



THE PARLIAMENT OF KENYA
Parliamentary Budget Office

**UNPACKING OF THE BUDGET POLICY STATEMENT &
MEDIUM-TERM DEBT MANAGEMENT STRATEGY 2020**

FEBRUARY, 2020

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Introduction

1. The Budget Policy Statement (BPS) is a policy document that gives an overview of broad strategic priorities and policy goals that will guide the national government and county government in formulating their upcoming budgets. The 2020 budget policy statement provides for fiscal policies that are meant to sustain Kenya's economic growth under a sluggish global growth. The budget policy statement sets the tone of the various policies that will need budgeting over the medium term so as to harness the national agenda i.e. "the Big 4 Agenda" for job creation and economic prosperity.
2. Article 201 of the Constitution lays the grounds for ensuring that burdens and benefits of resources and public borrowing are equitably shared between the present and future generations. As such this necessitates the establishment of a debt management strategy for managing stock of debt and financing the budget deficit through cost and risk effective mechanisms. The Medium-Term Debt Management Strategy (MTDS) FY 2020/21 was prepared and presented to the Houses of Parliament subject to Section 64(2), and Section 33 and Regulations 184 & 185 PFM Act, 2012.
3. The unpacking of the 2020 BPS & MTDS is divided as follows Part I entails recent economic developments and medium-term outlook, Part II gives a general overview of "the big four" agenda, Part III elaborates on the fiscal policy outlook, Part IV focuses on the County Financial Management and Division of Revenue, and unpacking of the Medium-term debt management strategy is presented in Part V.

Review of Compliance of the 2020 BPS

4. The legal underpinning of the 2020 Budget Policy Statement is articulated in Section 25 of the Public Finance Management (PFM) Act, 2012. The Act requires the National Treasury to submit the BPS to Parliament for approval by 15th February of each year. The PFM also stipulates the contents of the BPS. Additionally, the PFM Regulations, 2015 provided further requirements on the contents to be presented in the BPS. (Part 26, 27, 28, 29, and 34).
5. A review of the 2020 BPS indicates that it achieved an **85.7%** level of compliance. Despite the fairly good performance, the National Treasury did not present all the information required by law.

Emerging Issues

- ❖ *No tax policy.*
- ❖ *According to PFM regulations Part 27(5), the development expenditure and personnel spending of the national government approved by Parliament are binding for the next two years. The ceilings provided for development and personnel spending of the national government in 2020 BPS are not the indicative ceilings approved by Parliament in 2019 BPS.*

- ❖ *A list of pending bills was not presented as is required by law.*
- ❖ *No information was provided on the level of budgetary expenditures by economic and functional classifications.*
- ❖ *The funding of projects under PPP (Public-Private Partnership) was expressed in USD instead of KSHS. Further, the PPP projects were not factored in the national public debt.*

Table 1 Legal compliance of the 2020 Budget Policy Statement

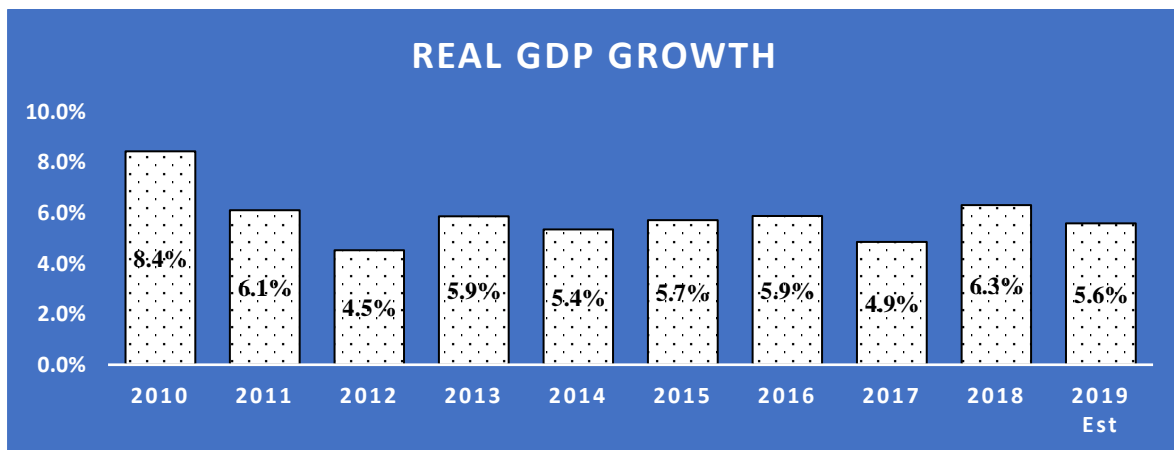
	Item	Constitution	PFM	PFM Reg.	Standing Orders	% Level of Compliance (1-5)	Comment
1	Adherence to the timeline: Was the BPS submitted to the Parliament on time?						
1.1	Submission of the budget policy statement by 15 th February every year		25(2)		232 (1)	5 out of 5	Laid on Thursday, 14 th February 2020
2	The comprehensiveness of the BPS: Does the BPS provide enough details?						
2.1	An assessment of the current state of the economy and the financial outlook over the medium term, including macro-economic forecasts.		25(4) (a)	27, 28	232 (2) (a)	4 out of 5	The ceilings for development expenditure and personnel spending approved by Parliament are not binding with 2019 BPS ceilings.
2.2	Financial outlook with respect to government revenues, expenditures and borrowing for the next financial year and over the medium term.	220(1)	25(4) (b)		232(2) (b)	3 out of 5	Limited Information provided on revenue i.e. no tax policies provided.
2.3	The proposed expenditure ceilings for the 3 arms of Government and indicative transfers to County governments.		25(4) (c)	34	232(2) (c)	5 out of 5	Information provided.
2.4	The fiscal responsibility principles and financial objectives over the medium-term including limits on total annual debt.		25(4) (d)	26, 29	232(2) (d)	3 out of 5	No information (list) is provided for pending bills.
2.5	The total resources to be allocated to individual programmes and projects within sector/ministries departments and agencies for the period identified indicating outputs expected from such programmes or projects during the period.		-		232(2) (e)	5 out of 5	Information provided.
3	The extent of stakeholder participation during the preparation of the BPS						
3.1	The principle of public participation and other stakeholders	201(1 a)	25 (5)		-	5 out of 5	Information provided
Total Level of Compliance						85.7 percent	

Source: Parliamentary Budget Office

Recent economic developments

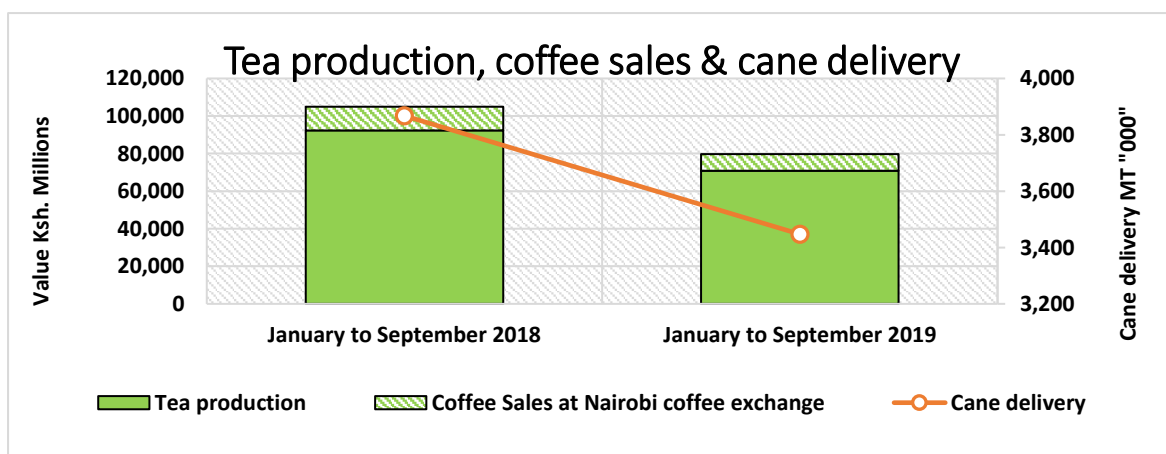
A. Economic Growth

6. Kenya experienced slow economic growth in 2019. The economy grew by 5.6% which was below the government's target of 6.2%. Further, the 5.4% expansion over the first three quarters of 2019 was one percentage point lower than the 6.4% economic growth recorded over a similar period in 2018.



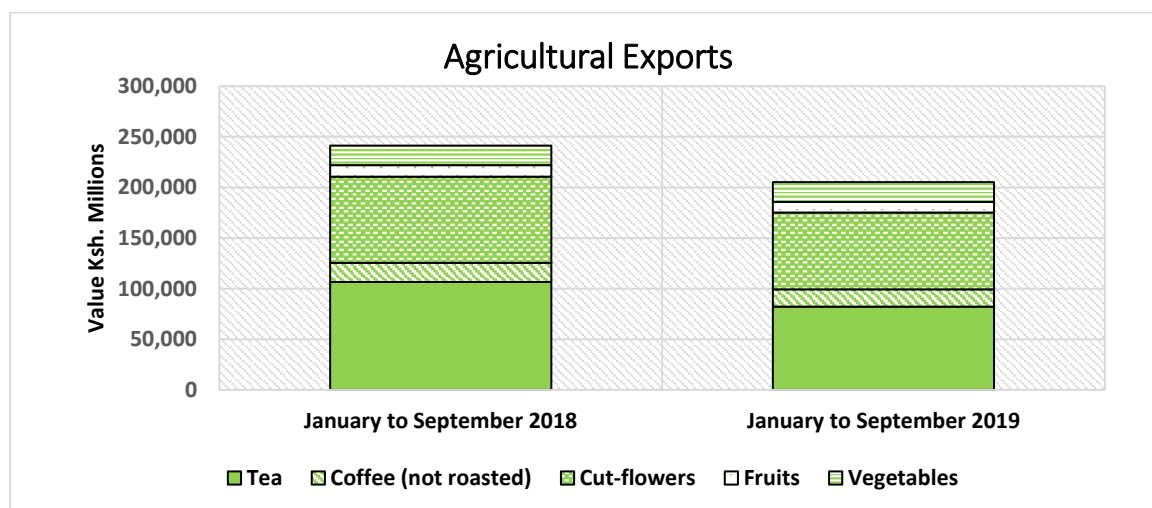
Source of Data: Kenya National Bureau of Statistics

7. The main contributor to the dampened economic growth in 2019 was the poor performance of the agricultural sector (See Table A 1 in the annex). This was occasioned by the contraction in production and sales of most of the major cash crops. Over the first three quarters of 2019, the quantity of tea production, coffee sales at the Nairobi coffee exchange and cane delivery fell by 9%, 4%, and 11% respectively.



