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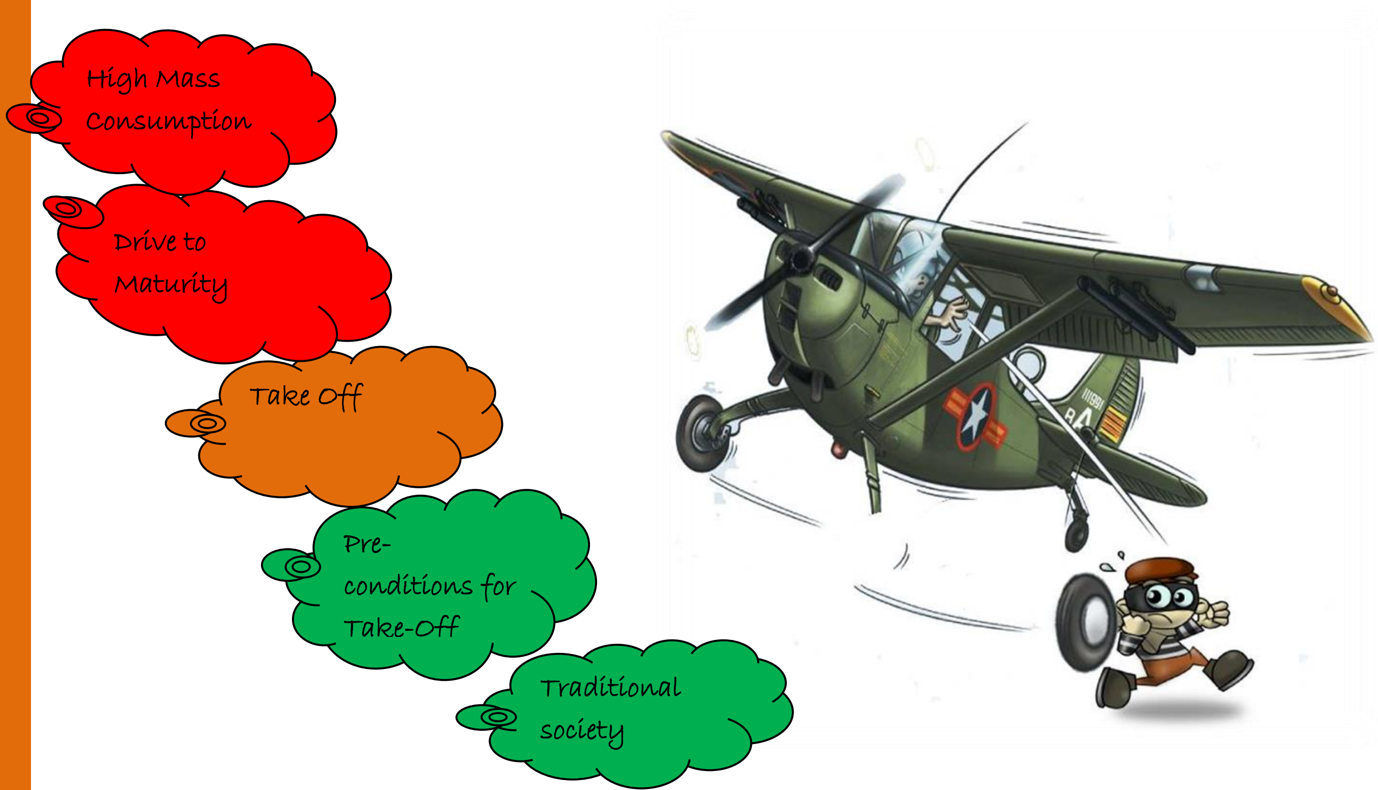
Budget Options for 2019/20 and the Medium Term



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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
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Preamble

The 2018/19 budget launched the 'Big Four' plan of the government which is targeted at supporting job creation by increasing value addition and the manufacturing sector's share of GDP; enhancing food and nutrition security; providing universal health coverage to all Kenyans as well as the provision of affordable housing. It is expected that the 2019/20 budget will continue with the implementation of policies and programmes which are geared towards the realization of the big four agenda. Besides the 'big four', other broad policy objectives of the government include fiscal consolidation and sustainable debt levels, increased exports,higher foreign exchange reserves, increased private sector growth and a general reduction in poverty levels and improvement of living standards. **The challenge of the 2019/20 budget however, is how to ensure that all these targets are achieved in the shortest time possible, with the least resources possible taking into account the need for higher economic growth, debt sustainability and poverty reduction.**

In applying Rostow's theory of economic development to the Kenyan economy, it is apparent that though the economy has moved from the traditional society and has attained certain pre-conditions to take-off, it is still bogged down by a number of factors which prevent it from truly taking off to a period of rapid industrialization, growing investments, better infrastructure and a positive cultural change. The country's productive potential has stagnated primarily due to inefficiencies in the supply and productivity of labour and capital - the main production inputs – as well as poor adoption of innovation. But central to the challenges in the production process and arguably the most distortive factor to the quality of production is the murky world of cartels –shadowy Companies that continue to reap where they have not sowed. **The invisible hand of cartels interferes with market forces and distorts supply, ultimately pushing prices upwards and some producers out of the market.** Indeed, cartels have played a significant role in stagnating development and have led to the collapse of some industries.

The Big Four agenda will not be achieved unless these challenges in the production process are effectively dealt with. The Budget Options for 2019/20 explores the dynamics of moving the economy from the 5-6% economic growth rate where the economy has stagnated over the past five years to a higher growth trajectory that will reduce poverty and enhance the living standards of Kenyans. The challenge lies in unlocking a higher productive capacity.

Acknowledgements

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The following were the key contributors: Millicent Ojiambo-Makina, Joash Kosiba, Chacha Machage, Danson Kachumbo, Ali Salat, Julie Mwithiga, Edison Odhiambo, Eric Kanyi, Abdinasir Moge, Omar Abdirahim, Abdirahman Gorod and Jonathan Lemurt.

List of Acronyms and Abbreviations

AGOA	Africa Growth and Opportunity Act
BPS	Budget Policy Statement
CBC	Competency Based Curriculum
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CIT	Corporate Income Tax
EAC	East African Community
EAC-COMESA-SADC	Tripartite between East African Community, Common Market for Eastern and Southern Africa and the Southern African Development Community
EPA	Economic Partnership Agreement
EPZ	Export Processing Zone
FY	Financial Year
GDP	Gross Domestic Product
HR	Human Resource
ICT	Information and Communications Technology
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
KARI	Kenya Agricultural Research Institute
KBA	Kenya Bankers Association
KEFRI	Kenya Forestry Research Institute
KIHBS	Kenya Integrated Household Budget Survey
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
MDAs	Ministries, Departments and Agencies
MSME	Micro, Small and Medium Enterprises
MTDS	Medium Term Debt Management Strategy
NACOSTI	National Commission for Science, Technology and Innovation
PBO	Parliamentary Budget Office
PFM	Public Finance Management
PV	Present Value
SEZs	Special Economic Zones
SMEs	Small and Medium Enterprises
UHC	Universal Health Coverage
US	United States
VAT	Value Added Tax

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Chapter One

Confronting the Trade Offs: Can the Government Achieve its Fiscal Rules?

Kenya has made significant progress over the past year; overcoming the headwinds of 2017 to register an estimated 6.0 percent economic growth rate in 2018. Rainfall performance improved significantly and with it, increased food production. Political tensions have greatly subsided and the political climate is more conducive than ever; bolstered further by the renewed zeal and effort to fight graft. As a result, economic activity has rebounded and appears set to gain momentum. But how much momentum the economy actually gathers and how well the economy performs will largely depend on how the government raises money, where this money is spent and the responsiveness of the national budget to the immediate needs of Kenyans.

A review of economic performance

1. **With provisional estimates of economic growth at 6.0 percent for 2018, the Kenyan economy has been on a steady recovery path - but this growth should be interpreted with caution.** The high growth rate in the period under review is attributed to improved weather conditions which increased agricultural output as well as electricity and water supply; increased business and consumer confidence attributable to calmness in the political front; a rebound in manufacturing activities, as well as a fairly stable macroeconomic environment.[1] These factors – notably, increased agricultural output; political stability as well as a low and stable inflation – are undoubtedly significant in Kenya's economic growth story and a rebound in their performance in 2018 following a lacklustre performance in 2017 was always bound to increase the economic growth rate. Enhanced agricultural performance has also had spill over effects on the manufacturing sector whose improved growth is attributable – at least in part – to increased manufacture of dairy products, beverages, sugar as well as the processing of tea and coffee. Other key factors that enhanced manufacturing performance in 2018 include motor vehicle assembly, manufacture of basic chemicals, fertilizers as well as primary plastics, pharmaceutical products and preparations. However, despite the improvement in performance, quality concerns remain a challenge. Increased agricultural output – the main contributor to economic growth in the first half of the year – is attributed to increased rainfall as opposed to agricultural innovations. The manufacturing sector continues to face challenges ranging from shortage of capital, raw materials and skilled labour to inadequate access to finances in addition to a number of regulatory challenges. Despite the impressive economic growth statistics, very few policy interventions can be attributed to the improved economic performance of any sector in 2018 implying a business as usual scenario which may not offer sustainable growth.

2. **It is also important to keep the base effect in mind as this may have distorted economic growth, making it appear stronger than it actually was.** Economic growth is expressed as a year over year or quarter over quarter figure but a low growth in the previous year may produce a spike in the next year due to the low base, implying a higher economic growth when it's really just a

[1] KNBS

reflection of the base effect due to the lower value in the previous year. The same applies for the low levels of inflation recorded in 2018 compared to the high inflation rates in 2017. As a result, though statistics indicate a higher GDP growth - and lower inflation for that matter - it may not be reflected in improvement of the living standards of Kenyans.

3. **The enactment of the Finance Act 2018 may have had an unintended negative consequence on the manufacturing sector due to the perceived higher cost of doing business but may also hold some benefits for the sector.** It has been posited that tax measures such as introduction of fuel VAT and excise duty on internet data services were likely to increase the cost of doing business. This coupled with the reduced purchasing power of consumers on account of a higher tax burden would impact negatively on investment and job creation. It should be noted however that some measures in the finance act 2018 coming into effect in January 2018 may actually be favourable for businesses if well implemented. These include additional reduction of 30% of the electricity bill incurred by manufacturers in addition to the normal deductible electricity costs (in a bid to reduce energy costs), VAT exemption of plant and machinery used for manufacture of goods as well as special tax rates under a special operating framework with the government which could possibly introduce lower taxes for companies and businesses that partner with the government to carry out specific investment projects (an incentive for public private partnerships).

Medium Term Economic Outlook and Prospects

4. **Over the past years, the government has expressed commitment to prudence in public finance – achievable through a set of fiscal rules that will be realized over the next five years.** These fiscal rules relate to the budget balance (fiscal deficit including grants at no more than 3% of GDP), debt (gross public debt at no more than 50% of GDP in Net Present Value Terms), development expenditure (minimum of 30% of total expenditure) and wages (not more than 35% of total revenue) among others. Most of these commitments were entered into several years back for various reasons. The budget deficit and the debt targets were adopted as part of the primary convergence criteria as the EAC countries prepare to join the East Africa Monetary Union. However, expenditure pressures particularly from labour unions, government investment projects as well as increased size of government with the advent of county governments have sustained government expenditure at high levels and as a result, low debt and deficit levels have become moving targets. As such, though the target over the past 3 years has been to maintain the fiscal deficit level at 4 – 5% on average, by close of financial year 2017/18, it was estimated at 7.1%. A detailed description of the current fiscal rules is in table 1 below.

Table 1: Government Fiscal Targets

Target	Unit	Target	2017/18 (actual)	2018/19 (target)	2019/20 (target)
Budget Deficit (commitment basis excl. grants)	% GDP	< 3%	7.1	6.8	5.6
Present Value of Government Debt	%GDP	< 50%	55.4	60.6	59.9
Foreign Reserve Stocks in months of import cover		> 4 Months	6.9	7.0	7.1
Development expenditure	%Total Expenditure	> 30%	26	31	30
Wages Government	% Total Revenue	< 35%	32	28	28
Inflation		2,5% / 7,5%	5.25	4.8	5.0
Poverty (consistent reduction through 2022)					
Gross Investments	%GDP	27.2%	21.1	24.0	24.0
Gross National Savings	%GDP	23.2%	15.5	18.2	18.1
GDP Growth rate		7%	5.4	6.1	6.2

Data Source: BPS 2019, IMF Country Report No. 18/295, October 2018

The number of policy goals a policy maker can pursue can be no greater than the number of instruments the policy maker can control (Jan Tinbergen, Nobel Prize Winner). Thus at any given time, the number of policy targets must be less than or equal to the instruments.

5. **Though the fiscal rules are expected to foster fiscal responsibility, there is a risk that they could be in conflict with other government objectives as well as counterproductive at some point in time depending on the stage in the business cycle.** Arguably, the most critical concern of the government in the recent years– and the hardest target to achieve - has been to reduce the budget deficit level. As part of the strategy to reduce the deficit, austerity measures have been implemented in recent budget cycles, typically within the year in the form of supplementary budgets. This outcome is typically attributed to revenue underperformance. Whereas reducing overall government spending may reduce the deficit levels, it may not augur well for economic growth. There is an emerging concern that austerity measures tend to focus too much on the aggregate figure rather than what exactly is being cut. As a result, critical development spending and even some crucial operational funds have been slashed on account of austerity. Development expenditure typically bears the brunt of any expenditure reduction from government. The impact of spending cuts on the economy depends on what is being cut. A reduction in investment levels and essential development project spending is likely to have a negative impact on economic growth and development including poverty reduction. It should be noted also that the current fiscal rules do not appear to be flexible enough to take into account the upswings and downswings of the business cycle. As a result, we have implemented austerity measures and increased taxes during periods of slow growth which is likely to lengthen the downturn period. Fiscal policy should be

designed in such a way that it protects the economy during the 'rainy days' by increasing savings (reduce expenditure /increase taxes) during boom periods so that these can serve as a cushion during the slow growth periods. This is referred to as counter-cyclicality of fiscal policy.

Without adhering to the fiscal policy direction, the budget fails to be effective as a tool for economic growth and development.

6. **Under the prevailing circumstances, it may be difficult to achieve all fiscal targets at the same time.** It is important therefore to identify a policy mix that will enhance economic growth and development as well as poverty reduction while still ensuring that the general path towards fiscal consolidation is adhered to. Focus should be on the quality of government expenditure as well as the responsiveness of the fiscal policy to the stages of the business cycle.

The government can consider a number of policy options:

I. Baseline: The 'Business-as-usual' Scenario

7. **Assuming no significant change in policy, in terms of fiscal years, the economy is projected to grow at 5.5 percent in 2019/20 and average 5.6 percent over the medium term.** This growth projection assumes a business as usual approach to economic development despite allusions of increasing government investment particularly with regard to strategic interventions under the 'big four' plan. It is assumed that government investment will follow the usual pace whereby expenditure on development projects is under-absorbed within the year and reoriented towards recurrent spending due to bureaucratic delays in project implementation, revenue underperformance among other reasons. Drastic and broad based cuts on development expenditure are a recurring phenomenon in almost every budget year and this can slow down economic growth as well as render the budget ineffective as a tool for economic growth.

8. **No change in policy also implies underperformance in revenue collection amidst increasing expenditure pressures that are not effectively dealt with, leading to a widening budget deficit.** One of the targets of government is to achieve a 3% growth in deficit by the year 2021/22 in line with the EAC convergence criteria. However, revenue has routinely underperformed in the past years and in the absence of innovative revenue raising measures, is likely to continue with the same trend. Expenditure pressures arising from mega investment projects, as well as routine operations and maintenance including wage demands will continue exerting pressure on resources leading to a wider than expected deficit and likely continued debt accumulation.

9. **Agriculture is slowly recovering given the improved weather outlook and is likely to perform modestly in 2018, though not extraordinarily so.** Despite proposed interventions to boost the sector, agricultural performance has routinely been left to the mercy of climate vagaries and weather outcomes. Investment in agriculture mostly remains 'business as usual' with no real or clear strategy to enhance agricultural productivity.

10. **The trade deficit is likely to continue expanding on account of stagnating exports and increasing imports.** Reported increases in Kenya's exports are mostly due to increase of exports in value terms, not volume terms. Structural competitiveness or quality of exports is still wanting and Kenya's export market share in sub-Saharan Africa has been declining. On the other hand, given continued huge government investment projects, imports are likely to continue increasing.

11. **Inflation is likely to remain within single digits given reduced volatility from food prices but downside risks remain particularly from energy prices.** Downside risks will most likely emanate from fuel and raw material prices which have slowly been edging upwards. High prices of raw materials are also likely to increase the import bill thereby worsening the trade balance even further.

II. Scenario II: Mix of Policies that will lead to higher economic growth (above 6%)

i) Increase Tax Revenues – raise the revenue base from 18.6% to 20% of GDP

12. Central to the achievement of a lower budget deficit is higher revenue performance. Higher revenues will increase the fiscal space for the government; reduce the budget deficit and consequently, reduce overreliance on borrowing. Under this outcome, the government will be on schedule towards achieving lower deficit and debt levels in line with the EAC convergence criteria, higher development spending resulting in higher investment levels as well as higher economic growth rate which leads to even higher revenue collection. Even government wages as a share of revenue – another key fiscal target – will decrease.

13. In financial year 2018/19, the government introduced a raft of revenue financing measures which were deemed to have increased the general tax burden in the country. These include 8% VAT to be levied on petroleum products, Ksh. 18 adulteration fee per litre of kerosene (in addition to the VAT) as well as a 1.5 percent National Housing Development Fund on gross monthly earnings of employees (matched by the employers). Other revenue measures include the doubling of duties on money transfers to 20 percent, as well as higher taxes on mobile phone calls, internet usage and mobile phone cash transfers.

14. Increasing taxes without assessing the sector-wide effects sometimes carries negative inferences and can dis-incentivize investment. Many businesses tend to view higher taxes – and sometimes rightly so – as an additional cost to their businesses that is likely to narrow their profit margins. When these higher taxes target consumers, the result is a reduction in the purchasing power of these consumers which leads to lower aggregate demand. Such an outcome will invariably lead to a lower-than-expected GDP growth rendering the move counterproductive in the short run. Increasing taxes can therefore be problematic especially if deemed to be punitive by businesses as well as consumers.

