritization would help to ensure that all projects started are implemented and finalized as planned. This includes coming up with a criteria for use in decision making pertaining to identifying the community's most pressing needs and making deliberate efforts to prioritize these in the budget. **Indeed, lack of community participation is responsible for a number of abandoned projects in the counties.** Auditor General Reports reveal that in Kapsuser market in Kericho County, market traders prefer trading their goods and services near the road despite a market shed having been constructed for them. Had community participation been carried out, the project would have been located at a place that is favourable to traders to meet their needs.

f) Lack of legal framework on projects prioritisation

There is no legal framework to ensure that ongoing projects are completed before starting new ones whenever there is a change in governance. This has led to several abandoned or stalled projects after a change in County leadership. There is need for legislation to make it unlawful to abandon on-going projects with stiff penalties to the relevant authorities should this occur. Such a law will ensure completion of abandoned/stalled projects in order to achieve value for public funds.

g) Revenue estimation

There is inadequate capacity in Counties to forecast revenue and this has resulted to overestimation of revenue over the years as shown in the Table 12. Counties are yet to establish strong systems for revenue collection. Indeed, actual revenue collection in counties has not maintained an upward trend over the last seven years.

Table 10: Counties Revenue Target and Actual for 2013/14- 2019/20

FY	Revenue Targets	Actual Revenue Collection	Shortfalls	% Shortfall
2013/14	54,207,798,427	26,296,089,510.00	-27,911,708,917.00	-51.5
2014/15	50,376,859,951	34,468,720,354	-15,908,139,597	-31.6
2015/16	50,539,746,840	36,905,771,161	-13,633,975,679	-27
2016/17	57,664,858,199	32,522,875,093	-25,141,983,106	-43.6
2017/18	49,219,014,037	32,491,694,261	-16,727,319,776	-34
2018/19	53,863,582,921	40,304,833,142	-13,558,749,779	-25.2
2019/20	54,901,270,000	35,772,580,000	19,128,690,000	-34.8

Source: COB Various Issues

3.2 Budgeting process and enhanced service delivery

3.2.1 County planning and budgeting is regulated by several laws including chapter 11 of the constitution on estimates of Revenue and Expenditure, how to finance any anticipated deficient for the period to which they apply, management of borrowing and other forms of public liabilities. The County Government Act, 2012 requires the County Government to prepare County Integrated Development Plan which is a five-year plan, Annual Development Plan and Strategic Plans for Urban areas and cities in line with the County Fiscal Strategy Paper. The Annual Development Plan gives the strategic priorities including the programmes and capital projects to be implemented in the Financial Year as per the PFM Act, 2012. There should be no project in the budget that is not derived from the county Plans. The ADP gives a good opportunity to review or modify the proposals in the CIDP and gives specifics as to which sectors or programmes will be prioritized in the next financial year.

3.2.2 The County Fiscal Strategy Paper gives the County financial projections, sector priorities and sector ceilings for the next FY and is used in the formulation of the budget for the next Financial Year as per the PFM Act,117. The CFSP is informed by the County Budget Review and Outlook paper that reviews the actual fiscal performance of the previous FY as well as updating the economic and financial forecast information. CBROP therefore provides provisional sector ceilings for each sector and informs the sector hearings leading to the preparation and approval of the CFSP. The county budget proposals are prepared by translating the government policy goals into action. However, this procedure is not followed and this has led to a number of challenges.

3.2.3 The above budget documents are critical for engagements with stakeholders especially for purposes of enhancing participation and inclusiveness in the budget process. However, the documents are complex to most stakeholders. Implementation of the MTEF in the counties has had challenges since the inception of County Government. The weaknesses are especially in the following areas;

- Programme Based Budget is not linked to the IFMIS system and with line budgets typically uploaded into IFMIS, it is difficult to track activities within the PBB.
- Poor execution of the approved budget and inadequate monitoring and evaluation has led to incomplete projects, accumulation of pending bills, poor workmanship and misplaced priorities leading to no value for money.

- Lack of public participation in the budget process due to inadequate sensitisation and information sharing of the budget cycle to the stakeholders.
- Inadequate technical capacity in terms of the number of staff dedicated to the budget process.
- Inadequacy of legislation and policies to support counties, for example, ring-fencing of funding such as for health by having a bill that would allow counties to retain the revenue generated by health facilities for use in improving infrastructure development in the facility and other services.

Policy Options.

i) The County Government should leverage on Information Communication and Technology for county data management. The use of IFMIS system should be reviewed so as to enable the capturing of information from the Programme Based Budget which is necessary for effective monitoring of budget implementation.

ii) Develop and maintain a compendium of projects for each county that should include information on name of the project, source of funds, start date, expected date of completion, status, allocation per financial year, total expenditure to date and total estimated cost. This compendium of projects should be updated every year and information obtained analysed and used in project prioritisation.

iii) Project prioritisation should focus on the total project cost not just the annual cost of the project and the information used to ensure on-going projects are completed before starting new ones.

iv) Establish a system of sanctions and rewards for availing budget information to the general public. This includes clear project timelines, adequate financing, accountability and participation of the relevant professionals in project implementation.