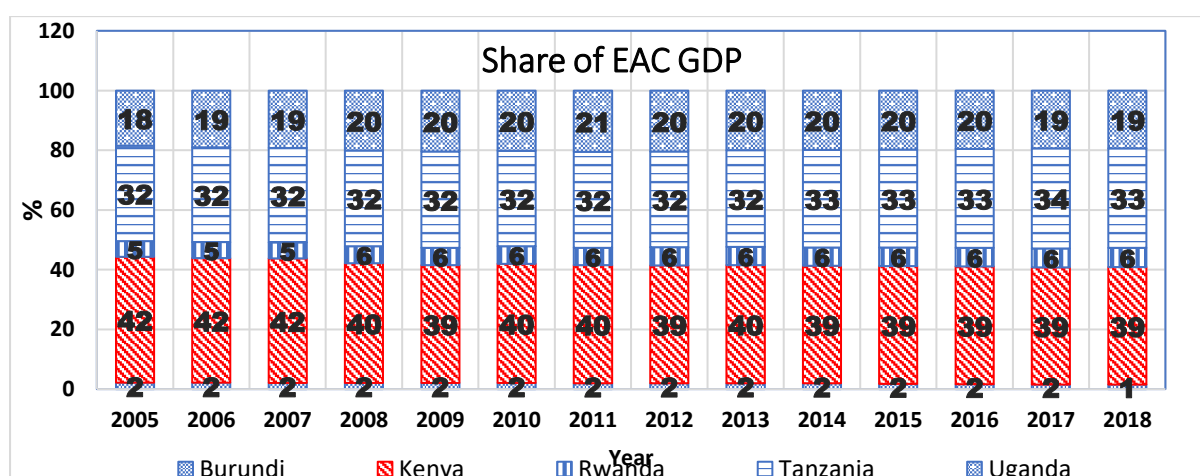
Source of Data: Kenya National Bureau of Statistics

8. **Declining export prices of the major agricultural exports over the first three quarters of 2019 also contributed to the slow growth in the agriculture sector.** The average price per kg of tea and coffee between January and September 2019 was 23% and 29% lower than the average price over a similar period in 2018. Consequently, the value of tea, coffee, and horticultural exports declined by 23%, 10%, and 9% respectively in the first three quarters of 2019.



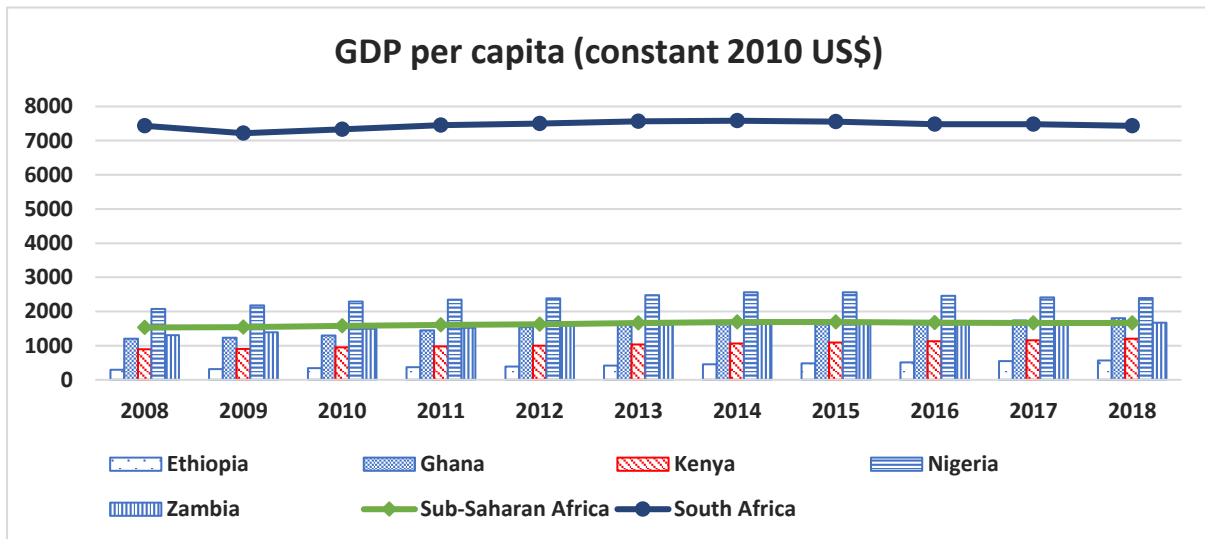
Source of Data: Kenya National Bureau of Statistics

9. **Kenya has experienced slower economic growth relative to some of the East African Community (EAC 5) countries over the last fifteen years.** This has resulted in a decrease in her share of EAC cumulative GDP. Its share of EAC GDP declined from 42% in 2005-2007 to 39% over the last five years.



Source of Data: World Bank (GDP constant 2010 US\$)

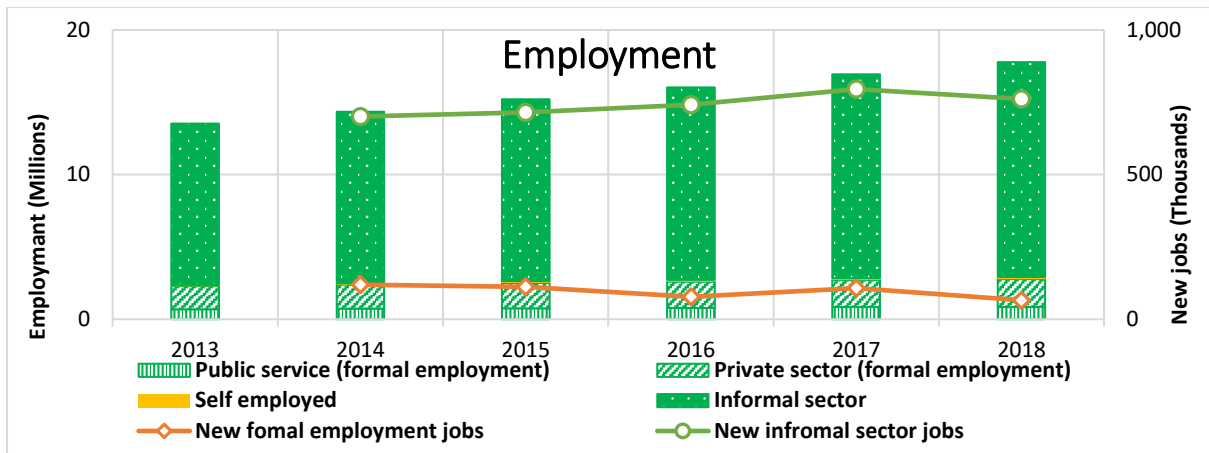
10. **The real per capita income has remained lower than that of other comparable African countries, despite Kenya having made some progress over the last fifteen years.** Kenya’s per capita GDP (current prices) grew from Ksh. 47,000 in 2005 to Ksh. 204,000 in 2019. However, as of 2018, Kenya’s real per capita GDP (constant 2010 US\$) was US\$ 1,200 while that of Zambia, Ghana and Nigeria was US\$ 1700, US\$ 1800 and US\$ 2400 respectively.



Source of Data: World Bank

11. **The number of new jobs created each year between 2014 and 2018 was below the government’s target of creating one million new jobs annually.** Further, over 83% of the 800,000 new jobs created annually between 2014 and 2018 were in the informal sector. Kenya’s informal sector is necessary for the process of structural transformation as labour shifts from agriculture to well-paying formal sector jobs.

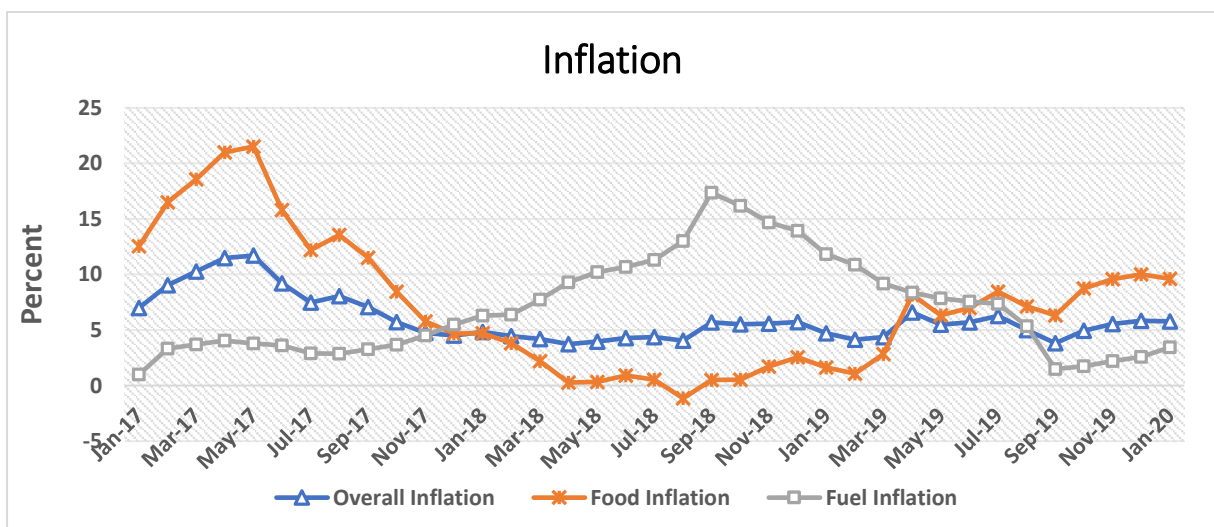
12. However, the income levels of informal sector jobs are often low [1]. Further, the growth of the informal sector is one of the constraints to enhanced tax revenue mobilization in Kenya [2] and a large informal sector also poses challenges in financing universal healthcare (UHC) through a contributory scheme [3].