15. Given the revenue raising measures introduced in 2018/19 whose full effect is yet to be realized, it may be more prudent in the short term to explore other avenues of enhancing revenue collection

that do not necessarily entail higher taxes. Revenue underperformance has been linked to a number of challenges, notably revenue leakages due to existing loopholes, unnecessary incentives, waivers and exemptions to large businesses and companies as well as lower-than-expected economic growth. In addressing these challenges, the government could possibly unlock higher revenues thereby increasing the revenue base to approximately 20% of GDP. A detailed discussion on revenue underperformance and unlocking the revenue potential is in chapter 6.

ii) Reduce material government consumption

16. High budget deficit and debt levels have been attributed to increasing government expenditure over the past decade. In particular, public expenditure pressures emanated from an increase in the general size of government following the advent of county governments. Both at the national and county levels, there was a surge in the number of government workers leading to higher wage bill and operation costs. Other expenditure pressures over the same period include higher wage demands from labour unions as well as the commissioning of mega infrastructure projects in a bid to enhance economic growth and development. Most of these infrastructure projects have been funded through debt. It should be noted that debt is not bad so long as it is supporting development. However a rise in general consumption expenditure has been detrimental to the efforts by government to minimize borrowing.

17. A significant reduction in government material consumption will have an immediate impact in reducing the budget deficit levels without necessarily affecting the development plans of the government. Caution should be observed however, to ensure that the expenditure cuts do not adversely affect the operations of government. Previous attempts to reduce non-core government spending have been applied across the board for all Ministries, Departments and Agencies of government without due regard to the unique characteristics and needs of each MDA. It is important that we do not view government material consumption as wasteful. Without adequate recurrent expenditure, many government operations would grind to a halt. Depending on the nature of work of the MDA; more recurrent expenditure provisions may be required. Actual needs differ from MDA to MDA. As a result, it is important to ensure that any expenditure cuts on government material consumption are targeted at areas of over-provision and not recurrent expenditure as a whole. Expenditure cuts shouldn't hamper operations of an MDA otherwise they will be counterproductive to the economy.

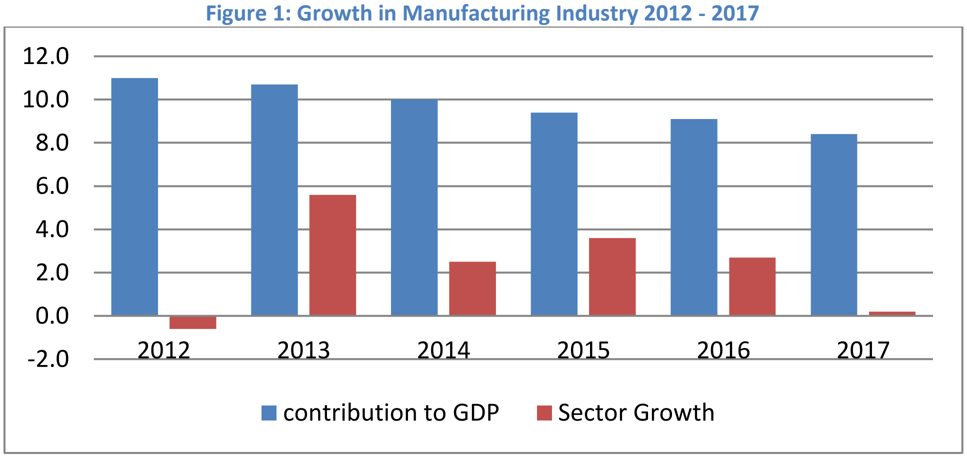
18. The main argument by proponents of reduced overall government spending is that it yields little returns. However, given the existing public infrastructure deficit in the country, government investment is still required in various sectors that may open up the economy to higher growth and development. This could be in terms of yields from the actual project implementation such as through increased employment for project workers or a boom in the construction sector; as well as longer term economic returns based on the opportunities the development project makes available to the country. Increased development spending, if properly implemented, is therefore bound to increase economic growth and revenue for the government.

19. The main concern with regard to the fiscal rules is that increased government development spending may have a negative impact on deficit and debt levels. It should be noted that development projects especially if funded through debt have to be carefully selected to ensure that the economic returns outweigh the cost. There have been concerns on the pace of project implementation in the country as well as the quality of government investments. Many development projects in the country take too long to complete leading to higher costs or abandoning of the project midway. In addition, it has been postulated that some development projects are an end in themselves and unlikely to stimulate economic expansion. This is despite sinking billions of shillings into the said projects. Proper project identification, feasibility studies and impact assessment is therefore very crucial before initiating a project.

iii) Increase employment

20. Another key challenge facing the government is high unemployment levels especially among the youth. According to the recently released KIHBS survey 2015/16, there are 1.4 million unemployed Kenyans with the unemployment rate[2] estimated at 7.4 percent. The key to unlocking the unemployment burden in Kenya lies in the manufacturing sector which is one of the four pillars of the government's Big Four agenda. Though the sector is considered a key engine of economic growth, its contribution to the country's economic growth has been on the decline over the past five years (Fig 1). Majority of the country's additional employment growth is accounted for by the informal sector; notably under wholesale and retail trade, hotels and restaurants (approximately 60% of total informal employment) as well as the manufacturing sector (20% of total informal employment). Recent statistics indicate that the informal sector constitutes 83.4 percent of total employment and accounted for the creation of 787,800 new jobs in 2017[3]. Thus, any meaningful intervention in employment should include strategies to revamp the informal sector.

Figure 1: Growth in Manufacturing Industry 2012 - 2017



Data Source: KNBS

[2] Not working, available and looking for work
[3] Kenya National Bureau of Statistics (2018), Economic Survey 2018

21. Over the past decade, the public sector has recruited extensively especially with the implementation of the devolved government and as a result, the public sector wage bill has become a concern. Thus any policy measure on employment should be guided by the need to maintain the public sector as lean as possible while targeting higher employment levels by the private sector. Since employment growth is mostly registered under the informal sector, measures should be put in place to incentivize and increase productivity of the micro, small and medium enterprises as these hold the key to higher employment levels in the country.

22. One of the key challenges facing the informal sector is access to credit. According to the 2016 National Small and Medium Establishments survey, 46.3 percent of MSME businesses close down within the first year of operation with shortage of operating funds cited as the main reason for closure of establishment. Private sector credit has reportedly been on the decline since the beginning of 2016 but may have been exacerbated by the coming into force of the interest rate capping law, increased appetite for borrowing by the government and an unfavourable climate in 2017 pending the outcome of the general elections. In recent months, credit to private sector has reportedly been slowly edging upwards from 2.4 percent in December 2017 to 4.3 percent in August 2018 and is expected to continue recovery in the coming year. If MSME businesses are sustained, then they can be significant in addressing the employment problem in the country. Evidence indicate that private sector investment enhances economic growth faster than public investments and that this growth is more sustainable.

23. It should be noted that under the current economic circumstances, it will be difficult to pursue fiscal consolidation through reduced government expenditure and still maintain the fiscal target of a higher economic growth rate unless that growth is private sector led. As a result, interventions to enhance private sector investment in the current financial year and the medium term are critical not only in increasing employment growth but also in ensuring that the economy continues to grow.

24. Addressing the challenges under manufacturing will portend great benefits for the country's employment levels. This includes addressing challenges in agriculture since most industries in Kenya are agro based. Agriculture continues to play a significant role in the economy as a key contributor to economic growth and is also one of the four pillars of the big four agenda. The contribution of agriculture to GDP is currently estimated at 31.5 percent, making it the single most significant factor in the country for economic growth and poverty reduction. It is estimated that the Agriculture sector accounts for 75 percent of the country's labour force and is also a key source of revenue including foreign exchange earnings as a source of raw materials for the manufacturing industry as well as for exports in addition to providing nutrition for the masses. Simulations indicate that enhancing agricultural productivity by 5% will increase economic growth by 0.3 percent and also increase revenue earnings leading to a decline in government debt as a percentage of GDP by approximately 0.6 percent. Of all policy proposals, improved agricultural productivity has the highest impact on poverty with results indicating a decline in poverty levels by 1 percent.

iv) Creating a healthy nation

25. Achieving universal health coverage to guarantee quality and affordable healthcare to all Kenyans is another key pillar of the big four agenda. Already, the government has initiated a pilot project in Machakos, Nyeri, Isiolo and Kisumu counties. The objective is to enhance the quality of service provision in these hospitals through upgrading infrastructure in hospitals, provision of medicine, expansion of hospitals, provision of key medical equipment as well as addressing HR concerns in the health sector.

26. Good health is a significant form of human capital. A healthy labour force is likely to have higher returns on labour input. The devolved system of government brought with it new challenges to the health sector that triggered doctors' unrest across the country. The decentralization of healthcare service provision to the counties brought to the fore deficiencies in county health infrastructure and its capacity to handle this transition. Many of the teething problems under the decentralized health sector particularly on human resource concerns have been addressed to some extent. Considerations should now focus on increasing the quantity, quality and distribution of health infrastructure particularly to the marginalized areas where health facilities are not readily available or accessible.

27. It should be noted that Health is primarily a devolved function and therefore counties remain the key stakeholders of health service provision. The coordination between the national and county government in this process of achieving universal health coverage remains unclear. Thus there is need for an extensive collaboration plan with county governments to enhance service delivery in the health sector.

Analyzing the Impact of the Policy Mix

Efficacy	Cost	Equity	Unintended consequences	Sustainability	Political Feasibility
Policy 1: Increase Revenue Base from 18.6% to 20% of GDP					
Higher taxes may increase revenue in year of implementation but may dis-incentivize investment resulting in lower revenues in the medium to long term	No implementation cost?	May be deemed punitive to some companies especially if tax incentives are being offered to some businesses and not others	Tax avoidance Reduced profitability of companies May dis-incentivize investment	Probably unsustainable; businesses may relocate	Too political
Policy 2: Reduce material government consumption and increase development spending					
Budget deficit may reduce but depending on quantity and magnitude of cuts, economic growth could slow down; higher development spending	MDAs will have to cut down on non essential activities	Without critical assessment of impact of each cut on the affected MDAs some may be more adversely affected than others	Critical operations of some MDAs may grind to a halt especially if the merit of the expenditure cuts isn't properly determined	Can be sustained for a period of time	Depending on nature and magnitude of cuts, could be feasible

Efficacy	Cost	Equity	Unintended consequences	Sustainability	Political Feasibility
may sustain financing pressures and offset impact of reduced recurrent budget leading to higher debt levels					
Policy 3: Increase employment					
Higher employment levels will increase income levels and aggregate demand, leading to higher GDP and revenue growth	Increase resource allocation to agriculture, agro-processing, and manufacturing	Likely to improve quality of life for all Kenyans and increase earnings across a number of sectors	Too much focus on employment creation may lead to numerous low value jobs being created	Sustainable	Feasible
Policy 4: Promote a healthy nation					
A healthy workforce is a productive workforce	Increase resource allocation for medical infrastructure: medical equipment, facilities, human capital	Quality universal healthcare will boost good health across all income categories	Increased unemployment leading to lower GDP growth and higher poverty levels	sustainable	Feasible

The Verdict:

Policy I: Increase revenue base from 18.6% to 20% of GDP

Consider enhancing revenue collection through non-chargeable means such as sealing of revenue loopholes, as well as reduction of unnecessary incentives, waivers and exemptions especially for the big companies/businesses/corporations. Avoid increasing taxes especially at this juncture. Increasing taxes can be re-considered in future. Reduction of unnecessary exemptions can boost revenue collection.

Policy II: Reduce material government consumption and increase development spending:

Review the operational costs of MDAs on an individual basis and identify areas of non-core expenditure that can be reduced without adversely affecting the operations of the MDAs. This includes leveraging technology to save on money spent on stationery as well as implementing the report of the presidential task force on parastatals reforms particularly with regard to reorganization and restructuring of state owned corporations.

Policy III: Increase employment

Implement policies that will increase competitiveness of the informal sector such as through skills development, increased credit access as well as addressing market constraints affecting small businesses. Increasing employment also includes policies that enhance agricultural productivity.

Policy IV: Promote a healthy nation

Establish a collaborative framework between the national and county government on matters health and increase resource allocation for medical infrastructure: medical equipment, facilities as well as human capital.

28. Simulations indicate that an increase in total revenue by Ksh 257.3 billion over the medium term (if we remove VAT and corporate exemptions – chapter 6), reduction of government material consumption by Ksh. 50 billion, an increase in total productivity by 5% and an increase in private investments by 5% (measures implemented over the medium term) will enable the country to achieve an economic growth rate above 6.0 percent with inflation maintained at reasonable levels, barring any adverse shocks. The debt and deficit position is also likely to improve significantly. A detailed outcome of the macroeconomic framework is provided in the table below:

Table 2: Select Macroeconomic Indicators: Alternative Package

	PBOM		
	2019/20	**2020/21**	**2021/22**
GDP and Prices	Annual Percentage Change		
Real GDP	6.1	7.3	7.6
CPI inflation, average	5.5	5.5	5.5
CPI inflation, end of period			
	Percentage of GDP		
Investment and Saving			
Gross Investments	18.2	18.3	18.5
Gross National Savings	11.2	11.7	12.3
Central Government Debt			
Revenues	18.4	18.7	19.1
Expenditures and net lending	25.1	24.1	23.2
Overall balance (commitment basis) incl. Grants	-5.7	-4.9	-4.2
Overall balance (commitment basis) excl. Grants	-6.0	-5.2	-4.4
General Government Debt/GDP	59.7	58.7	57.2

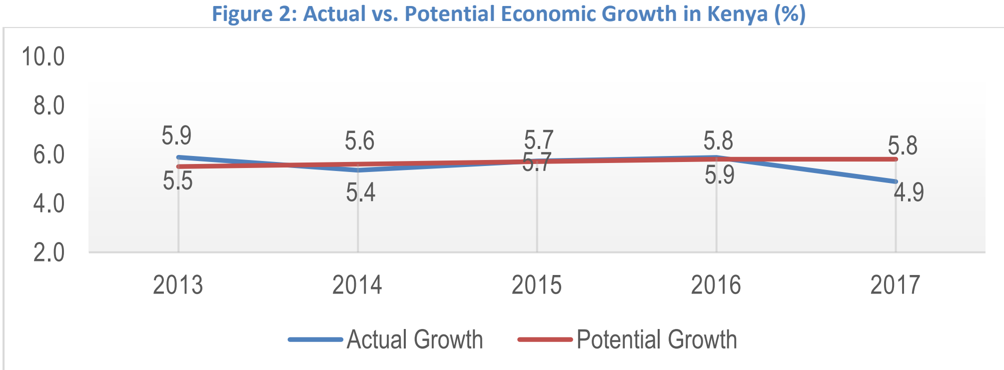
Chapter Two

Economic Growth, productivity and the invisible hand of cartels

Productive capacity and economic growth: Has economic performance peaked?

29. **Kenya's economic growth rate has averaged 5 – 6% over the past decade, implying challenges in the country's productive capacity.** In a 2018 study by the PBO, it was established that Kenya's potential output is at 5% on average which implies that the country's economic performance may have peaked in the past decade[4]**.** Actual economic growth has coalesced at approximately the same level as potential GDP (figure xx), and unless there is a significant change in policy direction and budget execution to scale up the country's productive capacity, it will be difficult for the economy to achieve a growth rate that is significantly higher than 6 %. It is worth noting that policy documents target a higher economic growth of 7 – 10%.

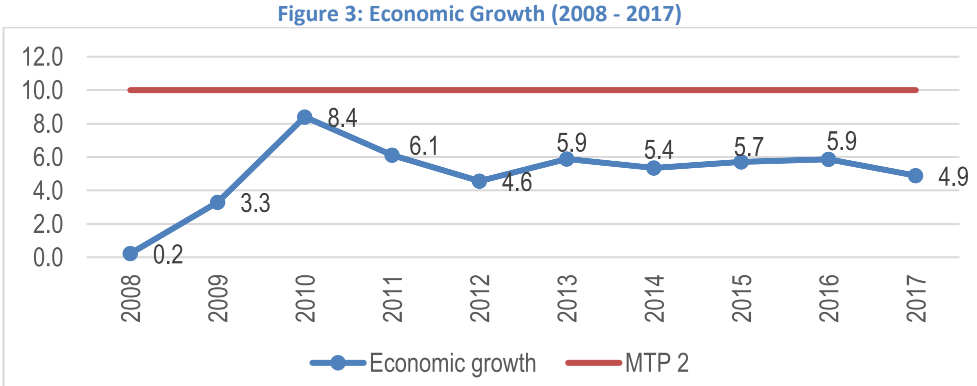
Figure 2: Actual vs. Potential Economic Growth in Kenya (%)



Source: KNBS, PBO

30. **In the past five years, there has been an average deviation of 12 percent between the actual and targeted growth (see Fig. 3).** This can partly be attributed to the 'business as usual' scenario that seems to be the fate of every budget in any given year. Each year, policy directives are made towards enhancing agricultural productivity as well as infrastructure among other sectors as the key drivers of economic growth but each year, the budget fails to adequately and convincingly execute these policy directives. As a result, the government spends, but the returns on investment are limited.

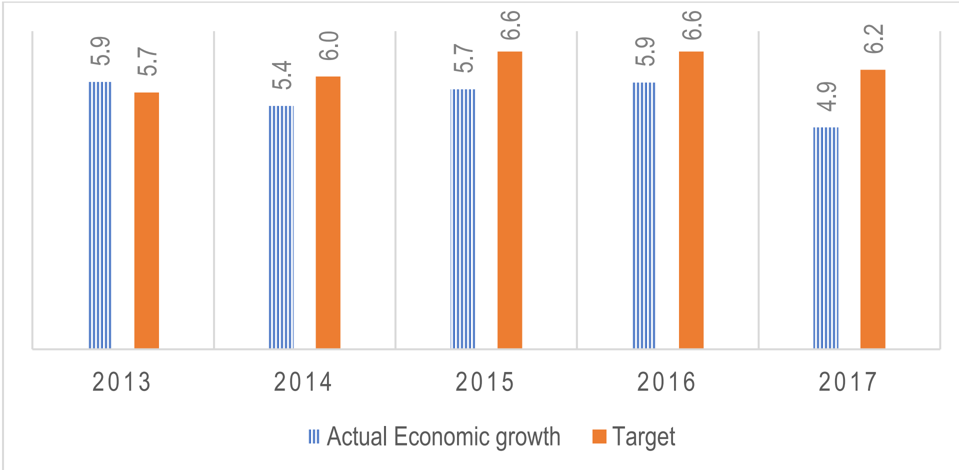
Figure 3: Economic Growth (2008 - 2017)



Source: KNBS

[4]Kenya Parliamentary Budget Office (2018), Budget Options for 2018-19 and the medium term "*Stimulating economic growth for prosperity*"

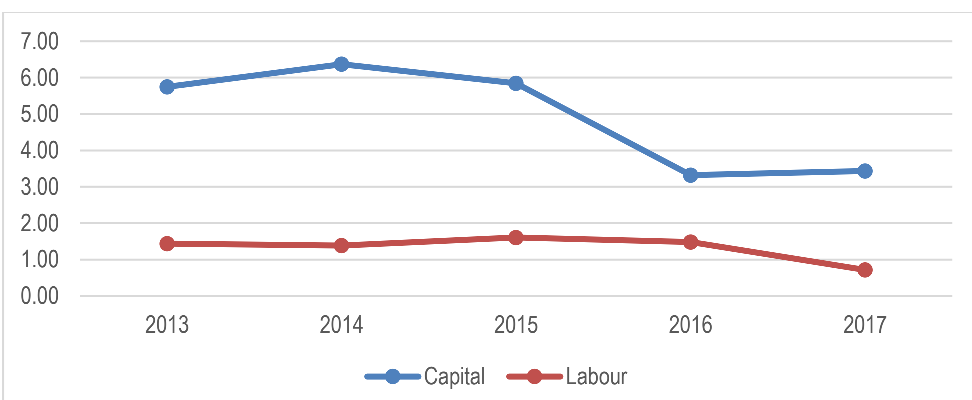
Figure 4: Actual vs. Target Economic Growth (2013 - 2017)



Source: KNBS, National Treasury

31. **Any measures to enhance economic growth and development must be geared towards enhancing the country's productive capacity.** This mostly calls for the reengineering of capital and labour, the main inputs of production, so as to enhance productivity. Low capital productivity can be attributed to low investment in contemporary, efficient production inputs such as industrial machinery, equipment and technology. On the other hand, low labour productivity is mostly due to poor skills-set of the labour force, lack of motivation as a result of the mismatched skills during job entry-level selection, inadequate on-job training, inadequate salaries especially for the middle-skilled workers and lack of adoption to technology as well as innovative ways of increasing efficiency in service delivery.

Figure 5: Contribution of Capital and Labour to Economic Growth (%)



Source: KNBS, PBO

Cartel-Economics and Productivity: who will bell the cat?

32. **Though the country's lacklustre economic performance is attributed to inefficiencies in supply and productivity of factor inputs; it can also be linked both directly and indirectly to the murky world of cartels.** They are everywhere; permeating almost every sector but are most notable in the Transport, Agriculture, Manufacturing, Education and Health sectors.

The tragedy of agricultural input subsidies

33. **The cartel stranglehold on the agriculture sector manifests itself even before the first seed is planted.** The government initiated the fertilizer subsidy programme in 2009 at a time when fertilizer prices had become cost prohibitive. The idea behind the fertilizer subsidy programme was to assist impoverished farmers to be able to access fertilizers at affordable prices in order to promote fertilizer use and boost agricultural output. To obtain the subsidized fertilizer, farmers are vetted and registered by the subsidy fertilizer vetting committee in their local areas. The farmers then submit approved forms indicating amount of fertilizer required based on land size to the distributing agency where the fertilizer is paid for and collected.

34. **As a result of infiltration by cartels, this well meaning government policy is far from achieving its intended target and is in fact being blamed for impoverishing poor farmers even further.** Anecdotal evidence indicates that shadowy cartels, which may also include some wealthy farmers, obtain the fertilizer in bulk from the National Cereals and Produce Board (NCPB) thereby creating an artificial fertilizer shortage in the market as they assume the position of fertilizer suppliers. The fertilizer is then re-packaged and sold at almost double the subsidized price in the retail market. It is reported that subsidized fertilizer is sold at Ksh. 1500 per 50 kg bag but can fetch as much as Ksh. 3000 in the retail market. There have also been reports of the fertilizer being adulterated in order to increase quantity. As such, the poor farmers do not benefit from a lower price and are in fact exploited and likely to end up using substandard adulterated fertilizer which is damaging to their crop production. In its Kenya Economic Update of 2018, the World Bank reported that the fertilizer subsidy programme was not only costly but also disproportionately benefited the large and medium scale farmers at the expense of the small scale farmers thereby impoverishing them.

35. **Equally, the distribution of certified seeds appears to be shrouded in mystery and is typically delayed; a factor that disadvantages the farmer as it may delay planting.** It has also been reported that the certified seeds may also be adulterated since the quality assurance measures applied are not very stringent. Indeed in early 2018, it was reported that the Kenya Plant Health Inspectorate (KEPHIS) had uncovered a scheme whereby tonnes of uncertified seeds were being sold by a major seed company to unsuspecting farmers. Uncertified seeds generally do not germinate and if they do, the produce is of poor quality. This compromises the country's food and nutrition security.

The tragedy of agricultural output storage, marketing and distribution

36. **Lack of clarity over maize prices in Kenya, often leaves farmers vulnerable and the country food insecure.** Many times, maize farmers and the government fail to agree on the best price for the produce and this exposes farmers to significant losses as their grain is left to rot. Low prices are sometimes engineered by well off farmers exploiting economies of scale and benefiting from subsidy programmes that were not targeting them to begin with. The country's grain storage facilities are also questionable as there have been one too many incidences of the country losing precious grain storage on account of contamination by *aflatoxins.* Such wastage raises pertinent questions on the maintenance of NCPB silos as well as the likelihood of an artificial grain shortage being engineered in order to facilitate importation for exorbitant profits. Indeed, grain importation has sometimes reportedly occurred even when farmers still have produce to sell which forces them to lower their prices, sometimes below production costs – a factor that renders agriculture unattractive as an income generating activity.

37. **Importation is not only limited to grains but has also adversely affected the livestock sector.** In 2018, there was a furore by the Kenyan pastoralists on account of livestock being imported from Tanzania which was being sold at cheaper prices forcing Kenyan pastoralists to sell theirs at lower prices. In reviewing the situation critically, it is apparent that cattle from Tanzania are generally healthier than those within the country probably due to availability of pasture and better grazing lands in Tanzania. The focus then should be on how we can improve the health of our livestock at the lowest cost possible so that they can effectively compete with their Tanzanian counterparts. Government policy on agricultural land zoning would have gone a long way in alleviating this challenge.

38. **The middleman has captured the agriculture value chain process and is literally reaping where he has not sowed.** Middlemen deal with inefficiencies in the market and provide storage for most small scale farmers who are often ill equipped for post harvest handling. The farmers are forced to dispose their produce at a throwaway price and the middlemen re-sell at a much higher price, reaping profits that the farmer can only dream of. It is reported the middlemen set the prices of commodities and have captured the market such that any farmers who attempt to venture beyond the control of the middlemen are promptly ostracized from the market. This is very discouraging and indeed ruinous for any farmer trying to earn living from agriculture.

Cartels in Health

39. **Cartels in the Health Sector mainly operate in the sale and distribution of drugs.** Unscrupulous businessmen have infiltrated the health care system and have succeeded in diverting medicine meant for use in government hospitals to their privately owned chemists, many of which could be unregistered. Though these cartels are faceless, their power and influence has

negatively affected the provision of quality and affordable healthcare through their effort to control the supply of medicine in terms of the quantity and quality and determine the prices of the medicine in the market. The stolen medicine is typically sold to other hospitals as well as individuals for profit and remains unavailable at the government hospitals, compromising health service delivery especially for those who cannot afford private hospitals or even to purchase the drugs. As recently as February 2019, the County Government of Machakos reportedly unearthed a syndicate that was stealing county medical supplies in collusion with government officials and selling them to private hospitals, clinics and laboratories. Universal Health coverage cannot be achieved unless all government hospitals are adequately supplied with medicine among other medical facilities.

Cartels in Education

40. **Cartels in the Education Sector are mainly concentrated in book supplies as well as the national exams.** The credibility of the national exams especially the Kenya Certificate of Secondary Education (KCSE) has been marred by the sale of counterfeit exam papers orchestrated by a network of head teachers, teachers, students, parents, invigilators, and even security officers involved in the national examinations. In 2018, the Kenya National Examination Council (KNEC) reported that there was a breakthrough in the war against cartels that compromise the credibility of national tests. It remains to be seen whether exam cheating will continue to be rife given the stringent measures introduced by government.

41. **A book supply racket has adversely affected distribution of books in schools.** Cartels control the publishing and sale of school text books leading to either oversupply or poor distribution of books. It is reported that sometimes, textbooks are not delivered on time by the contracted publishers or if they are, they do not serve the needs of the public schools. This forces parents to buy the required textbooks. For those who cannot afford, the quality of education for their children is adversely affected. In 2017, the government introduced a *one text book per subject* policy and committed to supplying the free text books directly to schools. However, it is has been alleged that schools are now being inundated with books that they do not really need leading to massive wastage.

42. **The impact of these cartels on the economy is that they demoralize producers/ suppliers, compromise quality of output and dis-incentivize investment thereby killing productivity and innovation.** Not unless the cartels menace is decisively dealt with, it will continue to stagnate economic growth and development despite any major policies and budgetary allocations the government may put in place to enhance the living standard of Kenyans. The pertinent question remains; “who will bell the cat?”

Policy Options:

i. Reengineering of capital and Labour:

Productivity should be the centre point for the formulation of all government policies. As indicated in the previous Budget Options 2018, Institutions such as the National Productivity Centre whose outputs ultimately center on improving the country's productivity should account for their resource allocation through tangible verifiable outputs that are geared towards enhancing the country's productive capacity or be done away with. It is high time that institutions such as NACOSTI, KARI, KEFRI and Kenya Numerical Machining Complex among others are held to account in terms of innovation and adoption of advanced methods of production. Going forward, resource allocation to all research and innovation institutions should be pegged on productivity and specific outputs.

Labour productivity can also be improved by realigning the education system in a way that encourages innovation, entrepreneurship and technical skills. This is applicable from the primary schools to tertiary institutions of learning. Many industries have indicated that the education provided to graduates is not necessarily fit for purpose and as such, they have to be re-trained after being hired or expatriates hired to do the work. This indicates a significant gap in our education system.

Enhancing labour productivity will also require investment in latest technology (machinery and equipment) that can enhance the output of workers.

Addressing the prevailing challenges in the business environment that increase our cost of doing business will also attract Foreign Direct Investment which may attract more capital in the country.

ii. provision of requisite infrastructure:

Cartels typically exploit inefficiencies in the value chain process that make it difficult for the market to operate effectively. In Agriculture for instance, the cartels menace can partly be addressed by equipping the farmers better for post harvest handling such as through setting up community run food storage facilities and other equipment. This may serve to protect the farmer from having to sell his produce to the middleman at a throw away price or risk losing his harvest.

Bringing markets closer to the people as well as addressing transportation bottlenecks may also protect the consumer from having to rely on the middleman. Poor access to markets is a well known factor that exposes farmers to exploitation by middlemen. Removing the middleman from the equation may bring food prices downwards.

iii. Legislation:

There is urgent need for the formulation of a stand-alone regulatory law specifically for cartels identifiable in all sectors of the economy. The law should be seamless in that it provides for definition of cartels, identification, investigation and prosecution of cartels.

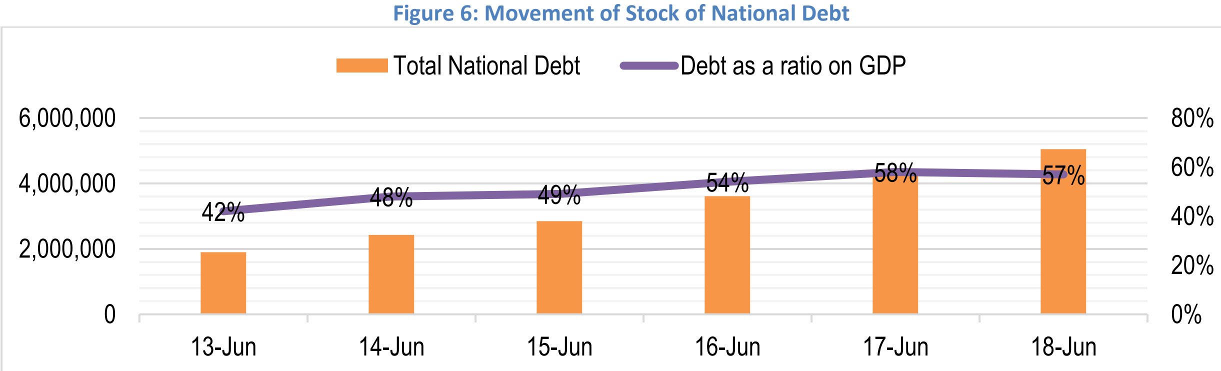
The warehouse receipt system bill 2018 which has been in Parliament since 2015 and is yet to be passed was meant to provide a legal framework for the country to develop a warehouse receipt system that would enable it to address marketing challenges in the cereals and grains subsectors including establishment of modern warehouses that can preserve grain for a maximum of three years without yellowing. Indeed, it is reported that there are investors ready to assist in setting up these modern warehouses but delay in enactment of the bill into law has placed the entire project in abeyance.

Chapter Three

Addressing Debt Vulnerabilities

43. **Kenya's debt vulnerabilities are expected to continue to persist into the medium term and will therefore require careful debt management and strict application of debt management strategies.** These debt vulnerabilities will arise due to increased exposure to solvency and liquidity[5] uncertainties and the underlying risks to the medium term growth outlook. The stock of Kenya's debt had reached Ksh. 5.6 trillion by the end of September 2018[6] and without any policy intervention, it is projected to approach Ksh. 6.5 trillion at the end of 2019. This will put the entire fiscal framework at risk due to rising cost of Debt Service Payments that will amount to Ksh. 775.6 billion in FY 2018/19 (and projected to remain above Ksh. 800 billion in the Medium Term).

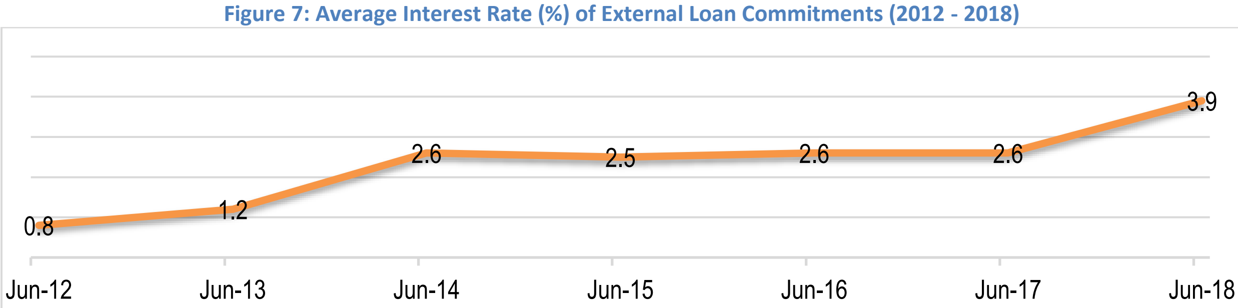
Figure 6: Movement of Stock of National Debt



Source: Annual Public Debt Management Report, 2018

44. **The growth in Kenya's debt over the years has been on account of little improvement in the budget primary deficit, increase in debt service payments, yearly revenue shortfalls and weak commitment to fiscal consolidation over the medium term.** As a result, the fiscal space has shrunk considerably, bringing commercial financing to the core of budget support financing. Currently, the stock of commercial debt accounts for 34% (Ksh. 898 billion) of the Ksh. 2.6 trillion external debt stock, with an almost equal weight to Bilateral and Multilateral Debt. The consequence of this trend has been large debt service payments and rising average interest rate of the external debt portfolio[7].

Figure 7: Average Interest Rate (%) of External Loan Commitments (2012 - 2018)



Source: Annual Public Debt Management Report, 2018

[5]Solvency risks refers to ability to meet long term obligations and looks at conditions such as future fiscal surpluses, stabilizing or falling debt ratios etc., while liquidity risks is the challenging distribution of ordinary revenue across competing expenditure needs, when debt servicing costscould account for between 35% to 40% of ordinary revenues in FY 2019/20

[6]2018 Budget Review and Outlook Paper

[7]This could worsen the Debt to GDP ratio if it raises the average interest rate of overall debt portfolio abovethe GDP growth rate.

45. **On the other hand, bilateral and multilateral debt is continually faced with challenges related to efficiency of acquisition and utilization** as is indicated through quarterly reports on loans and grants. A review of these reports indicate that from the pool of contracted loans, only a fraction of concessional (including semi concessional) debt agreements are ever disbursed within the required timelines (probable consequence of not meeting contractual terms within the agreed time limits). The resultant effect is the continuous costs on commitment fees annually i.e. Ksh. 3.1 billion and Ksh. 1.75 billion in FY 2017/18 and 2018/19. This reflects a costly resource acquisition process that also puts the respective projects at risk of late completion and reduces the role of non commercial debt in economic growth.

Challenges to development of the Medium Term Debt Management strategy

46. **Uncertainties related to the fiscal framework will be the major challenge to the development of a comprehensive debt management strategy for the medium term.** These uncertainties range from over estimation of revenues and/or under estimation of expenditures resulting in deviations of the primary deficit which affects the financing policy for the medium term. In addition, the end of year deficit finance policy usually deviates from the cost effective borrowing program determined under the medium term debt strategy. The resultant effect is the accumulation of debt in a manner that does not capture the anticipated debt pricing, destabilizes the domestic financial markets, and exposes the country to refinancing and exchange rate risks.

Table 3: MTDS Net Financing versus Budget (In percent)

	External			Domestic		
	MTDS	**Budget**	***Deviation***	**MTDS**	**Budget**	***Deviation***
2013/14	40	68	*28*	60	32	*-28*
2014/15	45	64	*19*	55	36	*-19*
2015/16	45	61	*16*	55	39	*-16*
2016/17	60	57	*-3*	40	43	*3*

Source: MTDS, 2018/19

47. **Debt sustainability concerns in the medium term arising from a risk of debt distress have been raised from low to moderate as a result of the breaching of three external debt indicators i.e. external debt to exports ratio[8], external debt service to revenue ratio and PV of external debt to export ratio[9].** The Present Value of public Debt to GDP ratio peeked in 2018/19 (60.6 percent against a threshold of 74%) and is expected to remain high up to 2020. Despite the availability of these thresholds, their enforceability may be a challenge due to non-alignment of thresholds locally and internationally; that is, while the IMF threshold is in *Present*

[8]Breached as a result of bullet Eurobond payments
9 IMF Staff Report, 2018

Value terms, the limit under the Public Finance Management Act Regulations debt is 50 percent of GDP in *Net Present Value terms*[10].