Source of Data: Kenya National Bureau of Statistics

B. Inflation rate

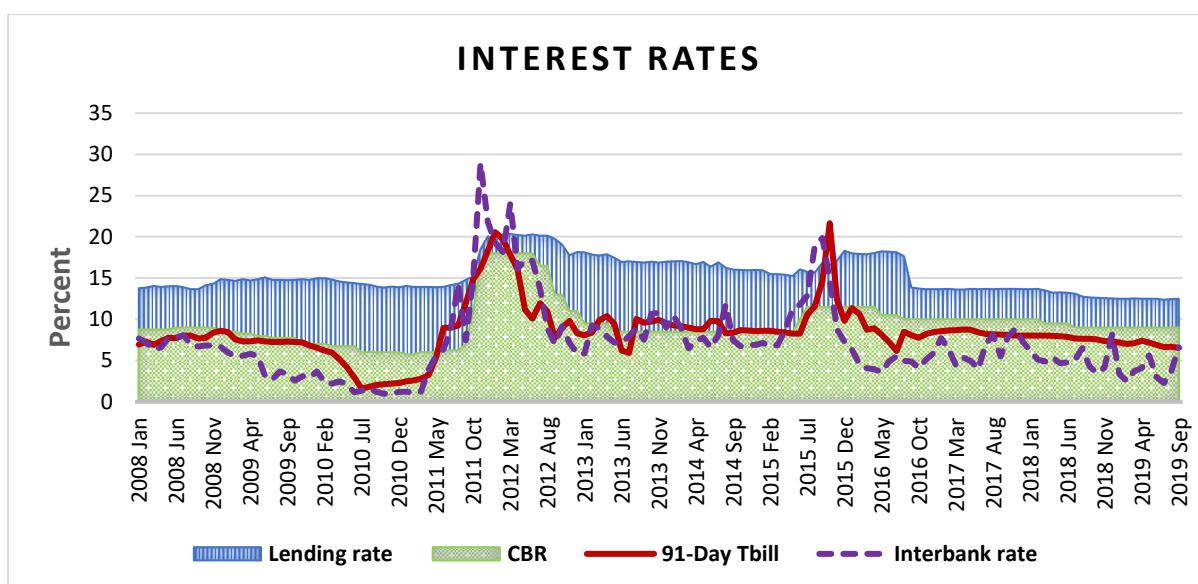
13. **There was an uptick in food inflation in the last quarter of 2019, with the price of some foodstuff such as maize and beans increasing.** The average price per kg of dry maize in September 2019 (Ksh. 41) was 32% higher than it was in a similar period in 2018 while that of dry beans (Ksh. 85 per Kg) was 14% higher. However, the impact of increasing food prices was dampened by the relatively low fuel inflation. Consequently, the overall inflation rate in December 2019 was 5.8% which was similar to the inflation rate in December 2018.
14. **The inflation rate rose to 5.8% in January 2020 up from 4.7% in January 2019** due to the upward trend in both food and fuel inflation over the last quarter of 2019. Going forward, the impact of the desert locusts on agriculture and food production as well as the possible rise in fuel prices due to the tensions between the United States of America and Iran may result in higher inflation rates.



Source of Data: Kenya National Bureau of Statistics

C. Interest rates and credit

15. **Interest rates remained stable over the period January 2018 to September 2019 with the weighted average lending rate by commercial banks decreasing to 12.5% over the first three quarters of 2019.** Between November 2018 and November 2019, net credit to the private sector expanded by 7%. In 2019, robust credit growth was channelled towards consumer durables, finance, and insurance sectors as well as the manufacturing sector while credit to the agriculture and mining sectors contracted. Credit to the private sector is expected to expand in 2020 due to the repeal of the interest rate cap.



Source of Data: Central Bank of Kenya

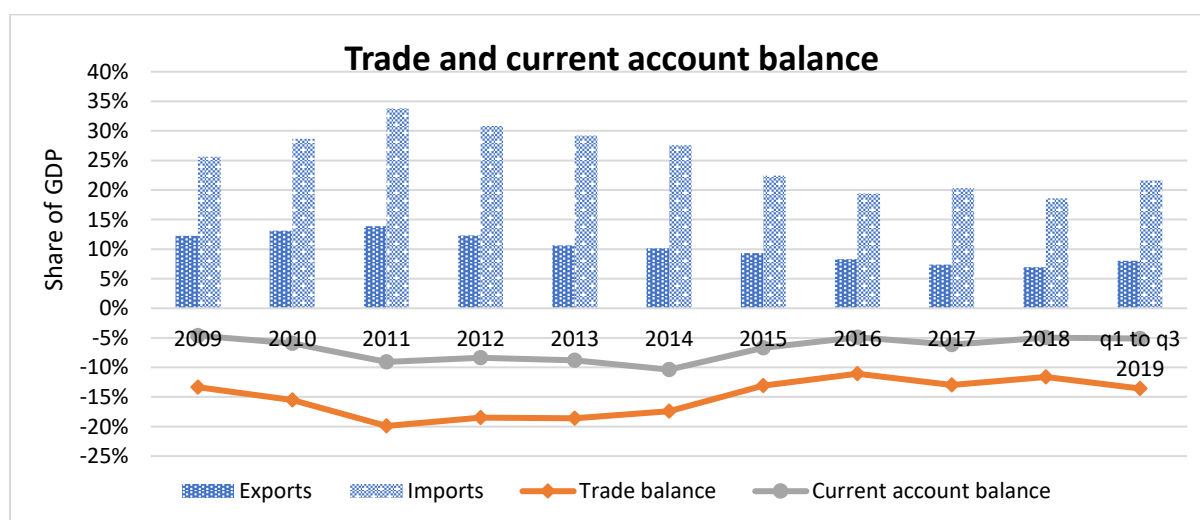
Table 2 Net credit to the private sector

	Annual growth rate Percent			
	Nov 2016	Nov 2017	Nov 2018	Nov 2019
Net credit to private sector	4.2	2.7	4.4	7.3
Agriculture	3.5	-7.7	-5.7	-6.1
Manufacturing	-4.1	10.6	14.9	7.5
Trade	15.7	10.0	3.9	8.8
Building and construction	-5.3	3.1	7.2	-6.1
Transport and communication	16.1	-8.0	-8.0	9.8
Finance and insurance	0.1	1.5	9.1	15.8
Real Estate	8.8	9.3	1.2	1.9
Mining and quarrying	-12.3	-3.2	-12.0	-3.2
Private households	10.6	2.7	5.1	6.1
Consumer durables	10.6	-0.4	7.3	25.9
Business services	-11.7	-7.6	12.4	-0.3
Other activities	-30.6	-23.1	-14.7	30.9

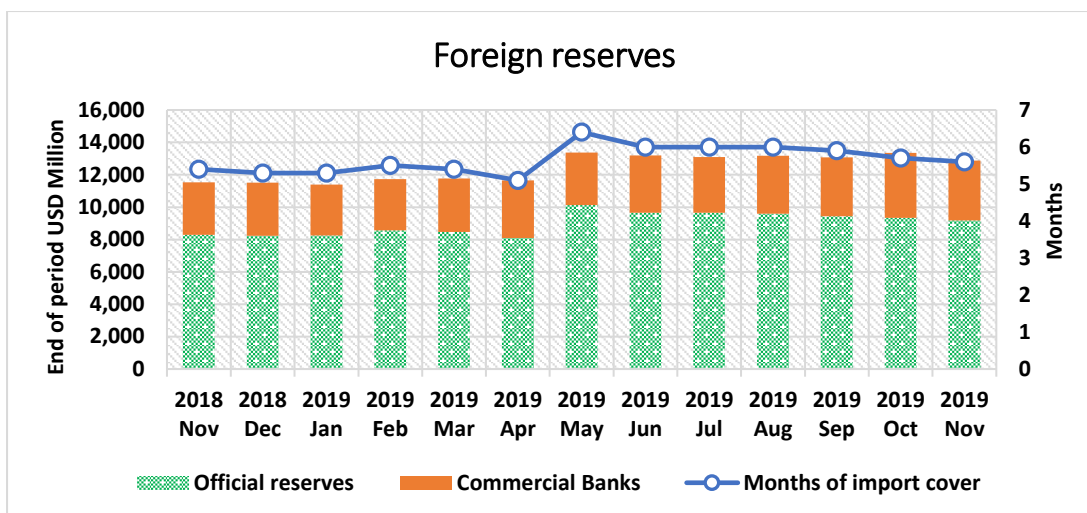
Source: Central Bank of Kenya

D. External sector

16. **Kenya's exports have been on a steady decline over the past decade.** Exports as a share of GDP declined from 14% in 2011 to 7% in 2018. The downward trend was driven by the relatively slower growth in the value of all the principal domestic exports. Exports of tea as a share of GDP decreased from 3% in 2010 to under 2% in 2019 while horticulture exports as a share of GDP decreased from 2% to about 1.2% over the same period.
17. **Remittances have replaced underperforming principal domestic exports such as tea, and tourism as Kenya's main source of foreign exchange.** In addition to being a major foreign exchange earner, remittances have had a greater impact on the expenditures of poorer households through their contribution to poverty alleviation, increased savings and human capital development [4–6].
18. Growth in remittances as a share of GDP has contributed to the maintenance of the current account deficit at about 5% of GDP over the past year. Further, remittances also contributed to the maintenance of foreign reserves at above 5 months of import cover throughout 2019.
19. **Going forward, reliance on remittances poses a risk because of the erratic nature of their annual growth.** The varied annual growth was single digits in 2010 and 2015 and over 30% in 2012 and 2018. Consequently, a negative shock to remittances could adversely affect Kenya's foreign reserves in the medium-term.



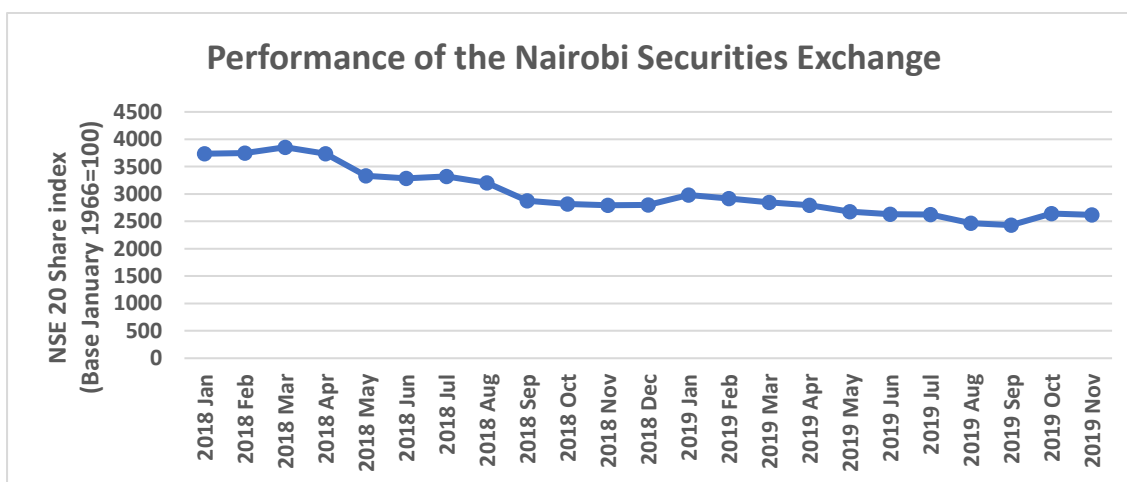
Source of Data: Central Bank of Kenya and KNBS



Source of Data: Central Bank of Kenya

E. Nairobi Securities Exchange

20. **The NSE 20 share index has been on a downward trend since the beginning of 2018.** However, unlike the steep decline that was experienced in 2018, the past year was marked by a more subdued contraction. The NSE 20 share index declined from 2,797 points in November 2018 to 2,619 points in November 2019.