Table 4: Public Sector Debt Sustainability Ratios

Indicator	Threshold	2016	2017	2018	2019	2020	2021	2022	2027	2037
PV of Public Sector Debt	IMF - 74% (PFM - 50%)	50.6	55.4	60.6	59.9	56.9	54.3	53.1	47.1	41
PV of public Sector Debt to Revenue	300	275.9	285	299.6	292.9	282.1	269.7	261.5	226	189.6
Debt Service to Revenue Ratio	30%	36.3	42.7	44.8	49.4	49.3	48.9	37.6	33.1	24.5
Debt Stabilizing Primary Balance		*3.1*	*0.1*	*-2.7*	*0.8*	*2.5*	*2.2*	*1.1*	*1.5*	*2.2*

Source: IMF, 2018

48. **The general consequence of rising public debt is that it requires an extremely low debt stabilizing primary balance[11] to remain nearly constant.** For instance, in 2018, the country would require a budget surplus and in 2019 only a marginal deficit of 0.8% of GDP. In the past, in order to achieve this, a lot of emphasis has been put on raising national revenue despite the fact that revenue alone cannot be expected to achieve this level of fiscal consolidation. Even changes to expenditure have to be gradual in order to avoid adverse effects on aggregate demand or real GDP growth that would exacerbate the Debt / GDP ratio. This will therefore require a concerted effort of fiscal consolidation (both expenditure and revenue enhancement), high levels of expenditure efficiency, stable real economic growth rate and also aligning fiscal rules to debt servicing.

49. **Contingent liabilities also remain risky to the country's debt management strategy.** These primarily comprise of guaranteed debt which is a provision of Kenya's public finance framework underpinned by the Constitution. As of FY 2018/19 the stock of debt guarantees remained at Ksh. 138.8 billion and a total of Ksh. 1.42 billion had been incurred as called up guarantee[12]. The weakness of the current debt guarantee framework is that it is capped at a ceiling of Ksh. 200 billion (National Assembly resolution, June 2011) and is therefore non-responsive to movements of both GDP and National debt stock growth.

10PFM Act Regulation 26(1)(c) and is derived from the EACs' Convergence criteria i.e. headline inflation of no more than 8%; fiscal deficit, including grants of no more than 3% of GDP; gross public debt of no more than 50% of GDP in Net Present Value terms; and maintenance of official foreign reserves of at 4.5 months of imports

11Primary balance required for debt is to be sustainable

12 For guarantees, East Africa Portland Cement, the Tana &Athi-River Development Authority and Kenya Broadcasting Corporation.

Medium Term Debt Management Options

Scenario 1: This will involve; a) Enhancing the role of Debt Strategy, b) Fiscal Consolidation, c) focus on Debt Sustainability Ratios and d) Aggressive Debt Reorganization

a. Role of the Medium Term Debt Management Strategy

This involves addressing weaknesses of the annual debt management strategy and the need to bring debt management to the core of fiscal policy due to rising debt related costs, make the fiscal position resilient to shocks and avoid the risk of tax rate adjustments or cuts to government programs. As currently designed, the MTDS provides policies which are geared towards designing a cost effective budget financing framework. This entails a borrowing framework of 38% external borrowing and 62% domestic borrowing to finance the national budget deficit with issuance of Domestic borrowing to largely depend on long term instruments i.e. medium term to long term Treasury Bonds with Treasury bills issued for cash management. The diversification of debt in terms of currency and creditor is intended to hedge against exchange rate risk.

The policies indicated have greater effect on the flow of debt than the stock position of debt. The MTDS, in the medium term, should be key in designing the fiscal consolidation path, determining debt reorganization and prescribing debt stabilization measures in order to address debt stock challenges.

b. Fiscal Consolidation

Fiscal consolidation within this period should be guided by the 3% fiscal deficit / GDP ratio EAC convergence criteria to make it enforceable as the annual maximum fiscal deficit. To achieve this therefore, the overall target for the country should be a stabilizing primary balance of 0.8% for 2019 if debt sustainability is to be achieved. Furthermore, a target of a budget surplus is required beyond the long-term time horizon in order to allow the stock of national debt to reduce organically and avoid effects of fiscal consolidation on aggregate demand in the short run which could also degrade the debt ratios.

c. Focus on Debt Sustainability Ratios

The PV of public sector debt to GDP ratio has breached the PFM Act Regulations 2012 (50% of GDP in NPV terms). In order to bring this ratio within prescribed limits, it will require a minimum constant economic growth rate of over 10 %(ceteris paribus) and an active drive to reduce the fiscal deficit below the 3% convergence criteria target.

The debt service to revenue ratio will also likely remain in breach up to 2037 with the worst periods being between 2019 and 2022. This points to a period of liquidity constraints and diminished role of revenue mobilization measures on reducing the fiscal deficit. While a reducing fiscal deficit can minimize accumulation of debt and slow down debt repayments, debt reorganization will have to be undertaken in a more aggressive manner in order to bring the indicator back to a range of 3% (+/-) of the threshold (30%), in the medium term.

d. Debt Reorganization

Debt reorganization involves rearrangement of debt or debt terms in order to provide some relief to the debtor. Currently, due to liquidity constraints the country has been undertaking debt reorganization in the form of debt refinancing i.e. replacement of existing debt with new debt instruments with favourable terms. Other forms of debt reorganization include debt rescheduling, conversion prepayment etc. While debt conversion can be a useful tool in controlling debt repayment, there are concerns on the need to protect the countries assets from foreign government ownership and control. Applicability of this tool should undergo Parliamentary approval before being activated. While debt refinancing is ongoing, albeit in a limited manner, it should be carried out alongside debt prepayment with a primary focus on reducing commercial debt by over 70% in order to avoid a debt trap.

Scenario 2: Business as Usual scenario

This scenario anticipates no change in fiscal policy and therefore debt vulnerabilities are neither acknowledged fully nor addressed adequately.

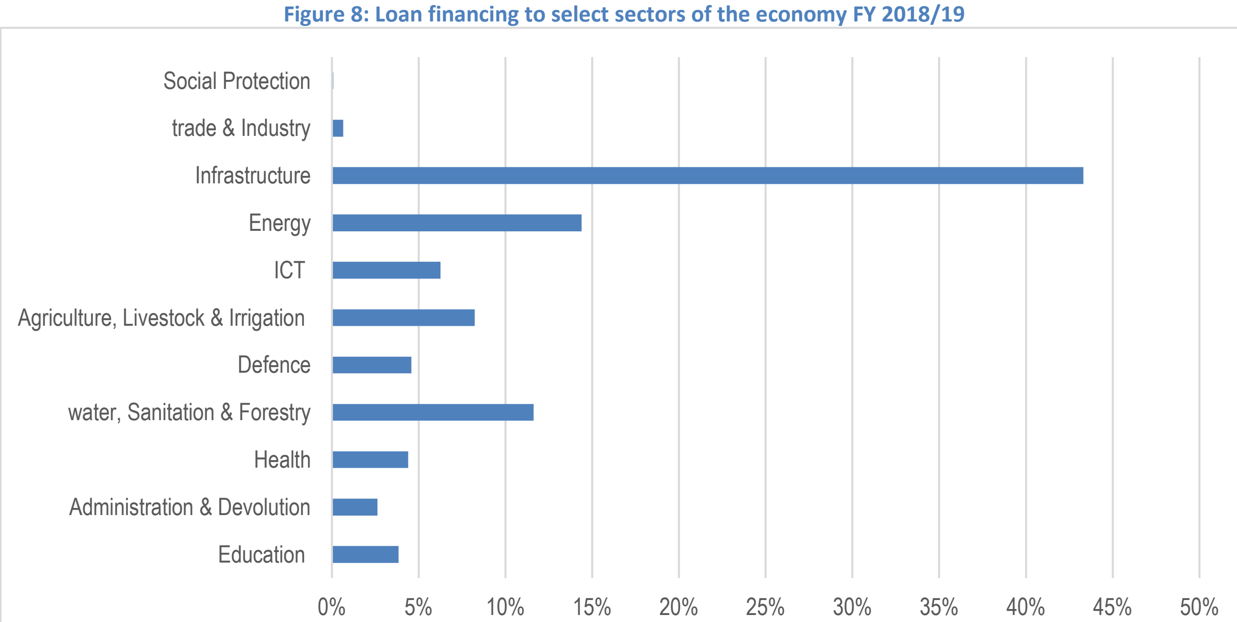
Box 1: Debt Financing: Good or Bad?

It is expected that the Expansionary fiscal policy of fiscal policy of choice in the medium term given the drive to achieve the critical development targets and complete ongoing capital investments. Therefore, unless private sector investment is enhanced, debt is expected to be critical (despite the fact that fiscal consolidation should take precedence)as revenue generated is not expected to be sufficient to match the estimated required level of expenditures. When this is aligned by liquidity pressures arising from debt servicing costs, it leads to complication of fiscal policy that would see the need to what kind of debt finance is good or bad, in order to carefully plan debt acquisition in line with strategic government needs.

Furthermore, there is need for consolidation of data on debt accumulation and reporting in order to determine the historical effects of all debt financing and promote transparency. This will be critical in reviewing sectors where debt is accrued, types of assets that are debt financed and debt contribution to structural transformation that will result in equitable and sustainable rapid economic growth. This will also require project by project analysis which will highlight the efficiency and effective of debt finance in terms of the completion rate of debt financed projects, project capacity to support the economy's capacity to repay debt, audit queries etc.

Ordinary revenue however should take a greater role in financing of development budget in the medium term and any increment in revenue generation should be channelled to development financing. Whereas infrastructure and energy projects account for substantial foreign financing other projects in other sectors such as water and sanitation projects, administration and devolution etc.should otherwise be financed by revenues. This is because these projects rarely generate direct income related benefits that are substantial enough to repay the amounts of debt channelled to these projects.

Figure 8: Loan financing to select sectors of the economy FY 2018/19



Source: 2018/19 Approved Budget Estimates

Chapter Four

Credit to the Private Sector and Economic Growth

50. **Micro, Small and Medium Enterprises (MSMEs) are the main drivers of the economy and a decline to supply of credit leads to GDP losses.** There are 7.41 million Micro, Small and Medium Enterprises (MSMEs). The MSMEs contribute about 28.4 percent of GDP, employing up to 14.9 million (KNBS, 2017). The Big Four Agenda has identified Manufacturing as one of the four pillars that the country will focus on in the next five years to 2022. The overall goal is to raise the sector's contribution to GDP from 9 percent to 15 percent. The Agenda explores the intention of creating 1,000 SMEs with a goal of creating 200,000 new jobs by 2022. For growth of Small Medium-Term Enterprises (SMEs) to be achieved, supply of credit is key. In 2015, a study was conducted to establish effects of funding source on growth of Small and Medium Enterprises (SMEs) in Kenya (Koech et al, 2015)[13]. The conclusion was that SMEs that get sufficient funding are able to increase employment, the number of branches, the inventory and the number of products.

51. **In Kenya, most of MSMEs are concentrated in three main sectors namely: Wholesale & Retail (60 Percent); Manufacturing (11.6 percent), Accommodation& Food Services Sector (9 percent).** Using private sector as a proxy for MSMEs, recent statistics indicate that the lending by commercial banks to private sector has declined to 17 percent in 2016 as compared to 23.4 percent in 2015 with small banks providing 39 percent of the total loans (KBA, 2016). The decline is mainly attributed to the interest capping law which has made commercial banks to become cautious lenders.

52. **Credit to the Private sector as percentage to GDP has declined significantly over the past four years, from 34.1 percent in 2014 to 30.9 percent in 2017.** The private sector plays a pivotal role to Kenya's GDP. The supply of credit to private sector by financial institutions ensures expansion of businesses, creation of employment and increased revenue for the government. A decline in credit to the private sector to GDP is likely to result in a dip in GDP.

53. **In 2017, the Central Bank of Kenya (CBK) conducted a survey and the findings indicated that 1.4 percent credit decline to MSMEs resulted in a loss of 0.4 percentage points of GDP (CBK, 2018).** These findings are similar to Were et al (2012)[14], where the research examined the effects of banking credit to different sectors of the economy. It was discovered that banks play a major role in providing and channelling funds from entities with surplus liquidity to those lacking thereby facilitating capital formation and trade. In addition, functioning credit systems alleviate financing constraints that impede credit expansion, and the growth of firms and industries. The conclusion was that private sector credit had a positive and significant impact on Kenya's GDP.

[13]Koech D. Oyugi L. A., Memba F. (2015) "Effects of Funding Source on Growth of Small and Medium Enterprises in Kenya: A Case Study of Juja Town, Kiambu County"Jomo Kenyatta University of Agriculture and Technology.
[14] Were, M., Nzomoi, J. and Rutto, N. (2012). "Assessing the Impact of Private Sector Credit on Economic Performance: Evidence from Sectoral Panel Data for Kenya" International Journal of Economics and Finance, 4(3).

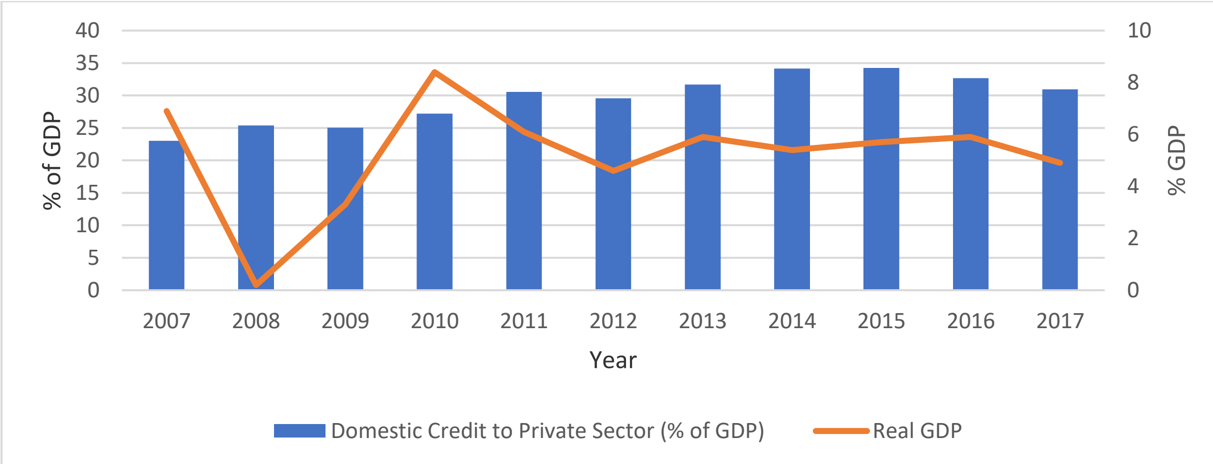
54. **As shown in the figure below, the highest GDP growth was experienced between 2008 and 2010 when credit to the private sector was steadily increasing.** When this dipped slightly in 2012, attributable to monetary policy tightening, decline in tourism as well as uncertainty in the run up to the 2013 general elections, GDP growth dipped from 6.1 percent in 2011 to 4.6 percent. In 2013, there was a notable improvement in credit access and this saw GDP rise to 5.9 percent.

55. **However, it's worth noting that despite a steady rise of credit to the private sector in 2013 to 2015, GDP growth dipped in 2014 to 5.4 percent before rebounding to 5.7 percent in 2015.** The dip in GDP was occasioned by other factors such as under performance of agriculture and tourism sector. Agriculture sector decline due to depressed rainfall and international arrivals declined by 11 percent to 1.35 million in 2014 compared to 1.51 million visitors in 2013 (KNBS, 2018).Tourism earnings declined by 7.3 percent to Sh87 billion in 2014 from Sh94 billion recorded in 2013 owing to adverse travel advisories due to terror attacks. In 2016, there was a slight decrease of private sector credit as a percentage of credit, this may have been occasioned by the enactment of the Banking (Amendment) Act, 2016. However, the economy was resilient being supported by increased activity in Agriculture, Tourism as well as increased Foreign Direct Investments (FDIs). International arrivals in 2016 increased to 1.3 million as compared to 1.2 million in 2015.Net foreign direct investment inflows rose from a surplus KSh 18.7 billion in 2015 to a surplus of KSh 42.9 billion in 2016 (KNBS, 2018). However, in 2017 credit to private sector declined further to 30.9 percent of GDP. Arguably, this may have contributed to the 1 percentage point dip in GDP to 4.9 percent in 2017.

56. **In 2017, the deceleration of credit to the private sector was occasioned by a series of shocks namely**; banks cutting back their lending to improve balance sheets as a result of a growing number of nonperforming loans. The ratio of gross non-performing loans to gross loans increased from 9.2 percent in December 2016 to 10.6 percent in December 2017 (CBK, 2018). This was attributed to a slowdown in business activities. This may have been occasioned by the uncertainty due to the run up of the general elections.

57. The enactment of the Banking (Amendment) Act 2016 complicated credit supply even further. The law ensured that any change to the Central Bank Rate (CBR) would directly affect the deposit and the lending rates. The lending rate for commercial banks was capped at four percent above the CBR while the deposit rate was capped at 70 percent above the CBR. As a result of the law, the banks tightened their credit to riskier lenders.

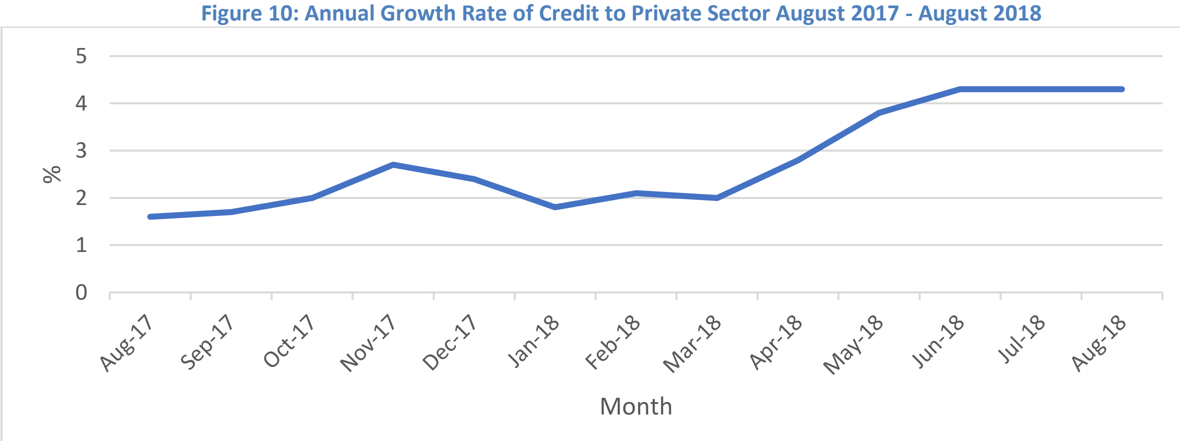
Figure 9: Credit to Private Sector (% of GDP) vs. Real GDP 2007 - 2017



Source, KNBS, World bank

58. **In 2018, the monetary policy easing cycle began.** The Central Bank Rate (CBR) which is the bench mark of all other interest rates was lowered in March 2018 from 10 percent to 9.5 percent and further to 9.0 percent in July 2018. However, despite this effort of lowering CBR so as to trigger uptake of credit, private sector credit has remained below 5 percent against the target of 8.8 percent (CBK, 2018).