Source of Data: Kenya National Bureau of Statistics & NSE

21. **Market concentration continues to be a major risk at the NSE.** The market value of the top five companies by market capitalization increased from 66% in the fourth quarter of 2018 to 73% in the fourth quarter of 2019. To stem the risk posed by market concentration, the Capital Markets Authority (CMA) has adopted a strategy aimed at encouraging other big companies to list at the NSE [7].

F. Economic outlook

22. **The economy is projected to grow at 6.1% in the year 2020 and 7% over the medium term.** The growth will be supported by investments under the “big four”, growth in tourism and exports as well as public investment in infrastructure. However, the following risks to the projected growth were highlighted in the 2020 BPS:

- I. An uptick in global oil prices resulting from USA Iran tensions.
- II. Uncertainty over the United Kingdom and European Union post-Brexit trade agreement.
- III. Low export prices of Kenya’s main agricultural exports.
- IV. Increased frequency of natural disasters such as floods, landslides, and droughts.
- V. The negative impact of desert locusts on agricultural output and food security.

The proposed mitigation measures for the identified risks include:

- I. Continued accumulation of foreign reserves to deal with external shocks.
- II. Adoption of a Disaster Risk Financing Strategy to deal with natural disasters.
- III. Expansion of irrigation schemes and promotion of value addition in agriculture.

Emerging issues

- I. *Wage related spending was identified in the BPS 2020 as one of the risks to the projected growth, however, the share of GDP of national government wages and salaries decreased from 5.9% in 2013 to 4.7% in 2018. The downward trend of the wage bill was also evident in national government wages as a share of tax revenue which decreased from 35% in 2010 to 30% in 2018. Thus the wage bill is no longer the key driver that is pushing overall government expenditure as a share of GDP upwards.*
- II. *The risk associated with public expenditure pressures may be attributed to the rising costs of debt service. Over the period 2013 to 2018, interest payments as a share of tax revenue increased from 14% to 26%.*
- III. *Reliance on remittances for the accumulation of foreign exchange reserves may pose a risk due to their volatility as well as the tougher anti-immigration policies being adopted in the United States of America and many European Union countries.*
- IV. *Enhanced foreign reserves are needed to cover the increasing foreign debt repayments. Between 2010 and 2018, the interest payment on foreign debt has increased from 1% of exports of goods and services to about 8%.*

HARNESSING THE BIG FOUR FOR JOB CREATION AND ECONOMIC PROSPERITY

23. In the BPS 2018, the government identified four key strategic areas of focus (“The Big Four”) that were to accelerate broad-based economic growth and address challenges such as unemployment, poverty, and income inequality. The strategic areas under the big four plan that were outlined in the 2018 BPS include:
- I. Creation of jobs and poverty reduction through supporting value addition and raising the manufacturing sector’s share of GDP to 15 percent by 2022.
 - II. Focusing on initiatives that guarantee food security and improve nutrition to all Kenyans by 2022.
 - III. Providing Universal Health Coverage thereby guaranteeing quality and affordable healthcare to all Kenyans.
 - IV. Improving living standards of Kenyans by providing at least five hundred thousand (500,000) affordable new houses by 2022.
24. The Big Four agenda has been in implementation over the past two years and with approximately two and a half years left to finalize implementation, the 2020/21 budget should not only take stock of what has been achieved so far but also provide a clear plan for how the remaining targets will be achieved within the remaining time frame.
25. Generally, it is not easy to keep track of the big four projects as these are scattered throughout the entire budget and the manner of reporting differs from year to year. Some of the targets/outputs that were specified in previous BPSs as part of the Big Four agenda have fizzled out and are no longer mentioned in the 2020 BPS. It isn’t clear whether these have been completely dropped off or were already achieved.
26. As indicated in previous discussions on the Big Four Agenda, it would perhaps be more useful to have a separate accountability framework for the Big Four that clearly spells out the policies and programmes with a results matrix for resource allocation as well as a monitoring and evaluation framework.

A. Supporting the manufacturing sector for job creation

27. The main goal of the manufacturing pillar is to support job creation through increased value addition and to raise the manufacturing share of GDP to 15% by the year 2022. As such, the government sought to undertake reforms with the aim of improving the business environment so as to encourage investment in manufacturing, and to protect local industries against dumping. Some of the main initiatives that were to be undertaken include;
- I. Development of Special Economic Zones and industrial parks.

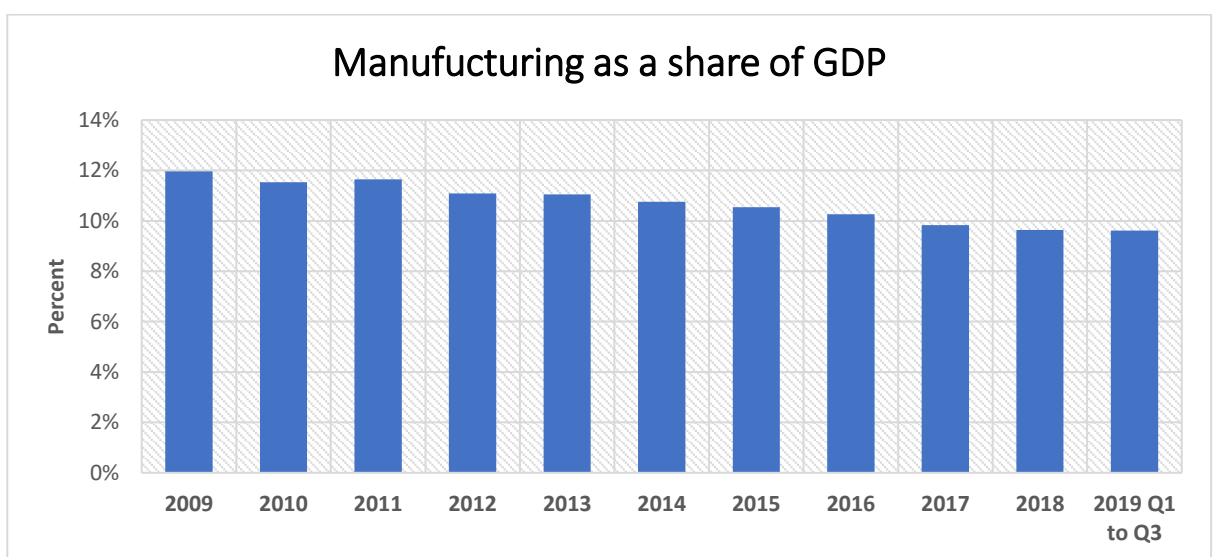
- II. Promotion of value addition to agricultural products.
- III. Promotion of manufacture of automotive and motorcycle parts.
- IV. Skills development and enhanced capacity for research and technology development.

28. In the 2020 BPS, some indicative progress on the policies and programmes under this pillar are provided. Under the Special Economic Zones (SEZ) and Industrial Parks, it is reported that the Dongo Kundu SEZ is being developed as is the construction of the Naivasha Industrial Park. Pre-feasibility studies for the Kisumu Special Economic Zone are also underway. However, this reporting is very scanty and a further review of the targeted outputs under this pillar reveals a few gaps.
29. **Leather Industry:** For the Kinanie Leather Park, it is reported that the Common Effluent Treatment Plant is 30% complete against a target of 40% completion by 2018/19. Further, the government targets to scale this up to 80% completion by end of 2019/20 and 100% completion by 2020/21.
30. A common Effluent Treatment Plant is arguably one of the most important targets for the industrial park to be functional. According to the Leather Industry report, one of the biggest difficulties facing the leather industry is a lack of quality effluent facilities which increases environmental and health costs associated with processing finished leather. One of the major attractions of any leather park, therefore, is the Common Effluent Facility hence the need to expedite its completion.
31. The BPS 2020, is not clear on why the 2018/19 target was not met, whether the 80% completion rate target for 2019/20 is on track and what measures have been put in place to ensure 100% completion by 2020/21. Furthermore, it is not clear whether interventions in the livestock industry have been adequate enough to improve the quality of hides and skins produced as this is one of the major challenges facing the leather industry. For FY 2018/19, the Kenya Meat Commission failed to achieve its targeted number of hides and skins production and it isn't clear whether it will meet its 2019/20 target.
32. The Dongo Kundu SEZ and Naivasha Industrial Park are reported as ongoing however, it is not clear whether the 40% and 30% completion targets respectively for 2019/20 are on track especially since previously reported actual achievement for 2018/19 was only 3% and 4% completion respectively. It would be very crucial for further details to be provided on what aspects of these SEZs are being developed in order to properly gauge progress.
33. **Textile Industry:** In the textile sector, Rivatex is reportedly making significant progress in the installation of machinery, an effluent plant as well as increasing the acreage under cotton production and the amount of cotton produced.

34. The government recently approved commercial farming of BT Cotton with effect from March 2020 following successful field trials. This is expected to boost production significantly as well as mitigate against losses from pests and diseases among other environmental stresses. The government is also targeting to distribute seeds and fertilizer in order to address quality concerns. While this is good progress for the textile sector, the focus should shift towards complementary interventions such as education of cotton farmers on proper planting, harvesting and defoliation practices in order to improve the quality of production.
35. In the unpacking of the BPS 2018, one of the biggest concerns in the textile and apparel sector is poor labour productivity. According to the 2015 textile industry report, training given to workers in the textile industry is not only of poor quality but has also been described as ‘not fit for purpose.’ Thus, though there is ongoing industrial training as reported in the BPS, it is not clear whether a training needs audit was carried out and the syllabus structured accordingly. Most of the training in textile training institutions has focused on fashion and design rather than production skills even though these are also in demand.