Figure 10: Annual Growth Rate of Credit to Private Sector August 2017 - August 2018



Source: CBK

59. **Recent statistics indicate that the 12-month growth in credit to the private sector rose gradually to 4.3 percent in August 2018 from 2.4 percent in December 2017 (table 1).** The rise in credit may have been occasioned by improved economic activity as well as lowering of the Central Bank Rate (CBR) which is the bench mark of all interest rates in the market from 9.5 percent in March, 2018 to its current rate of 9.0 percent. According to the table below, Building & Construction, Manufacturing &Trade sectors recorded significant improvements of credit uptake. However, some sectors such as Transport, Communication and Agriculture, the private sector credit has remained subdued.

Table 5: Private Sector Credit to various sectors of the Economy

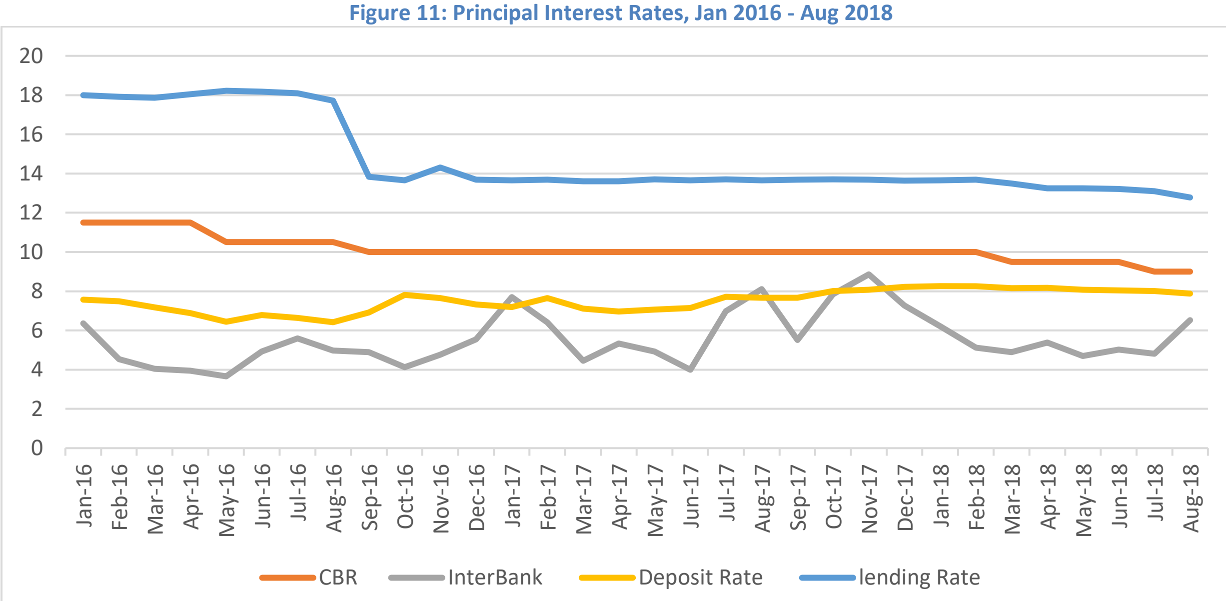
	Dec-17	Jan-18	Feb-18	Mar-18	Apr-18	May-18	Jun-18	Jul-18	Aug-18
Agriculture	-7.9	-7.9	-13.3	-6.5	-4.7	-3.6	-4.9	-6.7	-4.5
Manufacturing	13	12	13.1	11.3	10.1	12.2	12.3	11.6	13.3
Trade	9	5	6.8	5.4	5	6.8	8.6	6.5	7.0
Building & Construction	4.8	5.3	4.7	12.7	14.4	9.2	13.5	13.7	14.9
Transport & Communication	-7.2	-11.3	-14.4	-18.9	-18.2	-15.3	-13	-11	-11.3
Finance & Insurance	-4.3	-1.3	4.8	11.6	10.1	2.6	3.8	8.5	3.5
Real Estate	8.6	8.2	8.3	4.4	3.6	3.7	3.8	4.3	0.9
Mining and Quarrying	-5.5	-7.3	-7.3	-3.1	-4.9	-3.9	-9.5	0.1	-9.6
Private Households	-1.5	-1.5	-2.7	-0.7	2.6	3.8	2.9	2.9	2.7
Consumer Durables	0.6	1.4	2.3	4.7	5	5.5	7.8	9.1	11.5
Business Services	-9	-0.4	-0.8	-0.9	2.6	11.1	6.9	3.3	6.6
Other activities	-7.5	-12.5	-2.9	-7.3	-2.6	-8.6	-9.4	-7.1	-5.8
Credit to private sector	**2.4**	**1.8**	**2.1**	**2**	**2.8**	**3.8**	**4.3**	**4.3**	**4.3**

Source: CBK, 2018

Despite monetary policy easing in 2018, Credit to private sector is hindered by:

i. **Liquidity Challenges in the Market:** Tight liquidity in the market has raised the interbank rate, exposing smaller commercial banks to higher cost of borrowing in the overnight window. The weighted interbank rate ranged from an average of 6.37 percent in January 2016 to a peak average of 8.86 percent in November 2017. As at the end of August 2018, the Interbank rate stood at 6.52 percent

Figure 11: Principal Interest Rates, Jan 2016 - Aug 2018



Source: CBK

ii. Continued Uptake of Loans by Government:

At the beginning of the FY 2017/18, the total borrowing requirement to fill the deficit was Kshs. 535.5 billion, however due to the underperformance of revenue, the deficit was revised to Kshs. 627.3 billion (National Treasury, 2018). This resulted in increased domestic borrowing of Kshs. 273.6 billion against a target of Kshs. 248.7 billion. The increased borrowing resulted in uptake of Treasury Bills by banks.

In FY 2018/19, net domestic borrowing has been revised to Kshs. 317.1 billion against an initial target of Kshs. 268.7 billion. This therefore means that the government intends to borrow an additional Kshs. 48.4 billion in the domestic market. As government continues to borrow, commercial banks tend to shy away from lending the private sector as treasury bills are regarded 'risk free'.

Exploring Policy Proposals to Boost Private Sector Credit

i. **Business as Usual:** If the current situation remains, credit to private sector will continue to grow below target. However, the government will continue to access cheaper loans in the domestic market as banks will continue to shy away from lending to the private sector.

ii. **Credit guarantee schemes for SMEs**

Commercial banks consider SMEs as high-risk borrowers because they lack a track record and collateral. The provision of a guarantee for bank credit effectively substitutes for the collateral that is lacking. The costs associated with administering and monitoring credit services are quite high. The loan value required by people in this sector is low hence proportionally low revenue is generated from the loans. In case of default by the borrower, the lender recovers the value of the guarantee. Guarantees are usually provided against a fee, covered either by the borrower, the lender or both. In case of a default, the lender usually is obliged to proceed with the collection of the loan and share the proceeds with the guarantor. The government can establish a regulatory framework that encourages the establishment of such schemes in Kenya.

iii. **Settling pending bills as a first charge in the FY 2019/20 budget**

Latest statistics indicate that as at the end of FY 2017/18, pending bills stood at Kshs. 29.3 billion for the National Government and Kshs. 108.4 billion at County Level (National Treasury, 2018). The escalation of pending bills at the two levels of government may have been occasioned by underperformance of revenue as mentioned earlier, cashflow management problems and violation of laid down procurement rules, resulting to noon- payments.

That notwithstanding, lack of settling of pending bills on time affects businesses especially Small Medium Enterprises (SMEs) who are poorly capitalized resulting to cash crunch related problems. This also affects revenue collection for the government as most businesses affected by cash crunch tend to be insolvent. Therefore, payment of suppliers on time may increase economic activities thus increase money supply in the economy. This will also improve revenue collection for the government as well as improve liquidity in the market.

iv. Establish Data Bureaus for SMEs

The slow credit growth to SMEs is attributable to a number of factors including the limited information sharing about borrowers in the market and high overhead costs of administering such loans. Understanding movements within the SME sector can encourage banks to lend more since data is readily available. One way of streamlining definitions across public institutions and industry players would be for banks to collect information on the Single Business Permit (SBP).

The Single Business Permit is a license administered by county governments and renewed on an annual basis. It allocates a code to businesses depending on their sector, turnover and number of employees. The SBPs hold relevant information such as size range and specific sub- sectors in which firms operate. The validity of the data is checked by county assembly authorities and updated yearly. If banks collect this information consistently, comparable information about their customer base would be made available.

Assessing Impact of each Policy for FY 2019/20

Assessing the various policies highlighted above based on selected criteria such as Efficacy, Unintended consequences, cost, suitability and political feasibility.

	Policy Option	EFFICACY	UNINTENDED CONSEQUENCES	COST	SUSTAINABLE	POLITICAL FEASIBILITY
1	**Business as Usual**	Low economic growth and revenues for government.	-Lower GDP Levels - Increased Poverty Levels -Increased levels of unemployment.	No implementation Cost	Not sustainable	Feasible
2	**Credit guarantee schemes for SMEs**	Increase Export Earnings. Boost economic growth.	Increased cost of borrowing since there are additional fees	Additional infrastructure cost	Sustainable in the long-run	Feasible
3	**Settling pending bills as a first charge in the FY 2019/20 budget:**	Higher Economic growth and revenue collection.	Slower implementation of development projects by the government. Increased borrowing by government.	No implementation cost	Sustainable	Feasible

	Policy Option	EFFICACY	UNINTENDED CONSEQUENCES	COST	SUSTAINABLE	POLITICAL FEASIBILITY
4	**Favourable tax treatments for SMEs**	Higher Economic growth and revenue collection.	Low revenue collection Tax evasion	No implementation cost	Sustainable	Feasible
5.	**Establish Data Bureaus for SMEs**	Higher Economic growth and revenue collection.	Low revenue collection Low GDP levels and revenue collection	High implementation cost	Sustainable	Feasible

Going forward, the most feasible policies to boost private sector credit from the above assessment are:

iii. Credit guarantee schemes for SMEs

Commercial banks consider SMEs as high-risk borrowers because they lack a track record and collateral. The provision of a guarantee for bank credit effectively substitutes for the collateral that is lacking. The costs associated with administering and monitoring credit services are quite high. The loan value required by people in this sector is low hence proportionally low revenue is generated from the loans. In case of default by the borrower, the lender recovers the value of the guarantee. Guarantees are usually provided against a fee, covered either by the borrower, the lender or both. In case of a default, the lender usually is obliged to proceed with the collection of the loan and share the proceeds with the guarantor. The government can establish a regulatory framework that encourages the establishment of such schemes in Kenya.

iv. Settling pending bills as a first charge in the FY 2019/20 budget:

Payment of pending bills should be the first charge in the budget. Both the National Government and county governments owe more than Kshs. 130 billion to suppliers. If these resources are paid on time, there would be ample liquidity in the market hence driving down interest rates. In addition, it may lead to expansion of businesses. As businesses expand their will be increased levels of employment as well as increased revenue collection.

Box 2: Dealing with pending bills: a problem that has persisted

Pending bills can be a disaster in an economy and if not adequately dealt with it will remain a problem. This problem can be solved through a combination of the following strategies.:

a. Sealing the loopholes that lead to creation of pending bills by enforcing the PFM rules and regulations on commitment control

b. improving the credibility of the budget and minimizing in year adjustments to the approved budget

c. Instituting measures for commitment control

d. enhancing transparency in budget implementation by requiring every entity to publish the total pending bills on a quarterly basis

e. Developing a framework for assessment of the quantum of pending bills and a clear process of clearing them in a phased out programme.

Chapter Five

Stimulating the Big Four through expenditure prioritization

Expenditure allocations towards the Big Four Agenda

60. The government adopted the Big Four Plan in 2018. The plan aims at delivering economic transformation through focusing on four key strategic areas with targets set for five years as indicated below.

Table 6: Strategic Areas of Focus - The Big Four Agenda

Strategic Areas of Focus-The Big Four Agenda	
Key Strategic area	**Medium Term Target**
Health care	Providing universal health care hence guaranteeing quality and affordable healthcare to Kenyans by 2022.
Housing	Providing at least 500,000 affordable new houses to Kenyans by 2022
Manufacturing	Supporting value addition and raising manufacturing sector's share of GDP to 15% by 2022
Food Security	Expansion of food production and supply, reduction of food prices to ensure affordability in order to guarantee food security and improve nutrition

Source: *National Treasury*

61. In order to support the identified priority areas, the government has since 2018/19 allocated resources to both the Big Four key drivers and enablers to support the achievement of the set targets under each of the four areas. Enablers include investment or measures to improve the business climate (such as macroeconomic stability, national security), investment in infrastructure (such roads, railways, energy, sea ports) among others. The allocations to the enablers constitute a large portion of total expenditure allocation in the current financial year and medium term. Table 2 gives a summary of allocations to the Big Four in 2018/19 and 2019/20.

Table 7: Allocations to Big Four (Ksh. Millions)

Allocations to Big Four (Kshs Mlns)		
	2018/19	**2019/20***
Total **Sectoral Allocation** (A)	**1,750,208**	**1,822,801**
of which: Big Four related spending		
Food Nutrition and Security	13,818	16,400
Universal Health Coverage	21,361	22,761
Housing	4,500	3,000
Manufacturing	2,961	629
Total Big Four (B)	**42,640**	**42,790**
Proportion (%): A/B	*2.4*	*2.3*

Source: *National Treasury; *Projections*

62. According to the National Treasury, in 2018/19 financial year, the Big Four related expenditure amounted to Kshs 42.6 billion which is equivalent to 2.4% of the total sectoral allocations whereas in 2019/20 the proposed allocation is Kshs 42.8 Billion which is 2.3% of the 2019/20 sectoral allocations. It is notable that the proportion of spending could fall in 2019/20 which could slow down the delivery of the projects. Allocations for manufacturing dropped significantly, with the plan to allocate Ksh. 629 million to revive institutions such as RIVATEX, support the leather industrial parks, textile development and modernization of of the New KCC. Though the limited resources to manufacturing could be partly due to the fact that the government has limited direct investment in this sector, it does not account for the more than 100% contraction in planned spending. It can be inferred, from the allocations, that most of the growth and forecasted expansion in manufacturing will be private sector led, fueled by spending in the enablers.

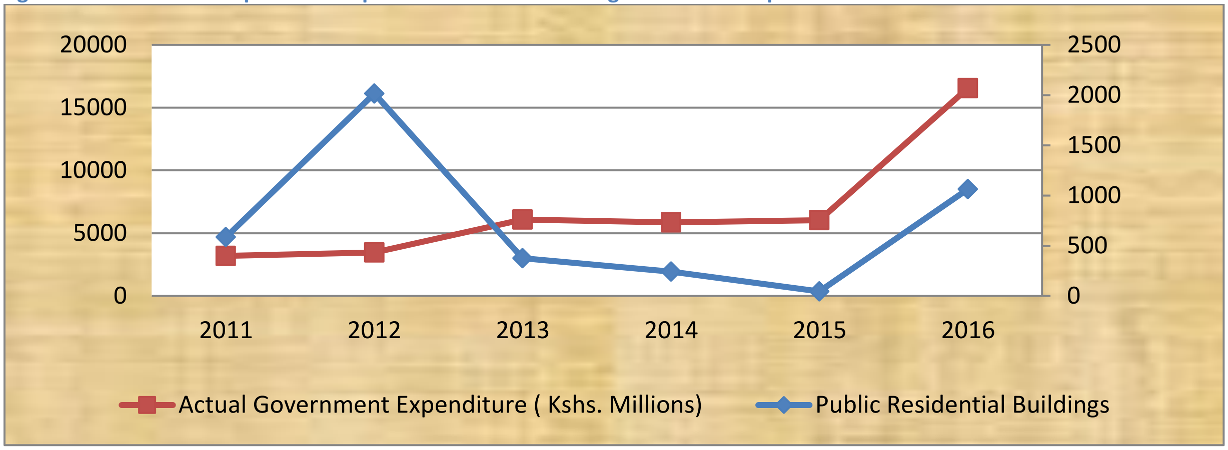
63. The spending outlined in Table 2 represents modest investment for delivery of the Big Four projects and does not represent a major shift in government's fiscal structure (spending) which remains fairly the same as prior to the announcement of the programme. For example, the structure of allocations to the enablers has not shifted or increased significantly to reflect the change in policy. This begs the question where the source of growth of manufacturing, for example, will come from if the government doesn't boost its direct involvement. The allocations for the four policies should be clearly identified, and isolated to allow for easy tracking, monitoring and evaluation. Additional resources to these four policies could imply a structural shift where certain sectors had been underfunded, but a strong delivery framework could efficiently achieve the planned policy targets. Additional policy proposals are explored below.

I. Providing Affordable and Decent Housing for all Kenyans

64. Figure 12 shows the trends in completed and reported new public residential buildings and actual government expenditure on housing for the period 2011- 2016. Provision of public residential building has been generally low with no predictable trend over the period, rising from 587 buildings in 2011 to 2,015 in 2012. Houses provided further fell to only 45 buildings in 2015 despite the actual expenditure not changing significantly in the period 2014 to 2015.

65. According to the State Department for Housing and Urban Development, the housing deficit in Kenya remains high with a shortage estimated at approximately two million homes. It is also estimated that more than 6.4 million Kenyans are currently living in slums due to unavailability of affordable housing. Low access to formal housing for the low-income segment of the population reflects limited supply of homes together with high cost of available homes. Major drivers of the affordability of houses are the cost of land, construction cost, and costly and tedious processes. These problems and cumbersome processes hinder both buyers and developers.

Figure 12: Trends in completed new public residential buildings and actual expenditure



Source: KNBS

66. The Affordable housing Programme in the “Big four” seeks to correct these problems. The Programme aims at delivering 500,000 affordable housing units to Kenyans by 2022. To deal with the cost and access to homes, the Programme will seek to reduce the cost of delivering affordable housing by unlocking serviced land, reduction in construction cost by 30% through value engineering and alternative building approaches, reduction in cost of building materials, streamlining processes and reducing financing costs for buyers and developers.

67. The Ministry of Transport, Public Works, and Housing and Urban Development estimates the capital expenditure for delivering the targeted number of units by 2022 at Kshs. 1.3 trillion translating to an annual construction cost of Kshs. 325 billion. To finance the Programme, the private sector will play a key role through Public Private Partnership (PPP), in addition the National Housing Development Fund will offer to buy completed houses as an undertaking to developers and then offer the houses to buyers through mortgages and tenant-purchase schemes. The source of resources for the Fund will comprise the recently the 1.5% employer and employee tax contribution to the fund which was approved through the Finance Act, 2018. The Kenya Mortgage Refinance Company (KMRC) was also established to make easier for banks and other financial institutions to access long term finances for housing loans.

68. Implementation of the Programme is not only beneficial to the prospective home owners but will have economic stimulus benefits through linkages with other sectors and industries in the economy. Among the four policy programmes, the Affordable Housing programme stands out due to its unequalled potential to trigger positive productive linkages in the economy through employment, skills transfer, and provision of building materials. The Programme will promote local industries through production and supply of building materials like cement, windows, doors, hinges, sand, nails and timber among others. This wills in turn stimulate job creation in the local industries due to the increased demand for their products in the construction industry. It can be expected that the programme could contribute significantly to economic growth, but with some upward pressure on prices of local building materials.

Policy Option: Complementary Financing framework

69. Provision of affordable and social housing is a capital intensive venture that requires long term support, prompting the need to diversify funding sources. In this regard, the government can consider issuing a well targeted Housing bond to help finance the affordable housing program. The government's successful introduction of infrastructure bond program in Kenya may raise hope that a Housing bond could as well become a success story. Infrastructure bonds have received exceptional support by market participants relative to ordinary Treasury bond mostly due to tax exemptions. If a Housing bond is designed with appropriate terms and if supported by credible implementation strategy for the housing plan, then it can easily serve as a robust way of financing this critical Big Four program. A good design of the bond is however essential for its success.

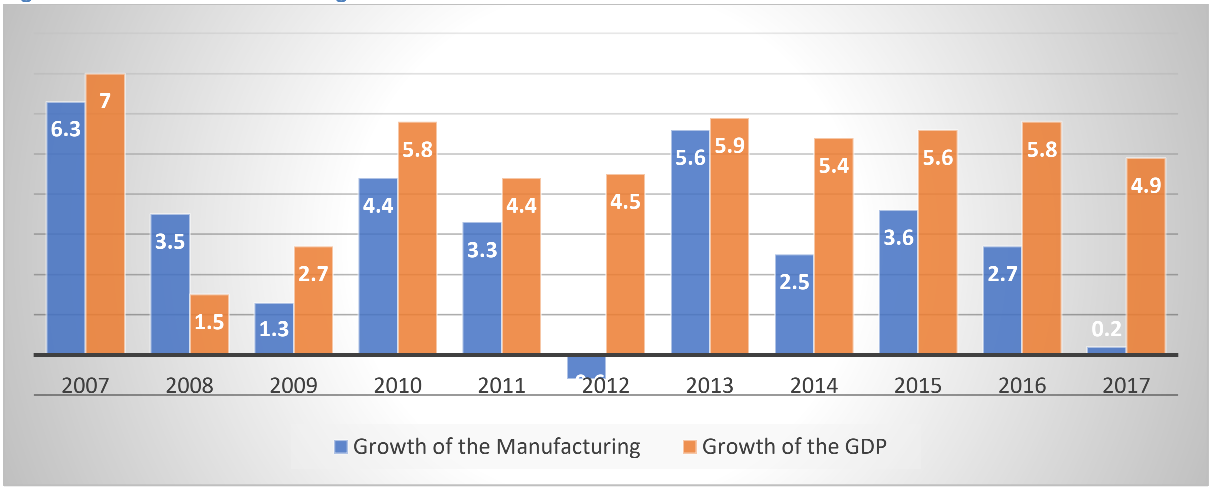
70. Essential attributes of such a Housing bond may require that the bond have a long tenor type of security, 20 to 30 years, with a fixed repayment and periodical amortization. The bond may be floated domestically or externally based on prevailing housing demand. Several bonds may be issued as would be necessary for the delivery of affordable housing. If the bond proceeds are quickly and efficiently delivered to the affordable housing program, the ensuing rental proceeds and interest from the mortgages can be used to build new houses or repay the bond. The rental income or mortgage interest may therefore serve as reliable long term income linked to the bond, which may allow easier securitization and trading in the capital markets.

II. Supporting Value Addition and Raising the Share of Manufacturing Sector to 15 % of GDP

71. The Vision 2030 aims to transform Kenya into an industrialized economy. Critical in the industrialization equation will be the manufacturing sector which the Government targets to raise its share in the GDP from 10 percent to 15 percent over the next four years. The sector holds the key to unlocking the potential of the economy by providing long term skills critical for job creation and sustainable economic development through its strong forward and backward linkages. The sector is also critical in improving the current account balance through exports of goods which are of a higher value compared to unprocessed commodities. While Kenya's manufacturing sector contributes mostly goods consumed domestically, raising manufacturing share in the GDP will ultimately raise the value of exports.

72. Kenya's Manufacturing sector also creates forward linkages by producing outputs which are further used in other sectors of the economy for further production including exports and promotes other sectors including the service industry. The backward linkages in the manufacturing sector can be seen in agriculture where it creates demand for inputs used in the manufacturing

Figure 13: GDP and Manufacturing Growth



73. Despite the benefits which accrue from the sector, the performance of manufacturing sector has been lackluster (See Figure II). While the Export Processing Zones have been partly successful and robust as a result of the AGOA scheme, there has been limited expansion of EPZs on account of adverse local business environment where power tariffs have remained high making the average cost of production to be high.

74. An over view of the performance of the sector reveals that it has been growing at a slower rat than the rate of the GDP over time and therefore, its contribution to the GDP therefore has been minimal. According to the Kenya National Bureau of Statistics, the sector's contribution to the GDP over the last five years has been on the decline. For instance, in 2013 the sector's contribution was 10.7 percent of the GDP which declined progressively to 8.4 percent by 2017. Over the same period, the sectors real value only increased by a marginal 0.2 percent in 2017 compared a growth of 5.6 percent in 2013.

75. The funding by the government has not made any significant change to the dwindling fortunes of the sector. The critical projects that are meant to spur its growth such Kenanie Leather Industrial Park, Modernization of Rivatex, Athi River Textile Hub are underfunded and are far way behind their scheduled completion dates (PBO, 2018). The Kenanie Leather industrial park for example is only 12 percent complete with the targeted date of completion of 2021. Similarly, the Modernization of Rivatex that was scheduled for completion in 2019 is only 45 percent complete. The slow rate of completion of these projects has been exacerbated by budget cuts during approval of the supplementary estimates. According to the Report of the Budget and Appropriations Committee on Consideration of Estimates of Expenditure for 2018/19, the sector's budget was cut by KSh. 6 billion.

76. According to Kenya Economic Report 2017, the manufacturing sector is majorly denominated by small and micro a enterprise which constitutes 80 percent of all the firms but only account for 20 percent of the manufacturing output. The SMEs have limited access to finance and despite the market access offered through preferential trade regimes such as AGOA, EPA, EAC-COMESA-SADC tripartite among others, the SMEs have limited capacity to produce for such markets.

77. For the manufacturing industry to be sustainable and contribute significantly to the GDP, there will be need to ensure that the SMEs are supported through business incubation programmes to enable them develop the necessary capacity to produce not only quality products but enable them access markets with preferential access.

78. While addressing business environment to reduce the cost of production, accelerating the Special Economic Zones programmes by the Ministry in charge of Industrialization will be critical to ensure that the areas in SEZs are identified to house incubation centers for such SMEs.

Options

- Restore the KSh. 6 billion that was cut during the 2018/19 estimates to facilitate the completion of the key projects in the sector
- To ensure that the objective of the contribution of the sector in economic growth as envisaged in the agenda, there is need to give incentives for setting up assembly plants in Kenya. The incentives may include:
    - i.) Giving subsidies on electricity, land, tax incentives for critical components which cannot be sourced from Kenya
    - ii.) Support to incubation programmes to facilitate the production of quality standardized products for export growth

79. The need for a responsive and well-functioning education and health care system has been given priority by the government in the recent years. This is because education plays a role in supplying of requisite skills to support social economic transformation. Similarly, an efficient and high quality healthcare system is a pre-requisite for accelerated economic development since it enabler for participation in productive activities.

80. Thus, the policy thrust by the government in the two sectors which is also in line with the sustainable development goals is the provision of Universal Basic Education and Universal healthcare. To support this, there has been significant financial investment through yearly budgetary allocations to these two sectors. The yearly budget allocation has almost doubled in the last six years from Kshs 289.4 Billion in 2013/14 to Kshs 529.3 Billion in 2018/19.

III. Provision of Universal Health Care

81. The Health sector has been identified as one of the big four agenda of the government and this illustrates the importance of this sector. It is envisaged that in the next five years, 51.5 million

Kenyans will have access to universal healthcare. This means that the government targets to offer health cover to the whole population by 2022.

82. The key supportive initiatives to support UHC envisaged by the government and are: establishment of ten referral hospitals, establishment of four new comprehensive cancer centres, establishment of a centre of excellence for kidney health as well as equipping twenty one more hospitals with specialized equipment. Some of these supportive projects are yet to begin, for instance, the establishment of additional ten (10) referral hospitals.

83. In order to support the UHC agenda the following are the budget options:

- **Address the resource gaps-** In the 2018/19 and medium term, the estimated resource requirement for the health sector is Kshs 374.6 billion. Given the 2018/19 budget allocation and the fact that some of the supportive projects such as construction of referral hospitals and the rollout of UHC across the entire country are yet to take shape, the sector has resource gaps which need to be addressed. As an option, Kshs 3 Billion be set aside in 2019/2020 to start the process of establishing of at least one additional referral hospital.
- **Efficiency in resource use-**The government has in the past rolled out various social programs through resource allocation such as Insurance for the elderly and the poor (indigents) and the Linda mama programme as wells as scrapping of user fees in health facilities, which were essentially the initial steps towards the UHC goal. If these social programs continue to exist independently of the UHC program, there are chances of duplicity thus creating inefficiencies in utilization of resources. Thus, as the government begins the pilot programme and subsequent roll out across the country, there is need to consolidate these initiatives into the overall UHC.

IV. Education

84. The education sector on the other hand is considered one of the enablers of the Big Four Agenda for the government. It is expected that through a well-functioning education system, the various sectors of the economy will benefit through provision of requisite and missing skills. The government has extended support to all levels of education especially through budget allocations and the sector is one of the big spenders. For instance, in this current financial year, the sector has a budget of Kshs 439.1 Billion, which places it in second in terms of sectoral resource allocation. However, the sector still faces a number of challenges, which if not addressed may continue to pose threats and affect education outcomes. The following are the medium term options to support this sector as an enabler of the big four agenda and to ensure that the resources allocated are well utilized:

- Support to the full roll out of the Competency Based Curriculum (CBC) - The CBC is designed to address the skills gaps in the economy and is expected to play a key role in the big four agenda delivery. The rollout of CBC has faced a number of challenges among them lack of well-prepared teaching resources as well as learning resources such as textbooks.

- Infrastructural support to primary and secondary schools - Most institutions of basic education continue to face infrastructural challenges which affect the quality of education being offered in these institutions. As the 100% transition policy takes shape, the various learning institutions need to be supported to guarantee quality education to learners.
- Continued austerity measures - Available data indicates that the allocation to non-core areas of spending in this sector has reduced from 3.5 % of the total recurrent expenditure in 2015/16 to 2.1 % in 2018/19. There is need for a sustained austerity measures especially in the non-core areas of spending. Thus, the 2018/19 budget for the one-core areas of spending be retained in 2019/20 and over the medium term to reduce expenditure pressures.

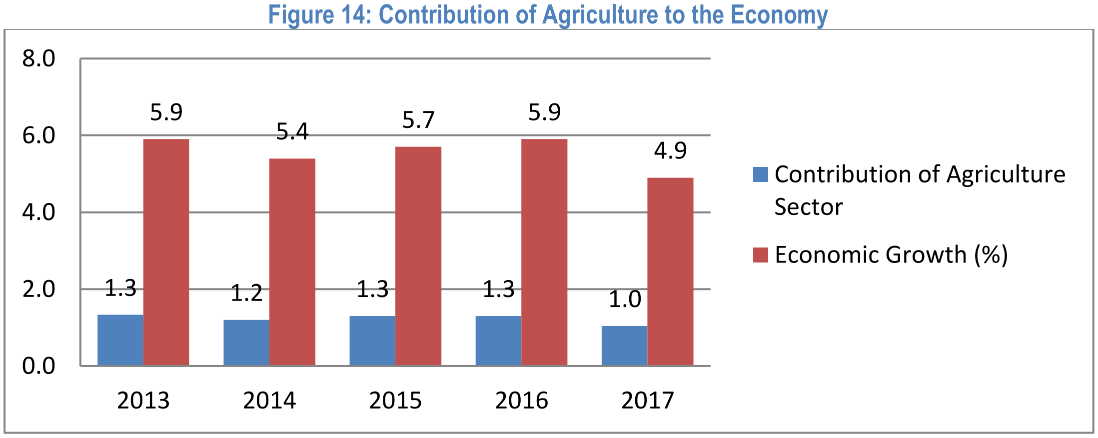
V. Enhancing Nutrition and Food Security to all Kenyans

85. The Agricultural Sector is key to the overall economic growth and development of the country. The Agriculture, Livestock, and Fisheries and the Blue Economy sub-sectors directly contributes at least 25 percent of the GDP and approximately 27 percent to GDP indirectly through linkages with manufacturing, distribution and other service related sectors. The sectors further account for approximately 57 percent of Kenya's total exports and 60 percent of employment in the rural areas (Economic Survey, 2017).

86. The sector is identified as one of the six sectors aimed at delivering the 10 percent economic growth rate under the Vision 2030. It contributes to economic and social development of the country through enhancing food security; income generation; employment and wealth creation; foreign exchange earnings as well as security of land tenure and public land management. It also contributes to economic activity through forward and backward linkages with other sectors.

87. This clearly demonstrates the significance of the agriculture sector in all the spheres of the economy and this underscores the need for the government to spur growth in this sector particularly in areas where the country enjoys comparative advantage to enhance income generation, foreign exchange earnings and employment. The significance of the sector in the economy is further illustrated in the figure below.

Figure 14: Contribution of Agriculture to the Economy



88. The government has identified the sector as one of its Big Four Agenda appreciating its significant role in the economy. The government strategy has largely been on expanding irrigation schemes, increasing access to agricultural inputs, implementing programmes to support smallholder farmers, fishing and pastoralist communities to produce and market their commodities.

89. However, the government has not been successful in realizing its goals since its interventions on key strategic areas as mentioned above have largely been non-responsive due to poor implementation strategies as well as in-efficient government policies and plans.

90. The challenge for the government has been non-responsive subsidies at the input level as well as at the output level. For instance, the fertilizer subsidy initiative has been financed since 2008 however the funding does not translate to improved production due to inefficient distribution channels coupled with corruption. In the current financial year, the government intends to spend Kshs 4.3 billion to buy 168,480 MT of subsidized fertilizers which will benefit 210,000 farmers within seven selected counties. However, the procurement of the fertilizer has not commenced and this could hinder the delivery of the fertilizer to the farmers on time.

91. The output subsidy offered to maize farmers by the government has also not been effective and has been prone to corruption. The Programme was meant to boost our strategic grain reserve but more importantly support the small scale maize farmers across the country. However, the programme has not been achieving its intended purpose due to corruption by unscrupulous middle men who import maize from neighbouring countries and lock out the genuine farmers from selling their maize to the government. In the financial year 2017/18, the government purchased maize worth Kshs 11.6 billion some of which has been imported. The situation has been aggravated by lack of adequate storage facilities and maize drying machines at the government facilities.

Options:

92. To address the urgent need to scale up food production, the government should consider the following options;

- Integrated Farmer Management System – the government should develop a data base of the all farmers in the country in order to eliminate middle men benefitting from the subsidized fertilizers as well as purchase of maize for the strategic grain reserve. The system will also ensure traceability and assessing the productivity of the subsidy.
- Manage food contamination and other forms of post-harvest losses – the government should invest in the acquisition of modern storage facilities to aid against post-harvest losses. The government fast-track the enactment of the warehouse receipt system bill so as to provide a warehouse receipt system for agricultural commodities to address marketing challenges associated with cereals and grain subsectors in Kenya.
- Efficiency in the use of resources - The sector is largely devolved, however resources at the National level appear to fund activities that also funded by the devolved units. Apart from the

donor funded projects which require commitments from the National Government, there is need to redirect resources from the devolved functions and duplicated activities to other initiatives which are National in nature like Value Addition and supporting youth in modern agriculture.

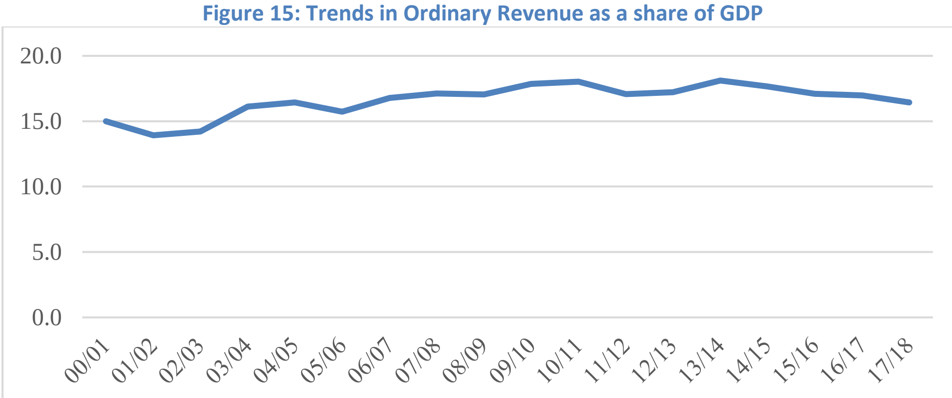
Chapter Six

Unlocking the Revenue Potential

Introduction

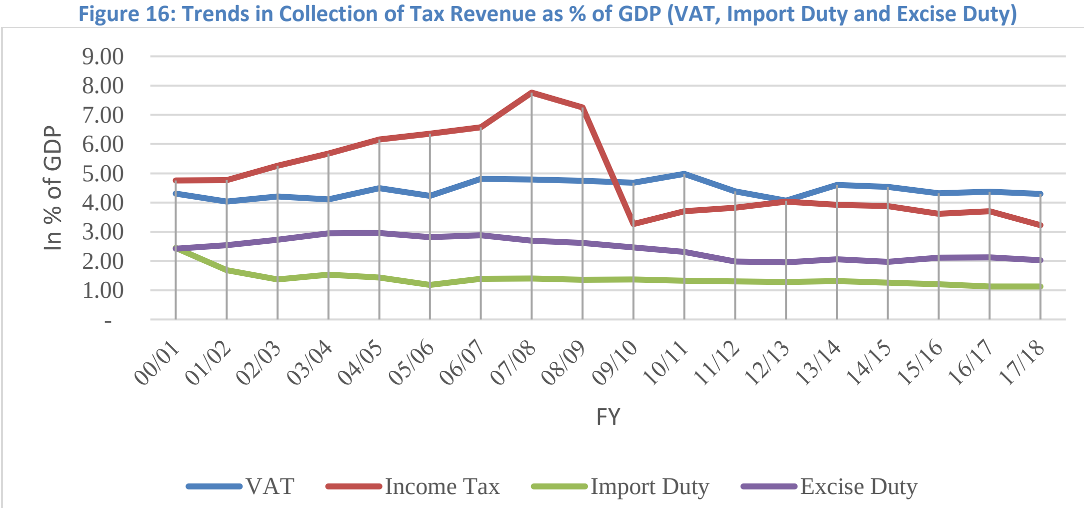
93. The trends in revenue collection compared to expenditure depict a widening budget deficit over the time. Total revenue has consistently underperformed. As a share of GDP, revenue collection has dwindled with 2017/18 collection standing at 16.4% of GDP (figure 1). Over the last decade, ordinary revenue has averaged 17.4 percent, with a gradual decline in the last 5 years. Revenue stood at 18.1%, 17.6%, 17.1%, 17.0% and 16.4% in 2013/14, 2014/15, 2015/16, 2016/17 and 2017/18, respectively. In annual terms, revenue fell by nearly Kshs.100 billion every year.