Emerging issues

- I. *Public investment on the manufacturing pillar over the past two years has not had an impact on the GDP share of manufacturing. Manufacturing as a share of GDP decreased from 10.5% in 2015 to 9.6% in the first three quarters of 2019. Consequently, there is a need to rethink some of the investments that are proposed under the manufacturing pillar. Further, there is a need to closely monitor the progress of the lagging programmes over the next two years.*



Source of data: Kenya National Bureau of Statistics

II. *The targets set for 2020/2021 and the medium term for many of the key projects under the manufacturing pillar may not be achieved. For instance, the Common Effluent Treatment Plant at Kinanie Leather Park which was reported to be 30% complete in 2018/19 is expected to be scaled up to 80% completion by end of 2019/20 and 100% completion by 2020/21. Similarly, the Dongo Kundu SEZ and Naivasha Industrial Park which reported 3% and 4% completion respectively in 2018/19 have a target of 40% and 30% completion targets respectively for 2019/20.*

B. Food and Nutrition Security to all Kenyans

36. The overall strategy under this pillar is to expand irrigation schemes, support large scale production of staples, increase access to agricultural inputs, implement programmes to support smallholder farmers and promote the use of appropriate farming techniques.
37. The government has made some strides towards increasing land under irrigation. Notably, the 2020 BPS reported that Galana Kulalu farm acreage increased from 52,000 to 100,000, further, both the Lower Nzoia Irrigation project and the rehabilitation of Bura irrigation scheme are underway. However, a review of the key outputs and performance indicators matrix reveals that only 2000 acres out of a targeted 10,000 acres were planted in Galana Kulalu in 2018/19 and the target for 2019/20 is an additional 5,300 acres. Further, it should also be noted that maize production in Galana Kulalu was only 4,320 tons in 2018/19 against a target of 54,000 tons and the targeted production for 2019/20 is 4,000 tons.
38. Bura irrigation scheme also appears to be off-target as the number of acres rehabilitated was reported as 196 acres against a target of 8,000 acres in 2018/19. Further, the target for 2019/20 is 7000 acres but it isn't clear what strategies were put in place to improve performance given the dismal performance of the previous financial year. It should also be noted that tons of seed maize produced in the Bura scheme was 1,186 tons against a target of 10,000 tons and given this performance it isn't clear how the target to produce 20,000 tons in 2019/20 will be achieved.
39. The National Expanded Irrigation Scheme has reported significant progress in increasing the amount of acreage under irrigation as well as the amount of rice and maize produced. Mwea Irrigation scheme appears to be performing reasonably well as is the Turkana, Perkerra, Lower Kuja and Lower Sabor Irrigation schemes in terms of increasing acreage under production. However, it is not clear whether there has been a concomitant increase in food production in these schemes as this is not expressly reported.

40. Fish production is also a key strategy being employed to attain food security. In the face of recent reports of pollution and poisons killing Lake Victoria, there is a need for a clear strategy by the government on how this issue will be addressed in order to protect the fish industry. In the output and KPI matrix, there are no clear interventions to address pollution concerns in Lake Victoria.

C. Universal Health Coverage

41. The main purpose of the Universal Healthcare Coverage pillar was to reduce inequalities in healthcare by making it easy for all citizens to access healthcare services at minimum cost. A pilot programme was rolled out in 2018 in Kisumu, Isiolo, Machakos and Nyeri counties.
42. Milestones reported in the BPS 2020 for this pillar include increased access to essential health services, increased skilled deliveries attributed to the Linda mama initiative, operationalization of the Othaya National Teaching and Referral Hospital as well as the Kenyatta University Teaching Research and Referral Hospital, Beyond Zero mobile clinics in all 47 counties, decentralizing of cancer management services, enhanced access to specialized services in 120 hospitals across the country under the Managed Equipment Service (MES) and increased health care access under the Health Insurance Subsidy Programme (HISP).
43. The BPS 2020 reports that moving forward the focus will be on addressing human resource needs, providing basic equipment and ensuring the availability of pharmaceutical and non-pharmaceutical commodities in all health facilities, however, the strategy of how this will be achieved remains unclear.
44. Lack of equipment and amenities, as well as strikes by doctors and nurses due to various concerns, are arguably the main challenges facing the health sector. It is therefore not enough to simply state that there will be an increased focus on these matters without providing a clear strategy complete with targets and Key Performance Indicators. Furthermore, it is extremely crucial for the National government to indicate how it is collaborating with the County governments as Health is a devolved function. This is a key missing link. Further, the challenges facing NHIF have to be addressed for universal healthcare to be successful.
45. There is no report on the progress of key policy reforms under this pillar such as medical tourism strategy, development of emergency medical care policy, implementation of the Kenya Environmental Sanitation & Hygiene policy; as well as legal reforms (enactment of the food and drug authority bill, National research for health bill, etc.). In addition, there are key reports pending publication to review the implementation of projects such as the MES project of the UHC program that if published, could enhance efficiency and value for money.

D. Affordable and Decent Housing for All Kenyans

46. One of the goals of this pillar is to provide 500,000 affordable housing units by the year 2020. In an effort to realise this goal, the government has forged partnerships with the private sectors. One such partnership is the Habitat Height by the United Nations Office for Project Services (UNOPS). Through this partnership, 8,888 low-cost units will be availed to Kenyans and a further 200,000 units in due course.
47. The government has also identified land to develop 100,000 units and ensure the provision of all amenities of a modern metropolis. However, it should be noted that beyond UNOPS it is not clear whether the government has been able to identify other Private Sector Partners in order to be able to fully fund this project. It may be difficult to convince other private partners to take on this project given the duration of implementation as well as uncertainty on whether the project will be carried forward when government transitions in 2022.
48. The BPS 2020 reports that the National and County Governments will appropriate land for affordable housing projects at no cost. However, it is not clear how much land the government can avail in this manner.
49. Other measures that have been identified as enablers to achieving the goals of this pillar include exempting homeowners from Stamp duty under the affordable housing scheme, doubling of the homeownership saving plan, waiving construction charges by NEMA and National Construction Authority as well as operationalizing the National Housing Development Fund and the Kenya Mortgage Refinancing Company. In addition, the government will reportedly amend the Housing Fund law to make contributions to the Housing Fund voluntary.
50. Under social housing, the government is looking for suitable investors to implement decent homes project for Nairobi's Kibera Zone B residents.

BUDGET FOR FY 2020/21 AND THE MEDIUM TERM

51. The FY 2020/21 budget framework is guided by a fiscal consolidation strategy which aims at containing the upward pressures of debt accumulation. In order to achieve this, the budgetary allocations will be as follows (Ksh. Millions):

i. Executive	Ksh. 1,778,133
ii. Parliament	Ksh. 36,222
iii. Judiciary	Ksh. 18,051
iv. Consolidated Fund Services¹	Ksh. 574,650
v. County Equitable Share²	Ksh. 316,500
<u>Total</u>	<u>Ksh. 2,723,556</u>
vi. Equalization Fund	Ksh. 6,500
vii. Contingency Fund	Ksh. 5,000
<u>Grand total</u>	<u>Ksh. 2,735,056</u>

A. REVENUE PERFORMANCE & OUTLOOK

52. The 2020 BPS has revised the ordinary revenue target for FY 2019/20 downward by Ksh 33.4 billion. The tax heads that have had their projections reduced include; income tax, import duty, and VAT as shown in Table 3 below. However, Excise duty and other revenues (including investment revenues) are projected to increase by Ksh 19.4 billion and Ksh 79.2 billion respectively.

53. Going forward, total revenue collection for the FY 2020/21 including appropriation-in-aid (A.I.A) amounts to Ksh. 2,134.1 billion (18.3 percent of GDP) as compared to Ksh.2,084.2 billion in 2019/2020 (20.1 percent of GDP). Ordinary revenue in the next financial year is projected at Ksh.1, 856.7 billion (16 percent of GDP). Growth in revenue projections will be occasioned by an increase in revenue collection from income tax head as well as VAT head. Generally, it is projected that overall revenue in the FY 2020/21 is expected to grow by 2 percent as compared to FY 2019/20 with ordinary revenue expected to grow by 1 percent while A.I.A is expected to increase by 18 percent to Ksh. 249.6 billion. It's worth noting that there is volatility in A.I.A, therefore the projection may not be achieved over the medium term.

54. The growth of revenues in the medium term is underpinned by on-going reforms in tax policy, revenue administration, automation, modernizing and simplifying various tax laws. However, further details of these tax policies have not been provided.

¹ Consolidated fund services is composed of domestic interest, foreign interest and pension

² The allocation for County Governments is based on the sharable revenue.

Table 3 Revenue Performance and projections for the FY 2017/18-2020/21

	2017/18 (Ksh. billions) (Actual)	2018/19(K sh. billions) (Actual)	2019/20 (Printed Estimates) (Ksh. billions)	2019/20(revis ed projections) (Ksh. billions)	Deviation s (Printed Vs. Revised) (Ksh. billions)	2020/21 (Ksh. billions)	2020/21 vs. 2019/20 (Ksh. billions)
Total Revenue	1,522.5	1,698.8	2,115.9	2,084.2	(31.7)	2,134.1	49.9
Ordinary Revenue	1,365.1	1,496.9	1,877.2	1,843.8	(33.4)	1,856.7	12.9
<i>Income Tax</i>	640.6	685.4	884.4	804.5	(79.9)	862.3	57.8
<i>Import Duty</i>	93.9	107.7	135.4	128.2	(7.2)	126.5	(1.7)
<i>Excise Duty</i>	167.8	194.3	242.2	261.6	19.4	258.0	(3.6)
<i>Value Added</i>	356.9	413.2	496.0	464.5	(31.5)	496.4	31.9
<i>Investment Income</i>	24.1	23.8	33.0	19.7	(13.3)	21.0	1.3
<i>Other</i>	81.8	72.6	86.1	165.3	79.2	92.5	(72.8)
<i>Railway Development Levy</i>	20.8	21.3	27.7	28.4	0.7	27.8	(0.6)
A.I. A	136.6	180.6	211.0	212.0	1.0	249.6	37.6

Source: National Treasury, 2020

B. EXPENDITURE

55. Given the modest projected growth of revenues in FY 2020/21, the government has contracted expenditures with the aim of contracting the fiscal balance deficit to 5.3 percent of GDP from 7.6 percent of GDP in FY 2019/20. Overall, expenditures are expected to contract from Ksh. 2,874.2 billion to Ksh. 2,748.2 billion (23.6 percent of GDP). The recurrent expenditure will witness an increment of Ksh. 21 billion occasioned by an increase in interest payments, wages & salaries and pensions payments.
56. The development expenditure is set to be reduced by 143.5 billion or 5 percent of GDP. Under development expenditure, both foreign-financed, as well as domestically financed projects, are set to reduce by 0.6 percent and 1.4 percent to stand at 2.1 percent of GDP and 2.9 percent of GDP respectively.
57. It's worth noting that despite the government exploring fiscal consolidation over the medium term, there is no clear strategy on how to get it done. Further, a significant reduction of expenditures, especially in development expenditure, may lead to delays in ongoing projects as well as the escalation of the number of stalled projects.