Figure 15: Trends in Ordinary Revenue as a share of GDP



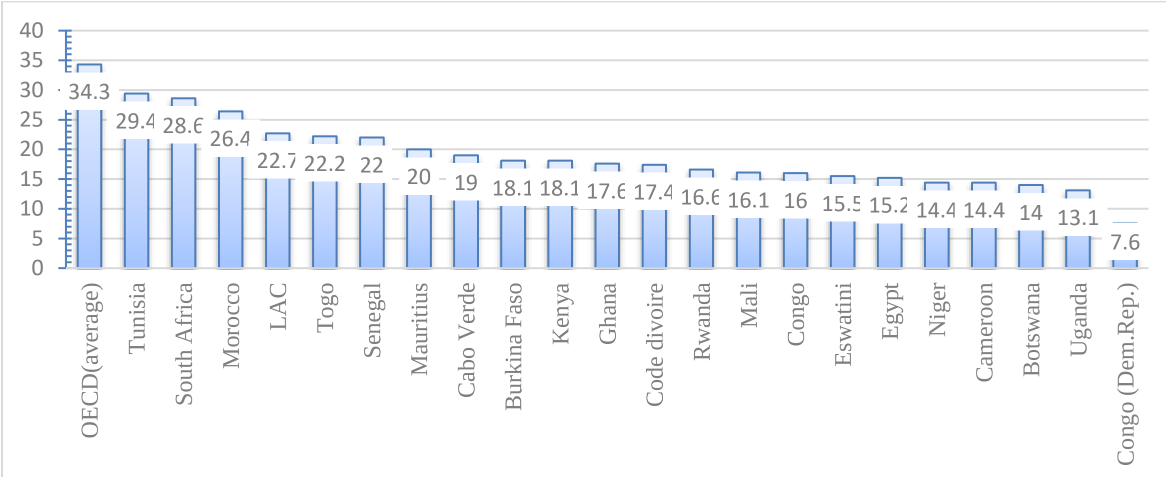
94. On the other hand, the collection of VAT, Import duty and Excise duty has remained broadly constant over the 10 year period (2008/09-2017/18). Arising from the implementation of the Customs Union, the share of import duty has reduced significantly from 2.45% of GDP in 2000/01 to 1.13% in 2017/18.

Figure 16: Trends in Collection of Tax Revenue as % of GDP (VAT, Import Duty and Excise Duty)



95. From a regional perspective, Kenya ranks 9th in the region, 11.3 percentage points below Tunisia, the best ranking country. Indeed, Kenya is just below the African average of 18.2 percent; when compared to Latin America and Caribbean countries average, Kenya performs below by 4.6. Compared to the average for Organization for Economic Co-operation and Development (OECD) countries, Kenya's tax to GDP ratio performs at a paltry 53 percent.

Figure 17: Tax to GDP Ratio for Middle Income in Africa[15]



Source: African Tax Administration Forum (ATAF)

96. From the above illustration, the high tax to GDP ratio depicted by countries like Tunisia, South Africa, Togo and Senegal is not unique. With clear strategies around tax administration as well as other legislative interventions, Kenya stands a chance of hitting the revenue to GDP ratio of above 20 percent.

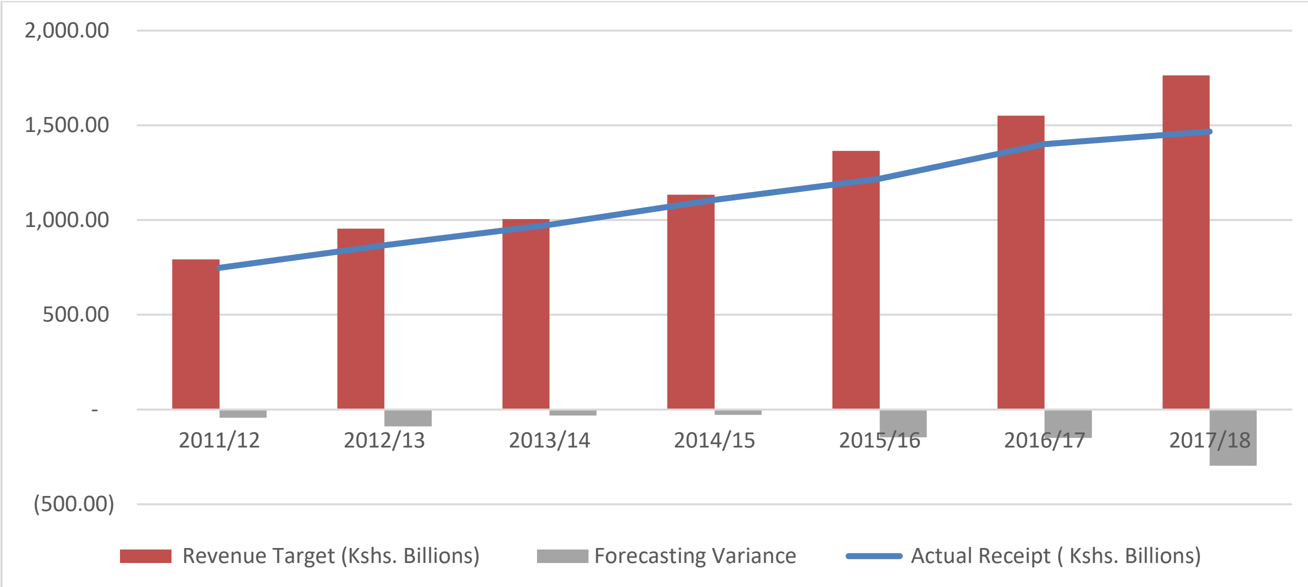
97. Revenue underperformance has been attributed to various factors including insufficient capacity to undertake credible revenue forecasting, weaknesses in tax administration and legislative deficiencies including granting of huge exemptions. From a tax administration point of view, there is an inherent plateau in the reform agenda of revenue administration. Indeed, some of the administrative measures that were supposed to increase revenue include integration of iTax and IFMIS, roll out of integrated customs management. As of now, these measures have not yielded any meaningful resources to the exchequer.

Are revenue forecasts realistic?

98. Persistent revenue underperformance has been an issue in the Kenyan budget for some time. A comparison of projected revenue and collected revenue for the past seven years provides evidence of huge disparities between actual and projected revenue. On average, the cumulative revenue shortfall stood at **Ksh.112.2 billion** for the period FY 2011/12-2017/18.

[15] *LAC Denotes for Latin American and Caribbean

Figure 18: Forecasted vs. Actual Revenues (FY 2011/12 - 2017/18)



99. Over the period 2011/12-2017/18, government revenues underperformed by **9.27 percent**[16] every year, indicating that the accuracy of the forecast is generally very low. The accuracy of the forecasting methods from FY2011/12 to 2017/18 (as shown below) was measured using Mean Absolute Deviation (MAE), Mean Squared Error, Mean Percentage Error (MPE), Mean Absolute Percentage Error (MAPE),and Theil's U-statistic. The result showed that the forecast model had low levels of accuracy as compared to the actuals.The forecast is said to be accurate when the forecasting error is less than or equal to one. This implies that the forecasted values of revenue are very close to the realized revenues. From the table1 below, the high level of accuracy of forecasted revenue was in FY 2014/15 when the forecasting error was 2.5 percent while lowest forecasting error was in 2017/18 when the forecasting error was 20.2 percent. In 2017/18, the forecasting error was significant due to the over estimation of GDP without factoring the effects of uncertainty in the 2017 General Elections as well as low economic activity in the agricultural sector due to drought.The unrealistic projection of revenue in the past seven years has led to serious revenue shortfalls against the ever-increasing expenditure pressures arising from the need for service delivery to the citizens. Overall the government has resolved to borrowing either domestically or externally to bridge the resource gap. Ultimately, this has led to the country running huge budget deficits, which has culminated into fast debt accumulation.

[16]Mean Absolute Percentage Error (MAPE) measures the average percentage of difference between the forecasted revenues and the actual revenues.

Table 8: Forecasted Revenues vs. Actual Revenues FY 2011/12 - 2017/18

Financial Year	Actual Revenue (Kshs. Billions)	Revenue Estimates (Kshs. Billions)	Deviation (Kshs. Billions)	Forecasting Error (%)
2011/12	748.12	792.10	**(43.98)**	5.9%
2012/13	866.50	955.50	**(89.00)**	10.3%
2013/14	974.40	1,006.40	**(32.00)**	3.3%
2014/15	1,106.40	1,134.50	**(28.10)**	2.5%
2015/16	1,219.10	1,365.90	**(146.80)**	12.0%
2016/17	1,400.60	1,550.50	**(149.90)**	10.7%
2017/18	1,467.20	1,763.30	**(296.10)**	20.2%

Source: National Treasury

Table 9: Forecast Errors (based on Budget Papers)

N17	**MAE**18	**MSE**19	**MPE**20	**MAPE**21	**Theil U** 22
7	112.27	20,480.62	-9.27%	9.27%	1.01

Source: PBO Simulations

Untapped Revenue Potential

100. The issue of transfer pricing leading to loss of revenue has been raised overtime and it remains an area of concern. It is noted that between 2000 and 2008, Kenya lost about 156 billion to illicit outflows perpetuated by wealthy business people and multinationals. In February 2018 Global Financial Integrity (GFI), a US based non-profit research and advisory organization, estimated that 0.7 percent of total trade in Kenya is lost through illicit outflows. This is evidence that measures to curb it are not very effective.

101. It is also important to note that underperformance of revenue is also as a result of revenue leakages due to non-compliance among taxpayers and transfer pricing. A study done by the Parliamentary Budget Office, Kenya in 2009 estimated that Kenya was losing on average Kshs.275 billion annually as a result of noncompliance. This translates to an average revenue effort of only 35.9 percent. This may have continued to persist since the tax gaps in the various types of taxes is still high. For example, the KRA corporate plan (2018-2021) indicates that the tax gap for VAT stands at 45 percent.

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[17] N- Number of Financial years in the sample
[18] MAE- (Mean Average Error)
[19] MSE- (Mean Squared Error)
[20] MPE- (Mean Percentage Error)
[21] MAPE- (Mean Absolute Percentage Error)
[22] Theil U Statistics. U_1<1 = High level of accuracy and U_1= low level of accuracy

(i) Is there a problem in VAT exemption?

102. Unbundling the Kenyan revenue base can provide some insights into areas of strengths, weaknesses, opportunities and threats. From table 1, nearly half the collection of taxes over the last 3 years came from taxes on income, profits and capital gains. This was followed closely by taxes on goods and services. Thus, the two tax heads combined amount to more than 80 percent of the total revenue collected at any given point in time. Indeed, despite the recent overhaul of the VAT Act, the lackluster performance of taxes on goods and services raises serious concerns. The main purpose of the overhauling the VAT Act was to reduce the many exemptions. The exemptions list was first expanding while the net gain from the same was not evident. On the contrary, evidence has it that immediately the VAT Act was passed, many exempt items were again re-introduced. From the foregoing, it is apparent that the existing exemption regime requires a fresh relook.

Table 10: Trends in Revenue Performance per Broad Economic Category

	Actual Receipts 2015/2016	Actual Receipts 2016/2017	Revised Estimates 2017/2018	2018/2019	2019/2020	2020/2021
Taxes on income, profits, and capital gain	48.99	48.08	48.93	47.67	48.73	49.22
Taxes on payroll and workforce	-	-	-	-	-	-
Taxes on goods and services	37.34	38.71	37.49	38.64	38.88	38.71
Taxes on international trade and Transactions	9.1	8.7	8.7	8.49	8.58	8.42
Other taxes (Stamp duty)	0.89	0.66	0.81	0.71	0.65	0.63
Other revenue	3.51	3.823	3.89	4.25	2.97	2.83
Miscellaneous and unidentified revenue	0.17	0.07	0.18	0.24	0.19	0.19
Total tax	100.000	100.000	100.000	100.000	100.000	100.000

103. According to World Bank 2017, there exists enough scope for rationalizing the Kenyan exemption regime. Indeed, the analysis by the bank indicates that there are significant amount of revenue foregone. Importantly, the World Bank indicates that some exemptions have continued to exist even after the initial objective might have lapsed. For example, foregone revenues from corporate income tax account for 1.8 percentage points of GDP. Moreover, the indiscriminate application of VAT exemptions resulted to revenue leakage close to 3.1 percent of GDP. The findings further indicate that the financial sector manufacturing, health and social work activities, accounted for over 88 percent of total exemptions.

104. The report further indicates that any rationalization of the exemption regime from the corporate income tax front requires a focus on sectors that are no longer a priority as detailed in the national development agenda. On the Value Added Tax (VAT) side, the report indicates that Kenya applies a relatively liberal VAT exemptions regime on domestic supplies. From the foregoing, there scope for streamlining VAT exemption regime relating to zero-rated supplies and VAT on exempt imports. The following section provides detailed analysis of the impact of exemption of Corporate Income Tax (CIT) and VAT.

105. The above analysis provides a pointer that indeed there is some room for unlocking the country's revenue by developing some alternative constructs. We analyse two main alternatives of raising additional revenue by exploring possibilities of increasing and or rationalizing the exemption regime in the area of VAT and CIT. In terms of deducing the most desired revenue raising policy option the following criteria is employed:

i. Revenue maximization;
ii. Tax head that does not extensively hurt the poor; and
iii. Tax head that does not increase inequality among the population.

(ii) Eliminating tax exemptions under Corporate Income Tax

106. The paper utilizes the sectoral cost of exemptions for CIT developed by the World Bank in 2017 (table 2). From the World Bank tax gap methodology (which entails holding tax rates constant), if all exemptions were eliminated, the potential corporate income tax could increase by 24 percent. This translates into revenue foregone of Kshs.33 billion. Bearing in mind that not all exemptions are bad, the World Bank isolated tax exemptions in health and education, the tax gap analysis indicates that still the revenue foregone still stands at Kshs.26.2 billion. Thus, there remains 19 percent potential for increase in CIT revenues, even after taking into account some exemption areas that are important.

Table 11: The Cost of Tax Exemptions from Sample Sectors

	Taxable Income (Ksh, millions)	Taxable income w/o exemptions (Ksh, million)	Cost of exemptions with ETR-TI (Ksh, millions)	Cost of exemptions with uniform 30 percent rate(Ksh, millions)	Potential CIT revenue increase if all exemptions eliminated* (Percent)
Agriculture, Forestry & Fishing	14,458	16,992	527	760	18
Mining & Quarrying	2,187	3,083	188	269	41
Manufacturing	63,039	73,804	2,459	3,229	17
Electricity, Gas, Steam & Air Conditioning	7,265	7,428	42	49	2
Water Supply, Waste management, sewerage	533	541	2	2	2
Construction	20,391	21,338	347	284	5
Wholesale, Retail Trade & Vehicle Repair	16,801	16,994	53	58	1
Transporation & Storage	22,880	24,003	395	337	5
Accommodation & Food Services	3,389	3,487	20	29	3
Information & Communication	57,023	61,849	1,487	1,448	8
Financial & Insurance Activities	171,801	218,328	11,897	13,958	27
Real Estate Activities	12,164	14,437	596	682	19
Administrative & Support Services	13,946	15,139	336	358	9
Public Admin, Defence & Social Security	76	121	8	14	60
Education	1,525	9,754	755	2,469	540
Human Health and Social Work Activities	2,845	14,176	1,581	3,399	398
Arts, Entertainment & Recreation	310	350	11	12	13
Other Services	12,164	18,074	1,766	1,773	49
Activities of Extraterritorial Orgs.	115	209	20	28	82
other income (not defined, employee & null)	33,689	47,746	3,690	4,217	42
Total	456,601	567,853	26,180	33,375	24

107. The 2017 report further indicates that the exemptions are concentrated in few sectors of the economy namely the financial services, information and communication technology, health, and manufacturing. They account for nearly 75 percent of all losses accruing in Corporate Income Tax. This reflects the relatively large size of these subsectors in GDP.

108. Assuming that CIT grows in line with the growth of tax from corporations (other enterprise) as provided in 2018/19 estimates of revenue grants and loans, the total revenue yield arising from removing unnecessary exemptions amounts to Kshs.35.3 billion and Kshs.40.9 billion, and Kshs.47.5 billion, respectively in 18/19,19/20 and 20/21 (table 10)

Table 12: Estimates revenue foregone (CIT exemptions)

	2018/19	2019/20	2021/22	2022/23
Income Tax from Corporations[23]	329,718,286,318	389,235,182,998	439,356,000,000	512,437,000,000
Average growth rate of Income Tax from Corporations		18%	13%	17%
Corporation Tax	185,668,712,665	215,375,706,692	249,835,819,763	289,809,550,925
Potential Revenue Foregone	35,277,055,406	40,921,384,271	47,468,805,755	55,063,814,676

[23] The definition of income tax from corporations as provided in the estimates of revenue and grants include advance tax , capital gains tax , and turnover tax

(iii) Relooking at VAT regime

109. The Value-Added Tax (VAT) Act governs VAT in Kenya. VAT is chargeable on goods and services supplied in and imported into Kenya. Liability falls on the person making the supplies of goods and services. The applicable VAT rate is 16 percent, with a nil rate applicable to zero rated goods. Zero-rated goods are determined by the Cabinet Secretary in charge of Finance, and are specified in the VAT Act.