Table 4 Expenditure Performance and Outlook

	2017/18 (billions)	2018/19 (billions)	2019/20 Printed Estimates (billions)	2019/20 Revised (billions)	Deviatio ns (2019/20 Printed vs. Revised (Ksh. billion)	2020/21 (billions)	Deviatio ns (2020/21 estimate s vs. Revised 2019/20) (Ksh. billion)
Expenditure & Net Lending	2,146.7	2,433.7	2,789.5	2,874.2	84.7	2,748.2	(126.0)
Recurrent Expenditure	1,349.9	1,531.1	1,760.0	1,760.0	-	1,781.0	21.0
<i>Interest Payments</i>	323.9	375.7	441.5	441.5	-	456.0	14.5
<i>Wages & benefits</i>	388.9	417.5	483.5	487.6	4.1	500.7	13.1
<i>Pensions</i>	65.1	70.8	108.6	108.6	-	118.7	10.1
<i>Other</i>	570.2	667.1	726.4	722.3	-4.1	705.6	(16.7)
Development & Net Lending	469.5	541.9	652.3	730.8	78.5	587.3	(143.5)
<i>Domestically Financed</i>	266.0	307.0	390.2	442.5	52.3	334.5	(108.0)
<i>Foreign Financed</i>	201.0	225.4	255.8	281.9	26.1	246.3	(35.6)
Net Lending	2.5	2.5	0.6	0.6	-	-	(0.6)
Contingency	-	-	5.0	5.0	-	5.0	-
Equalization Fund	-	7.0	5.8	5.8	-	6.5	0.7
County Allocation	327.3	360.7	371.8	378.3	6.5	375.0	(3.3)

Source: National Treasury

C. MTEF SECTORS ALLOCATIONS FOR THE FY 2020/21

58. The total allocation for ministerial expenditure is set to decrease to Ksh.1.83 trillion compared to Ksh.2 trillion in FY 2019/20. There is a significant decrease in the budget for most sectors. However, Education, National Security, and Environment Protection, Water & Natural Resources have received modest budgetary increments.

59. The decrease in budgetary allocation for the Agriculture, Rural & Urban Development sector is a result of the reorganization of government as some departments have been moved to the Ministry of Water, Sanitation and Irrigation. Budgetary reduction in Energy, Infrastructure, and ICT is a result of a budgetary reduction in the Roads and Rail transport programmes under this sector while the reduction in GECA sector is due to a budgetary reduction in the programmes such as industrial development and investments and Integrated Regional Development.

Table 5 Sectors ceiling for financial year 2019/2020(Kshs. Millions)

Sector	2019/20 Supplementary Estimates Ceiling	BPS Ceiling - 2020/21	Percentage Change
Agriculture, Rural & Urban Development	59,408.9	48,094.2	-19.0%
Energy, Infrastructure & ICT	480,866.0	388,974.8	-19.1%
General Economic & Commercial Affairs	32,734.2	23,553.8	-28.0%
Health	115,629.1	114,477.5	-1.0%
Education	496,732.1	497,798.5	0.2%
Governance, Justice, Law & Order	210,379.1	201,909.5	-4.0%
Public Administration & International Relations	285,925.1	232,187.4	-18.8%
National Security	159,150.6	159,319.8	0.1%
Social Protection, Culture & Recreation	71,354.4	69,361.7	-2.8%
Environment Protection, Water & Natural Resources	94,784.8	96,728.9	2.1%
Grand Total	2,006,964.3	1,832,406.1	-8.7%

Division of revenue between the two levels of government

A. Review of historical budget allocation to counties

60. The counties have received a total of Ksh.1.906 trillion since 2013/14. The total annual disbursements to counties grew from Kshs. 195.66 billion in the FY 2013/2014 to Kshs. 364.38 billion in the FY 2018/19. The nominal growth was driven mainly by an increase of equitable share, nominal growth of GoK funded conditional grants, and an increase in additional conditional allocations from the Road Maintenance Levy Fund and other conditional allocations. Table 6 provides a summary of the disbursements to the counties for the period 2013/14-2018-19.

Table 6 Summary of Disbursement to Counties in the FY 2013/14-2018/19 in Kshs. Millions

Transfer Type	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	Total
1. Equitable share transfer	190,000	226,660	259,774	280,300	302,000	314,000	1,572,735
2. GoK-Funded Conditional Allocations	5,665	3,261	10,901	13,705	15,408	19,317	60,558
a) Level Five Hospital	3,419	1,863	3,600	4,000	4,200	4,326	21,409
b) Free Maternal Healthcare ³	2,246	1,398	3,321	4,105	3,400	4,300	11,070
c) Managed Equipment Services	-	-	3,080	4,500	4,908	8,830	21,318
d) Foregone User Fees Compensation	-	-	900	900	900	900	3,600
e) Rehabilitation of Youth Polytechnics	-	-	-	-	2,000	961	2,961
f) Emergency Medical Service Grant	-	-	-	200	-	-	200
g) Construction of County HQs	-	-	-	-	-	-	-
3. Additional conditional allocations	-	1,137	5,547	10,905	17,797	31,070	66,456
a) Road Maintenance Levy Fund	-	-	3,300	4,307	10,262	7,424	25,293
b) External Loans and Grants	-	1,137	2,247	1,756	7,535	23,646	36,321
4. Allowances for County medical personnel	-	-	-	4,842	-	-	4,842
5. Coffee Cess	-	-	-	107	-	-	107
Total Disbursements	195,665	231,058	276,222	309,859	335,205	364,387	1,704,591
% Share of Conditional Allocations to the Total Disbursement	2.90	1.90	5.95	7.98	9.91	13.83	7.46

Source: The National Treasury, 2019

61. The gains of devolution have been felt differently across the 47 counties. In some counties, devolution has led to infrastructural developments, improved service delivery and the drafting of development plans that are more localized. Additionally, public services have now become more accessible to the residents of counties due to local control and management brought about by the devolution process.

Salient issues

- I. The disbursements to the GOK funded conditional grants increased from Kshs. 5.67 billion in the FY 2013/14 to Kshs. 19.32 billion in the FY 2018/19. While the number of these grants has increased over the years there is no clear basis/criteria that determines how much conditional grants are allocated and the basis of distribution.
- II. Conditional allocations financed by loans and grants from development partners have increased from Kshs. 1.11 billion in the FY 2014/15 to Kshs. 23.64 billion in the FY 2018/2019.
- III. The share of disbursements as equitable share to the counties grew from Kshs. 190 billion in the FY 2013/14 to Kshs. 314 billion in FY 2018/19. The allocation to equitable share is arrived at through calculation of parameters such as population, poverty e.t.c There is however no established criteria on how they are distributed. To spur economic growth and enhance service delivery in line with the scheduled county functions, there should be clear criteria used in the sharing of resources across sectors

³ In FY 2017/18 and FY 2018/19, Ksh. 3.4 billion and Ksh 4.3 billion, respectively, from the National Government's revenue share was paid to the National Hospital Insurance Fund (NHIF) as a special grant for Free Maternal Healthcare, to be disbursed directly to Counties on reimbursement basis.

once the funds reach the counties and a further need to assess the impact of equitable share on delivery of services.

B. Comparison between the National Treasury and Commission on Revenue Allocations proposed County Allocations

62. Out of the total projected shareable revenue of **Kshs. 1,856.70 billion, Kshs. 1,533.67 Billion** will be allocated as the equitable share to National Government. The National Treasury also proposes an allocation of **Ksh. 369.87 Billion** to the County Governments for FY 2020/21. This amount comprises of **Ksh. 316.5 Billion** as county equitable share and **Ksh. 13.73 billion** as GOK conditional grants, **Kshs. 9.43 billion** allocation from the Road Maintenance Levy and **Kshs. 30.20 billion** as allocations from loans and grants. The allocation for the Equalization Fund for FY 2020/21 is **Kshs. 6.53 Billion** which is a 13 percent increase from the **Kshs. 5.76 billion** allocated in the FY 2019/20.
63. In the Budget Review and Outlook Paper (BROP) 2019 as well as the draft BPS 2020, the National Treasury had proposed an equitable share of Kshs. 317.8 billion to county governments for the FY 2020/21, however the revised proposal to allocate Kshs. 316.5 billion is informed largely by;
- I. Continued underperformance in ordinary revenue, which forms the base for the annual division of revenue;
 - II. The fact that the National Government solely bears the shortfalls in revenue in any given FY;
 - III. The 10.3% projected contraction in National Government's net spending in FY 2020/21 vis-a-vis FY 2019/20
 - IV. The proposal by National Treasury that the entire incremental revenue in FY 2020/21 be earmarked for CFS, specifically debt repayment and pensions
64. The Commission on Revenue Allocation, on the other hand, recommended County Equitable share revenue of Kshs. 321.74 billion to be shared among county governments on the basis of its proposed third basis formula of revenue sharing. However, this basis has not been approved by Parliament pursuant to Article 217 of the Constitution.
65. The Commission recommended an adjustment to both the National and County governments' development expenditures on the basis of the average rate of the country's economic growth. The Commission recommended an adjustment of 5.7 percent (based on the Country's three year (2016-2018) average economic growth) on the actual three-year average development expenditure for each level of government. The adjustment translates to the additional allocation of Kshs. 5.24 billion to the counties thus translating to a proposed equitable county allocation of Kshs. 321.74

billion in the FY 2020/21 and additional Kshs. 31.35 billion to the National Government to finance development activities.

66. Table 7 shows a comparison of the proposals by the National Treasury and CRA in County allocations and the basis for the proposals.

Table 7 Proposals by N.T and CRA for Equitable Share of Revenues for FY 2020/21 In Ksh. Billion

Equitable Share of Revenues for FY 2020/21 In Ksh. Billion			
	Baseline FY 2019/20	Proposed FY2020/21	Remarks
National Treasury BPS	316.5	316.50	The FY 2019/20 figure remains the same. There is however no basis for this
The CRA	316.5	321.74	Adjustment of 5.7 percent (based on the Country's three the year 2016-2018 average economic growth) on the actual three-year average development expenditure. The adjustment translates to additional allocation of Kshs. 5.24 billion to counties (equivalent to 31% of Kshs. 1,038,035 of 2014/15)

Source: BPS 2020, CRA 2019

67. The latest audited accounts approved by the National Assembly is for FY 2016/2017 with revenue of Kshs. 1,357.698 billion. In using the audited reports for the FY 2014/2015, the allocation of Kshs. 316.5 billion as shareable revenue is equivalent to 30 percent of the total audited shareable revenue; this is 15 percent more than the minimum requirement set out in the Constitution. Whereas in using the FY 2016/2017 audited reports, allocation of Kshs. 316.5 proposed for the FY 2020/21 will only be 8 percent above the constitutional requirement of 15 percent.

68. The allocation towards additional conditional grants (National Government share of Revenue) for the FY 2019/2020 was Kshs. 22.895 billion. The National Treasury has proposed an allocation of Kshs. 23.164 billion as additional conditional grants to the counties for the FY 2020/21. This is an increase of Kshs. 268.85 million compared to the FY 2019/20 allocation.

69. The increase is explained majorly by the increase in Road Maintenance Levy which has increased by Kshs. 449 million (from the previous allocation of Kshs. 8.98 billion). However, there is a decrease in Kshs. 185.15 million in allocation towards Supplement for construction of county headquarters which had an allocation of Kshs. 485.15 million and has a decreased proposal for Kshs. 300 million.