110. Just like the CIT, there are substantial exemptions under the VAT regime. The World Bank report of 2017 revealed that:

i. That there is a leakage of up to 3.1 percent in VAT revenues arising from various exemptions;
ii. Exemptions on domestic supplies was estimated at 1.36 percent of GDP after including an adjustment for standard exempt supplies;
iii. Revenue foregone for zero rated supplies amounted to 1.06 percent of GDP; and
iv. Revenue loss arising from exempt imports amounted to approximately 0.49 percent of GDP.

111. Extending the foregone revenue approach developed by the World Bank, we attempt quantify VAT revenue losses arising from the categories of exemption (table 4). The results indicate that if the aforementioned exemption were eliminated, VAT collection could increase by Kshs.110 billion over the period 2019/2020- 2021/22. The basis for advocating for complete elimination of these exemptions is based on the fact some of this exemptions have outlived the original purpose, while others are not consistent with the current national development priorities. It is also important to note that some of the fiscal policy measures are better handled from the expenditure front.

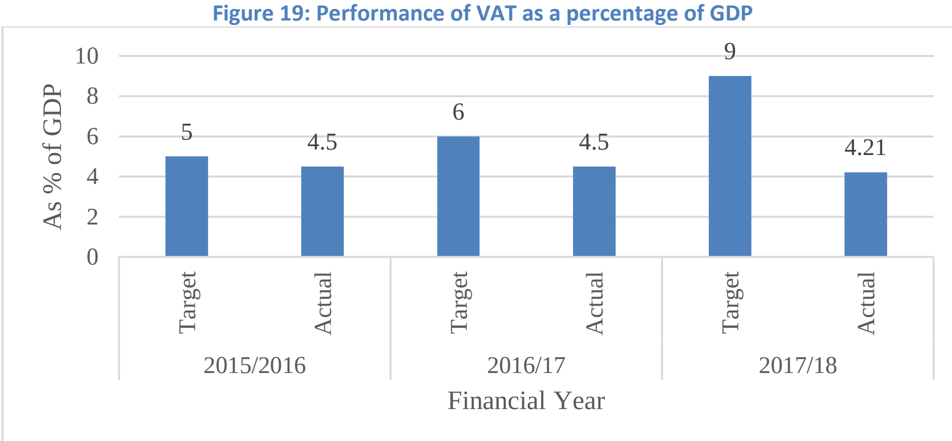
Table 13: Revenue foregone (VAT Exemptions)

	2019/20	2020/21	2021/22	Grand Total
Exemptions on domestic supplies after including an adjustment for standard exempt supplies (1.36%)	15,558.40	17,621.52	20,017.84	53,197.76
Revenue foregone for zero rated supplies (1.06 percent of GDP)	12,126.40	13,734.42	15,602.14	41,462.96
Revenue loss arising from exempt imports (0.49%)	5,605.60	6,348.93	7,212.31	19,166.84
GDP (Budget Review Outlook Paper, 2018)	**11,440**	**12,957**	**14,719**	

a) Aligning the VAT regime to regional level

112. In view the current deficit target of 3 percent envisaged under the EAC, one of the ways of achieving this target is through concerted efforts in revenue mobilization. One of the ways of achieving this is by increasing the top rate of VAT rate from 16 percent to 18 percent. This will be broadly in line with other EAC countries whose rate stands at 18 percent. In terms of performance, VAT has not performed to expectation (figure 4). VAT is a transactional, so everyone raises taxes in the process of consummation of goods and services.

Figure 19: Performance of VAT as a percentage of GDP



113. An increase in VAT rate from 16 percent to 18 percent will result to some significant revenue yield. We analyse the expected macro-economic impact of the increase of VAT using the Parliamentary Budget Office Macro Model (PBOM).

114. It has been estimated that the increase in VAT by 2 percentage points will yield revenue to a tune of Kshs.61 billion. The impact of the increase in VAT on economic growth higher in 2019/20, however, it peters out over the medium term. Specifically, growth is poised to reduce by 0.7 percentage points, 0.3 percentage points, and 0.2 percentage points in 2019/20, 2020/21, and 2021/22. The reduction in GDP is largely driven by reduction of exports by 1.7 percent, 1.1 percent and 0.7 percent in 2019/20, 2020/21, and 2021/22. On the other hand deficit including grants (commitment basis) will on average, improve by 0.7 percentage points of GDP over the 5 year period. Table 12 shows the overall impact (deviation) of the 2 percentage points increased in VAT.

Table 14: Macroeconomic impact of increase in VAT

	2019/20	2020/21	2021/22	2022/23	2023/24
Budget Deficit Inc. grants cash basis	0.60	0.69	0.71	0.72	0.71
Government Debt	-0.75	-1.59	-2.31	-2.96	-3.53
Foreign Reserve Stocks in months of import cover	-0.06	-0.18	-0.33	-0.50	-0.68
Development expenditure	0.03	0.09	0.09	0.08	0.07
Wages of Central Govt.	-1.15	-1.27	-1.35	-1.42	-1.47
Inflation	0.85	0.55	0.36	0.23	0.14
Poverty	0.11	0.10	0.10	0.09	0.08
Gross Investments	0.01	-0.01	-0.04	-0.06	-0.06
Gross National Savings	-0.08	-0.21	-0.31	-0.37	-0.41
GDP Growth rate	-0.69	-0.26	-0.16	-0.10	-0.07

Source: The Parliamentary Budget Office Model (PBOM)

In summary, the following are the suggested policy options:

Proposal	Potential revenue impact (2019/20-2022/23)
i. **Eliminate Corporate Income Tax exemptions**	143,454,004,702
ii. Removing VAT exemptions	113,827,560,000
iii. **Aligning the VAT regime to regional level**	210,000,000,000
Total Medium term impact (Additional Revenue)	467,281,564,702

115. Other Options for enhancing measures include:

(i) Enhancing Collection of arrears of revenue: - According to the Auditor-General's report for the FY 2015/2016, the government did not collect arrears of revenue totalling Kshs.380,600,178,374 as at 30June 2016. A small proportion of these arrears of revenues are tied-up in courts and quasi courts while a significant portion of the debt revenues is collectible but not collected by the relevant government agency. The government should revamp revenue debts collection strategy to ensure that at least 25% of the outstanding arrears of revenue are collected.

(ii) Coming up with strategic Partnerships with the County Governments to enhance revenue collection:- Collaborations between KRA and County Governments is likely to support revenue collection by the County Governments. To enhance county own source revenues, the national government should implement the just concluded national policy that supports and encourages strategic partnerships between KRA and County Governments.

Chapter Seven

Realism of County Expenditure and Options for the medium term

I. Introduction

116. Since the inception of devolution, substantial resources have been voted and transferred to the devolved units to fund various devolved functions despite fiduciary concerns as per various reports by the Senate and Auditor General on county resource utilization. The county equitable share and conditional grants form a major source of county financing while county own source revenue (OSR) – challenges on its performance notwithstanding – are also a key part of county budget financing. In addition, unspent funds have over the years also become part of the overall resource available for subsequent budgeting and spending, partly due to challenges such as inordinate delays and irregular inter fiscal transfers that do not follow the senate approved cash disbursement schedule as well as poor absorption by counties. This scenario points to poor expenditure execution strategies in the face of un (der) funded mandates at the counties.

117. The spirit and intent of the 2010 constitution when introducing the local level of governance was to give total financial independence to counties. One key principle to actualize this goal was to provide that resources would follow functions. However despite the total devolution of health and agriculture services, there are substantial resources voted for these functions at the national level giving an opportunity for some components in health and agriculture to be undertaken by both levels of government. This leads to duplication.

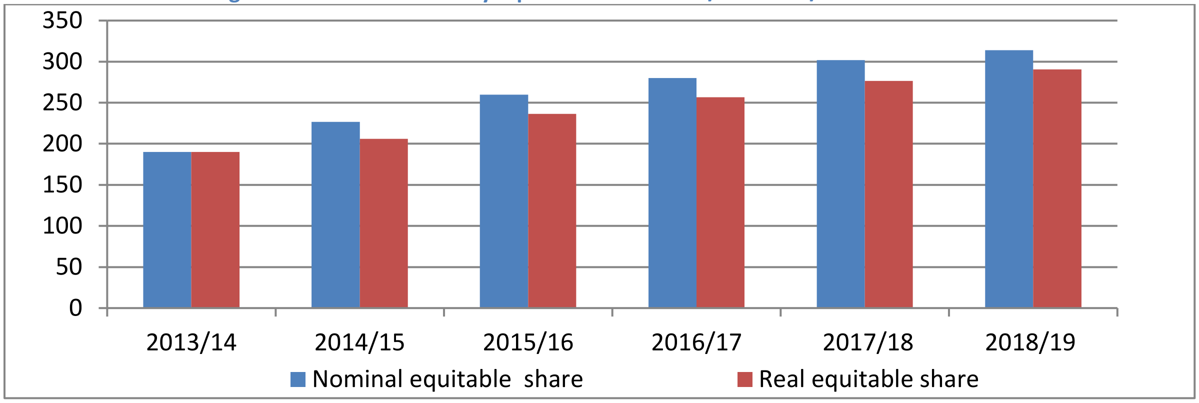
118. The desire to ensure that there is predictable flow of resources to the counties was the basis of Article 203 of the 2010 constitution, which was expected to guide the vertical distribution of the nationally raised revenues. However, to date, the vertical distribution of the nationally raised revenues has continued to be a game of numbers leaving the counties at the mercy of the legislature and the executive. Ideally, there should be a criteria that should guide the final decision of the resource allocation between the national government and the county governments.

II. Financing of County Budget

(a) National share

119. County equitable share and conditional grants, which accounts for over 95% of county financing, registered an increase in nominal terms from approved kshs.180 billion in FY 2013/14 to Kshs 314 billion for the current FY 2018/19*. However, in real terms the allocation is consistently lower.*

Figure 20: Growth in County Equitable Share 2013/14 - 2018/19

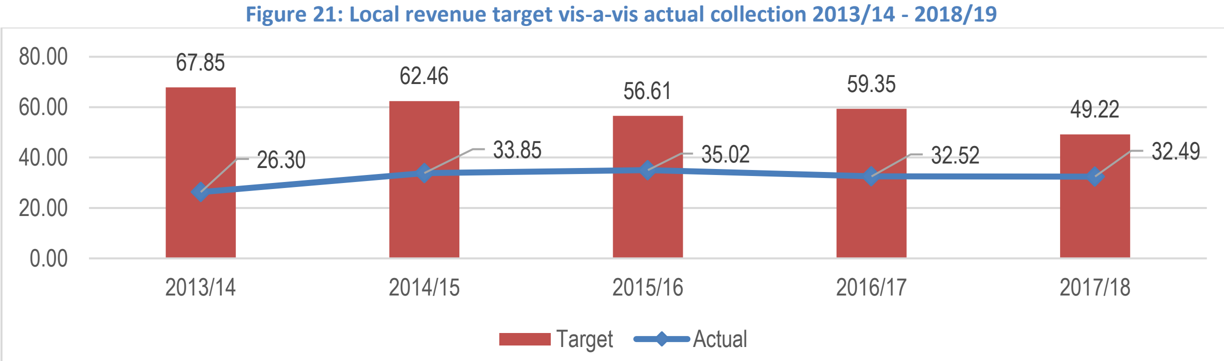


Source: Annual Division of Revenue Act (Various Issues)

(b) Own Source Revenue

120. Own Source Revenue (OSR) is a critical component for financing of county budgets. County strategies to enhance local revenue performance and administration are to support county fiscal effort to meet expenditure needs and augment fiscal transfers. Some key drivers of county revenue are utilizing and enhancing county revenue streams which largely remain sub optimal and portend major prospects such as the property tax and entertainment tax parking fees and business permits, level of urbanization and infrastructure development, use of ICT and automation to improve efficiency in revenue administration, among others. Indeed, The current revenue performance is a third of the estimated revenue potential from various revenue streams which is in the range of kshs 124 billion annually[24]. While OSR collection indicates improved performance in FYs 2014/15 to FY 2015/16 relative to FY 2013/14, performance in subsequent financial years indicate stagnation (See Chart xx). Local revenue target setting, which forms a basis for county budget estimates, also reflects downward adjustments over the same period. This is indicative of weak forecasting methodology/strategies and unrealistic assumptions underpinning target setting as evidenced in the huge variation between actual and expected revenue performance.

Figure 21: Local revenue target vis-a-vis actual collection 2013/14 - 2018/19



Source: Controller of Budget, Various issues

[24] Draft Policy on Enhancement of County Own Source Revenue

121. The major downside to poor local revenue performance includes rising pending bills (unsettled commitments) on account of the ‘unbalanced budget status’ of affected counties. This further promotes overreliance on equitable transfers from nationally raised revenue and with rising pending bills, the risks to budget flexibility increase.

III. Moving towards a Framework/criteria for Vertical Allocation of resources

122. In line with the imperative of devolution, some of the guiding principles and criteria critical to vertical allocation include desirability of stable and predictable allocation of revenue as well as the need for economic optimization of each county government. Pursuant to Art. 202 and 203. Principles/criteria for vertical distribution of nationally raised revenues: an economic interpretation of article 203.

1. **The basic minimum must be not less than 15% of all revenues collected by national Government.**

According to article 203 (2)of the constitution ‘ for every year, the equitable share of revenue raised nationally that is allocated to county governments shall be not less than 15% of all revenue collected by the national government which shall be calculated on the basis of the most recent audited accounts of revenue received, as approved by the National Assembly. This principle would guarantee flow of resources to counties as per provisions of the constitution and guarantee predictability and stability.

2. **Service delivery:**

The constitution envisaged a situation where there would be no disruption in service delivery which means the level of service delivery would remain at the same level as was done in the previous year. Article 203 1. (d) provides that there is need to ensure that county governments are able to perform the functions allocated to them. In the absence of a well developed framework for costing of functions in counties then the default is to maintain the previous allocation constant not unless there is justifiable arguments on why the baseline should be adjusted. Whenever the baseline is adjusted there should then be an indication of which services are being curtailed for the upcoming year.

3. **Resources follow function.**

Under this principle it would mean any time a new function is added to the counties there should be resources identified that should be set aside for that function. For example the national government recently adopted the BIG four agenda. In order for counties to participate in this new agenda there would be need for additional resources to be identified for such activities

4. **Adjustment for inflation:**

All expenditures are affected by the rate of inflation and so it is important to adjust the resources by the official target inflation. This will guarantee continuity and efficiency in performance of counties. This would also ensure counties are able to respond to issues of emergency and predictability of resources.

5. **Developmental needs of counties and the need for economic optimization of each county.**

The need to guarantee resources to counties was so as to spur development at the local level. In order to encourage counties to create assets there is need to give them a proportion of resources calculated on the basis of the minimum development which is 30% of total equitable share and project to grow for at least 1%. This would ensure adherence to Article 203 1 (i)

S/No	Criteria	Baseline	Factor adjustment
1.	Basic 15 Minimum Required by constitution	X(Quantum of audited revenues)	15% x X
2.	Service delivery	Cost of Delivery or last allocation	X of previous year or Cost of delivery of service
3.	Cost of New or Transferred Functions	Costed or an estimation	Y cost or estimation
4.	Adjustment for inflation	Target Inflation	TInfl x Baseline
5.	Development adjustment	A 1 % growth of the Development expenditure	Target development amount and annual growth of ! %
	Grand Total	The barest minimum a county allocation	1+2+3+4+5=

County Budgeting

Trend of county Expenditure by functions and Big 4 plan

123. In the FY 2017/18, functions of agriculture, health and housing and community amenities - major component of big 4 plan–indicate planned expenditure slightly above a third of total county budgets. Comparatively, expenditure performance under the same functions were at 31 percent in the FY 2016/17, meaning that counties are only marginally increasing the share of expenditure towards these core functions that are devolved. This invariably increases risks of duplication and overlaps if an inter-fiscal framework for implementing the big four is not developed and strategically harmonized to guide resource allocation and service delivery to minimize those risks. Allocation under General Public Services has been decreasing substantially while expenditure under general economic affairs and education increased from approximately .81 percent and 0.76 percent in FY 2013/14 to approximately 4.62 percent and 7.93 percent by FY 2017/18, respectively.

Table 15: Classification of Functions of County Government

Classification of Functions of County Government					
Description	2013/14	2014/15	2015/16	2016/17	2017/18
General Public Services	83.76%	50.21%	37.71%	41.59%	35.70%
Economic Affairs	6.87%	14.80%	21.15%	19.21%	19.30%
General economic affairs	*0.81%*	*2.32%*	*5.85%*	*3.80%*	*4.15%*
Agriculture	*1.78%*	*5.23%*	*3.52%*	*3.70%*	*4.62%*
Transport	*3.67%*	*6.95%*	*6.75%*	*10.96%*	*9.00%*
Other economic Affairs	*0.60%*	*0.30%*	*5.03%*	*0.75%*	*1.53%*
Environmental Protection	0.54%	1.95%	4.33%	2.90%	3.48%
Housing and Community Amenities	2.19%	2.58%	5.28%	7.08%	7.44%
Health	5.26%	20.15%	22.31%	20.20%	24.16%
Recreation, Culture and Religion.	0.57%	2.89%	2.06%	1.84%	1.88%
Education	0.76%	7.35%	6.84%	7.02%	7.93%
Social Protection.	0.04%	0.07%	0.31%	0.15%	0.11%
Total	**100.00%**	**100.00%**	**100.00%**	**100.00%**	**100.00%**

Source: Economic Survey, 2018

124. It is important to note that the quality of county expenditure is not clear as reporting is not based on performance. This is a major weakness in the quarterly and annual reports from different entities such as the county treasuries and other statutory bodies such as the Controller of Budget. In addition, the financial system (IFMIS) doesn't reflect and indicate performance levels for approved county programmes and projects (PBB) programmed for implementation.

125. Policy Options

- ✓ *Enhance current baseline by compensating for inflation and marginal support development allocation.*
- ✓ *In view of the increases, cap allocations towards recurrent outlay especially towards Operation and Maintenance and Personnel emoluments with focus on non - education and Health Sector recurrent budgets and channel additional allocations to programmes and projects in support of development outlays that targets to gradually enhance development thresholds to over 45% of total county allocations over the medium term.*
- ✓ *Empower county revenue administration units including county capacity to forecast revenue by linking revenue performance to specific targets that can be monitored over the medium term period.*

- ✓ *Fast-track the finalization and adoption of the national policy on performance and enhancement of county's own source revenue to provide necessary policy anchorage as well as conclude on the enactment of the draft legislation on revenue raising processes.*
- ✓ *Operationalizing fully devolved functions that are currently not operational*
- ✓ *Force performance based budgeting and reporting that is comprehensive and linked to county plans.*