Table 8 changes in conditional grants between FY 2019/20 and FY 2020/21

Conditional Grants	Allocation 2019/20	Proposed Allocation 2020/21	Change in Allocation
	Kshs. Millions		
Conditional Grants to Level 5 Hospitals	4,326.00	4,326.00	-
Supplement for construction of county headquarters	485.15	300.00	(185.15)
Conditional Grant Compensation for User Fee Foregone	900.00	900.00	-
Conditional Grant Leasing of Medical Equipment	6,200.00	6,205.00	5.00
Conditional Grant Road Maintenance Fuel Levy	8,984.00	9,433.00	449.00
Conditional Grant Rehabilitation of Youth Polytechnics	2,000.00	2,000.00	-
Total	22,895.15	23,164.00	268.85

Source: The National Treasury

70. In FY 2020/21, the BPS is proposing Kshs. 30.20 billion as conditional allocations financed from loans and grants from development partners. This allocation has decreased from Kshs. 39.09 billion allocated in the FY 2019/20.

71. In regards to conditional loans and grants, there is a lack of approved and published criteria on the distribution of external loans and grants from development partners particularly the negotiation process and selection of projects/counties which benefit from these grants.

72. In as much as the BPS has attempted to provide information on the rationale for the changes in the allocation of the conditional grants, it has not given sufficient information. For example, it is not clear why the Kenya Devolution Support Project level 2 grant and the Kenya Urban Support project (Urban Institution Grants) have not been allocated any funds in the FY 2020/21.

Salient Issues

The vertical distribution of nationally raised resources should be guided by the last audited and approved accounts and not the projected revenue.

The FY 2020/21 Medium Term Debt Management Strategy

73. The MTDS 2020 is prepared on the basis that the government will continue to operate on the objectives of achieving fiscal consolidation and the macroeconomic assumptions indicated under the 2020 Budget Policy Statement. In addition, it depends on the assumption that fiscal deficits will have to be contracted so as to reduce the overall cost of debt on the economy and safeguard debt sustainability.

74. A new introduction to the MTDS 2020 is the proposal that a portion of external debt should be in local currency (Ksh.) which will be expected to reduce the impact of exchange rate risk and change the currency composition of Kenya's debt portfolio. However, the strategy of how this will be achieved is not comprehensively explained.

75. On the domestic market, reforms have been proposed; however, these seem to be repetitive with little information provided on the progress of their implementation and impact so far.

Table 9 Achievement of MTDS Reforms since FY 2018/19 – 2019/20)

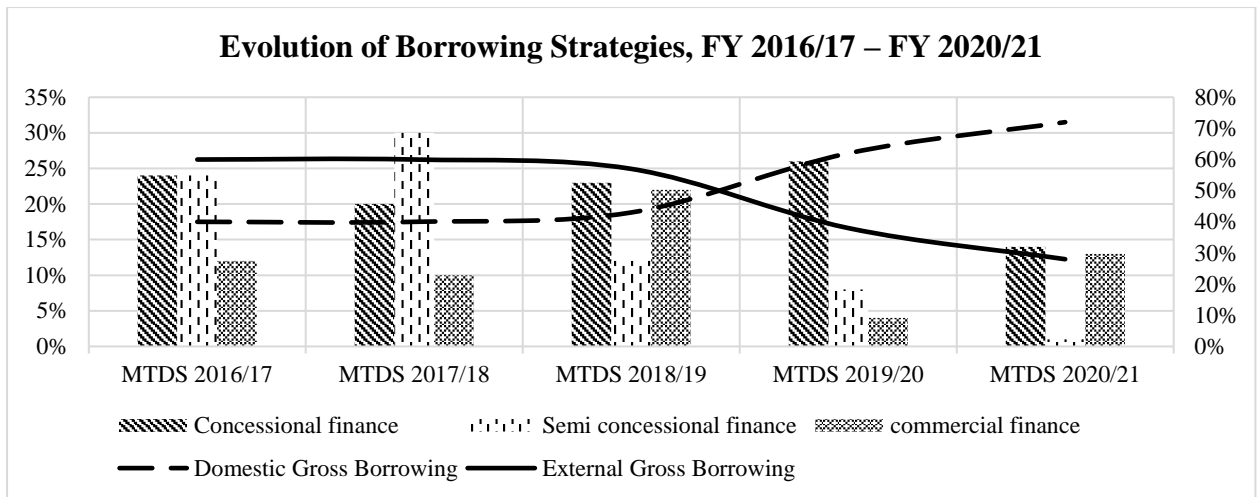
Reform	FY 2018 /19	FY 2019 /20	FY 2020 /21	Indicated Achievement
Separation of institutional investors and retail investors in the primary market to facilitate full automation of securities auction and shortening of the primary cycle	✓	✓	✓	-
Regular publication of issuance calendar	✓	✓	✓	-
Regular market engagement	✓	✓	✓	-
Restructuring of horizontal repo transactions			✓	-
Establishment of over the counter trading platform aimed at fostering transparency and efficiency in secondary securities trading	✓	✓	✓	-
Issuance of fewer but large size benchmark bonds to enhance market liquidity and attract capital flows	✓	✓	✓	-
Diversify market financing instruments to include zero-coupon bonds, indexed bonds and undertake periodic liability management operations such as bond exchanges			✓	-

Source: 2020 MTDS

76. Under the MTDS 2020, the *gross* external borrowing share of deficit finance is set to fall further from 38% in FY 2019/20 down to 28% while domestic borrowing is set to increase to 72%. External Debt will be financed by Concessional Finance - 14%, Semi Concessional Finance – 1% and Commercial finance - 13%⁴.

77. A review of the proposed deficit financing structure indicates a policy shift since FY 2018/19 whereby domestic borrowing would account for over 60% of borrowing with external borrowing declining. The decline in external debt is spurred by the reduction of semi concessional debt rather than the reduction of commercial debt resulting in an increase in overall interest rate cost of the debt portfolio and a possible weakness of the medium-term planning of the debt strategy.

⁴ Existence of ambiguity relating to the composition of projected external debt. On page 27, the composition is provided as 14% and 1% for concessional and semi concessional borrowing. This contradicts the ratio under the executive summary (page x) that provides for a ratio of 15% and 13% respectively.

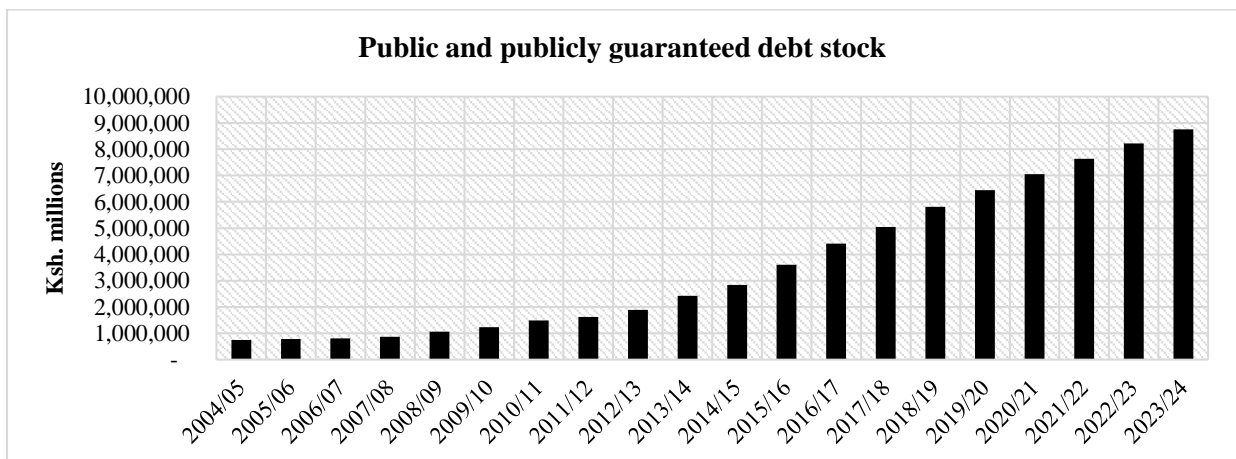


Source: 2020 MTDS

A. Kenya’s Debt - Current Status

78. Kenya’s Public and Publicly Guaranteed Stock of debt has grown by an annualized growth rate of 19% for the past 10 years due to an increase in expenditure (lead by infrastructural investments and cost of government free services), shortfalls in revenue forecast, and shrinking fiscal space (as a result of increase in compulsory expenditure such as debt servicing payments, pensions, etc.).

79. As at end of December 2019, public debt amounted to Ksh. 6.048 trillion⁵ (67% of the Ksh. 9 trillion national debt ceiling) and comprised of Ksh. 2.9 trillion (49%) in domestic debt and Ksh. 3.1 trillion (51%) in external debt.



Source: Annual Public Debt Management Reports & Central Bank (K) Bulletin.

⁵ The Central Bank of Kenya - January 2020 Weekly Economic Bulletin and the Half Year QEER

B. Risks & Costs Profile

- *Refinancing Risk*

80. The country continues to face increased debt refinancing pressure more so from domestic debt (Average time to maturity of 5.7) compared to that of the external debt (ATM of 11). As such, as of December 2019, up to 34.9% (Kshs. 990.9 billion) of total domestic debt is expected to reach maturity in the next 1 year. This only a marginal reduction from Ksh. 1.04 trillion in FY 2019/20 indicating sustained refinancing pressure for the next financial year. Over the medium term, this is projected to decline to Ksh. 331.7 billion as a result of increased uptake of medium to long term debt.

Table 10 Kenya remaining maturity of Outstanding Domestic Debt, as at end FY 2017/18

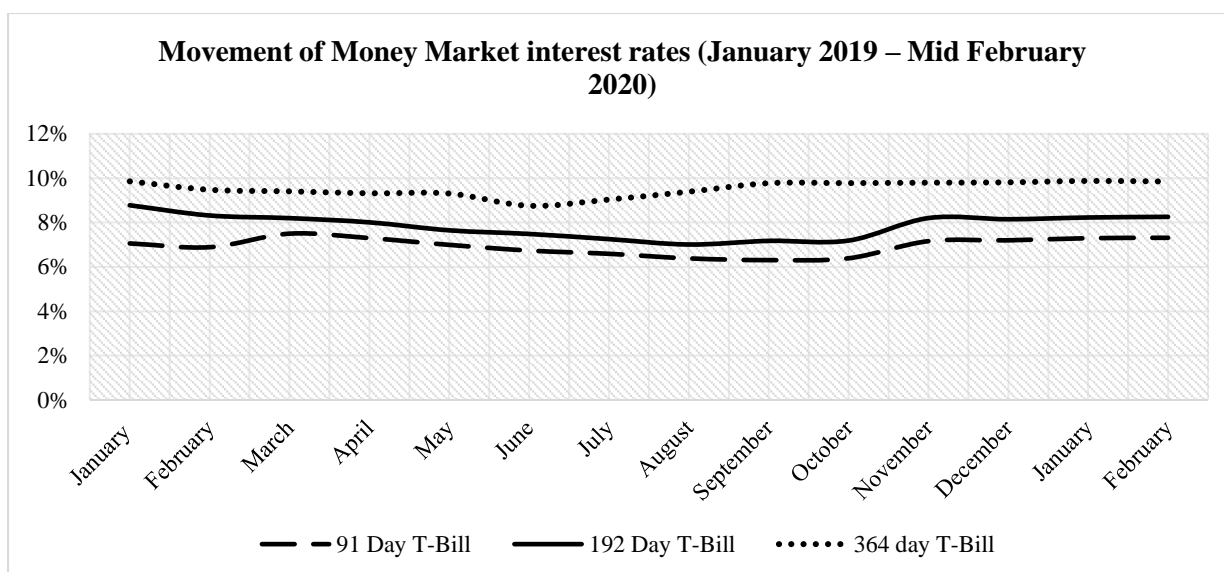
Maturity (Years)	End of Dec 2018 (Millions US\$)	In percent of Total	End of Dec 2019 (Millions US\$)	In percent of Total
<i>Less than one year</i>	10,376	42.8	9,909.22	34.9
2 to 3 years	2,419	9.9	3,528.58	12.4
4 to 5 years	3,225	13.3	3,317.56	11.7
6 to 10 years	5,118	21	6,029.96	21.2
Above 11 years	3,168	13	5,593.97	19.8
Total	24,306.00		28,379.29	

Source: National Treasury

- *Interest Rate Risk*

81. The debt portfolio indicated a rise in exposure to interest rate related risk as at end of December 2019. The level of interest rate risk is a factor of; *a)* The Weighted Average Interest Rate - of which the domestic debt portfolio had a higher average interest rate (11.4%) compared to that of the external debt portfolio (4.2%)., and *b)* debt with fixed interest rate – that fell from 93.2% of total debt to 85.3% indicating increased volatility of interest rate.

82. It is important to note that the above factors relate to the debt stock and that the future movements and volatility of interest rate risk is left to be catered under the borrowing strategy. A review of the volatility of money market interest rates indicates that interest rates of the 91day T-Bill, 182 Day, and the 364 Day T-Bills, after a period of decline, had increased by Mid-February 2020. If the trend continues, then this could result in a further increase in domestic borrowing related interest risk.



Source: CBK, Weekly Bulletin

- *Guaranteed Debt*

83. National stock of debt also comprises of debt guarantees under Article 213 of the Constitution and Section 58 of the PFM Act, 2012. These form part of fiscal contingent liability i.e. if an institution fails to make payments for a guaranteed loan it necessitates the government to step in and shoulder the extra-burden by use already limited financial resources. As of the end of December 2019, a total of Ksh. 158.1 billion worth of guarantees had been provided to 7/seven institutions and had increased from Ksh. 133.79 (December 2017). At this level, it is approximately Ksh. 41.9 billion short of the Ksh. 200 billion ceiling⁶.

84. Out of the portfolio, Tana & Athi Rivers Dev. Authority and East African Portland cement are non-performing resulting in Ksh. 305.1 billion incurred to meet the loan repayments.

Table 11 Outstanding Government Guaranteed Debt (AS at Dec2019)

Entity	Ksh. Millions
Kenya Power Company	12,549,335,918.02
Kenya Electricity Generating Company	27,808,475,106.38
Kenya Ports Authority	36,844,724,766.26
Kenya Airways	76,002,375,000.00
Kenya Railways (IDA Concessionaire)	4,560,142,500.00
Sub-Total Uncalled Guarantees	157,765,053,290.66
Tana & Athi Rivers Dev. Authority	136,365,022.08
East African Portland Cement	169,514,325.12
Sub-Total Called Guarantees (Non-Performing)	305,879,347.20
Grand Total Guarantees	158,070,932,637.86

Source: National Treasury

⁶ National Assembly resolution dated 17th June 2011

C. Public Debt Sustainability Analysis (DSA) Framework

85. Debt sustainability analysis compares debt burden indicators to thresholds over 20 - year projection period, if a debt burden indicator exceeds its indicative threshold then it would suggest that a risk of experiencing some form of debt distress exists. The objective of Debt Sustainability Analysis (DSA) is to evaluate a country's capacity to finance its policy agenda and service the ensuing debt without unduly large adjustments that may compromise its macroeconomic stability and/or that of its economic partners. The DSA framework consists of two complementary assessments of the sustainability of the following:

- (i) Total public sector debt, and
- (ii) Total external debt.

- *Public Sector Debt DSA*

86. The overall DSA ratios indicated that Kenya's debt (Public & Publicly Guaranteed Debt) is within sustainable range and is expected to remain so into the medium term as the PV of debt as a percentage of GDP will remain below its threshold of 70%. Furthermore, with the amendments to the PFM undertaken in 2019, the level of debt as of December 2019, constituted 67% of the Ksh. 9 trillion ceiling and therefore within legal set limits. By the close of 2021/22, BPS 2020 projections indicate that debt stock will account for 84% of the ceiling and therefore any expenditure related shock could eliminate any remaining ceiling margin.

Table 12 Public Debt Sustainability Analysis

	Threshold	2017	2018	2019	2020	2021	2022	2023
<i>PV of Debt as % of GDP</i>	70	55.4	60.6	55.4	55.7	54	48.5	42.2
<i>PPG Debt Services as a % of Revenue</i>	30	29.2	35.6	45.2	35.2	46.1	47.9	38.5
<i>Debt as % of Ceiling</i>	Ksh. 9 Trillion			67%	78%	84%	89%	94%

Source: 2020 BPS Debt Forecast, MTDS 2020

87. **In addition, one of the indicators of DSA, which is the ratio of debt service to revenue, having breached its threshold of 30 percent in the FY 2017/18 is projected to remain above the threshold over the medium term.** Given that the DSA for external debt indicates that external debt will remain within its revenue related threshold (*See the review of External debt DSA below*), the breach is therefore as a result of Domestic debt servicing requirements.

- *External Debt DSA*

88. Review of External debt sustainability indicates that while minimum risk will emanate from the pressures of external debt service on revenue, **external debt and its servicing**

are expected to surpass their corresponding thresholds as from 2020. This could indicate that for the medium term, external debt demands put pressure on externally generated income and the increase of resources required to finance external debt, could increase the risk of an exchange rate shock. This could, in turn, increase the refinancing risk of external debt while at the same time jeopardizing the macroeconomic assumptions underpinning fiscal planning for the medium term.

Table 13 External Debt Sustainability Ratios

	Threshold	2017	2018	2019	2020	2021	2022	2023
<i>PV of Debt to GDP Ratio</i>	55	25.9	31.4	27.2	27.4	26.5	25.3	24
<i>PV of Debt to Exports Ratio</i>	240	165.4	191.1	224.8	234.9	229.6	222.3	197.5
<i>PPG Debt Service to Exports Ratio</i>	21	16.5	19.9	29.3	21	24	23.3	19.1
<i>PPG Debt Services to Revenue Ratio</i>	23	13.3	16.2	20.4	13.1	15.2	14.2	12.1

Source: National Treasury

Emerging issues

89. While the sustainability of overall debt to GDP ratios indicates the solvency sustainability of stock of debt, i.e. comparison of debt to total assets and economic production, the debt servicing to Revenue or exports refers to the liquidity sustainability i.e. match against income generated by the economy. From the above review, it is expected that the main impact of rising stock of debt will arise from an increase in debt servicing expenses resulting in pressures on domestic and external revenue.
90. As indicated in the 2020 BPS, debt is expected to be the primary factor behind the Ksh. 76.9 billion increase in the Consolidated Fund Services (mandatory expenditures that include debt repayment, pension, and gratuities, salaries to constitutional offices, etc.). Being mandatory, this is expected to absorb the increase in revenue projected for FY 2020/21 amounting to Ksh. 89.8 billion and reduce the ordinary revenue. When coupled with other non-discretionary budgetary expenditures i.e. such as allocation to county governments, etc. a shortfall in revenue could necessitate a possible increase in borrowing or budget rationalization mid-year.
91. Given that liquidity will be the challenge to debt management, fiscal consolidation should be cognizant of this factor and consolidate resources to sectors that facilitate exports, increase in productivity and revenue generation such as manufacturing.
92. Summary of issues raised in this report include:
 - i. The need to strengthen the medium-term basis of Kenya's debt strategy in order to control the composition and resultant costs and risks related to the growth of the stock of debt.
 - ii. There is no provision indicating the status of implementation of the FY 2019/20 borrowing strategy.

- iii. *There is a need to limit the use of commercial debt over the medium term in order to reduce the related refinancing risk.*
- iv. *Information on the progress of the indicated domestic market reforms intended to support public debt management is missing.*
- v. ***Thresholds relating to debt service i.e. to revenue and exports have been breached therefore indicating sustained pressure on both domestic and on externally generated income.***

Annex

Table A 1 Sectoral GDP Growth

	Sectoral growth		Contribution to growth	
	2018 Q1 to Q3	2019 Q1 to Q3	2018 Q1 to Q3	2019 Q1 to Q3
Primary sector	6.8%	4.4%	1.6	1.0
Agriculture, forestry and fishing	7.0%	4.4%	1.6	1.0
Mining and quarrying	2.8%	4.0%	0.0	0.0
Secondary sector	5.4%	4.7%	1.0	0.8
Manufacturing	4.4%	3.5%	0.4	0.3
Electricity, gas and water	7.6%	5.5%	0.2	0.1
Construction	6.4%	6.5%	0.3	0.4
Tertiary sector	6.5%	6.1%	3.2	3.0
Wholesale and Retail trade	6.2%	5.4%	0.5	0.4
Accommodation and Restaurants	14.6%	9.9%	0.2	0.1
Transport and Storage	8.6%	7.0%	0.6	0.5
Information and Communication	11.2%	10.0%	0.4	0.4
Financial Intermediaries and Insurance	5.0%	6.1%	0.3	0.4
Public administration	6.0%	6.1%	0.2	0.2
Professional, admin and support services	6.8%	5.4%	0.1	0.1
Real Estate	4.6%	4.9%	0.4	0.4
Education	5.6%	5.7%	0.4	0.4
Health	4.7%	4.7%	0.1	0.1
Other services	4.8%	2.6%	0.1	0.0
Plus: FISIM	0.6%	-1.0%	0.0	0.0
Total gross value added	6.5%	5.5%	5.8	4.9
Taxes less subsidies on Products	5.6%	4.8%	0.6	0.5
TOTAL G.D.P. AT MARKET PRICES	6.4%	5.4%	6.4	5.4

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