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Decision Time: Spend More or Spend Smart?

KENYA PUBLIC EXPENDITURE REVIEW

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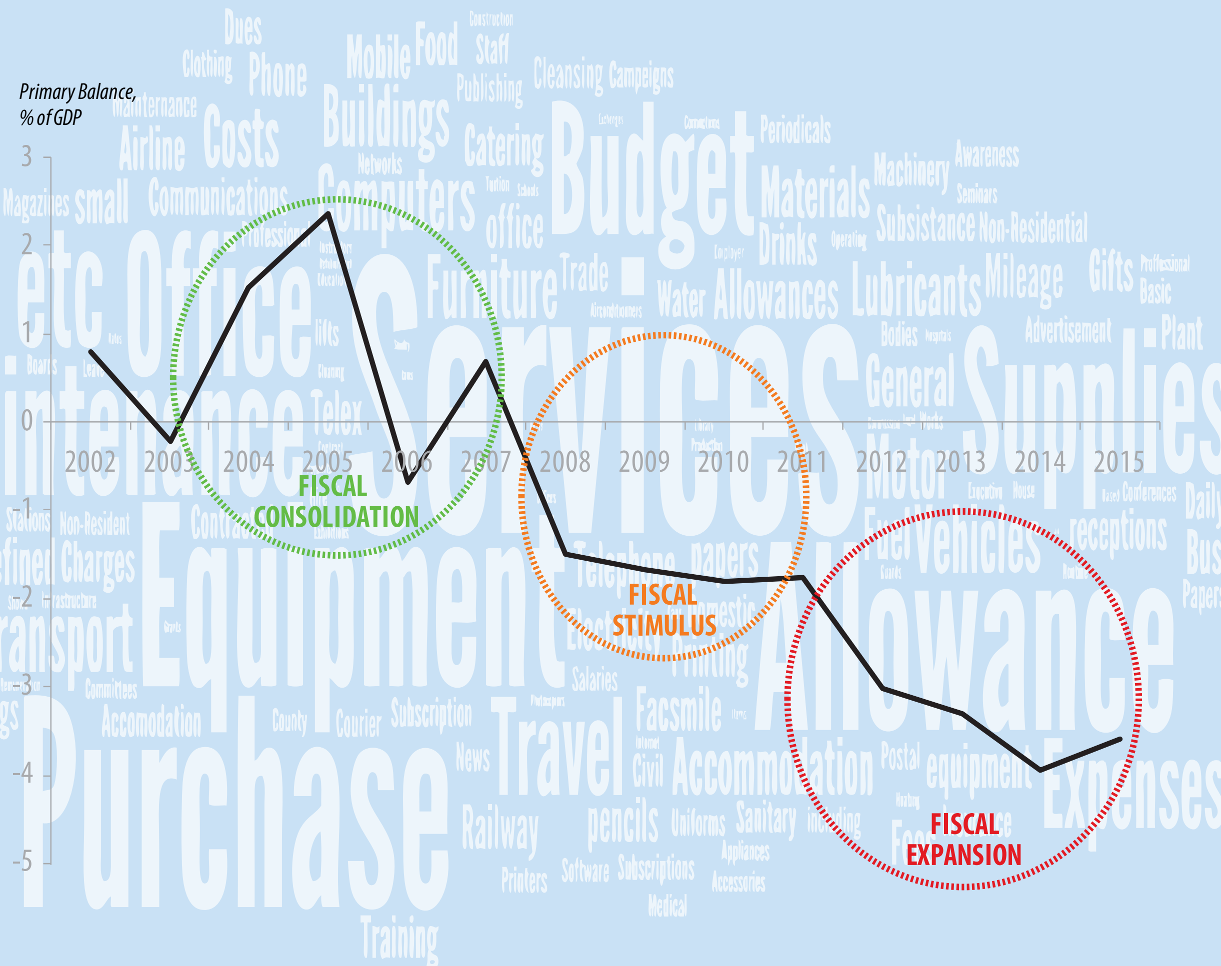

WORLD BANK GROUP

Decision Time:
Spend More or Spend Smart?

KENYA PUBLIC EXPENDITURE REVIEW

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ABBREVIATIONS AND ACRONYMS

AFR	Africa
AG	Attorney General
ATM	Average Time to Maturity
BPS	Budget Policy Statement
BROP	Budget Review and Outlook Paper
CAs	County Assemblies
CARA	County Allocation of Revenue Act
CARB	County Allocation Revenue
CBK	Central Bank of Kenya
CBROP	County Budget Review Outlook Paper
CDF	Constituency Development Fund
CDMS	County Debt Management Strategy
CEC	County Executive Committee
CECF	County Executive Committee for Finance
CFSP	County Fiscal Strategy Paper
CG	County Government
CIC	Commission for Implementation of the Constitution
CoB	Controller of Budget
CRA	Commission on Revenue Allocation
CS	Cabinet Secretary
CT	County Treasury
DARA	Division of Revenue Act
DARB	Division of Revenue Bill
DMS	Debt Management Strategy
DSA	Debt Sustainability Analysis
EAC	East African Community
ERS	Economic Recovery Strategy
FY	Fiscal Year
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GoK	Government of Kenya
IBEC	Intergovernmental Budget and Economic Council
ICOR	Incremental Capital Output Ratio
ICT	Information and Communications Technology
IFC	International Finance Corporation
IFMIS	Integrated Financial Management and Information System
IMF	International Monetary Fund
KENAO	Kenya National Audit Office
KIPPRA	Kenya Institute for Public Policy Research and Analysis
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
KSh	Kenya Shilling
LAIFOMS	Local Authorities Integrated Financial Operations Management System
LATF	Local Authority Transfer Fund
LTO	Large Taxpayers Office
MCA	Member of County Assembly
MDTS	Medium Term Debt Strategy
MTEF	Medium Term Expenditure Framework
MTP II	Medium Term Plan 2
MTO	Medium Taxpayers Office
NG	National Government
NPV	Net Present Value
NT	National Treasury
OECD	Organization for Economic Co-operation and Development
O&M	Operations and Maintenance
PAYE	Pay As You Earn
PBB	Programme Based Budget
PBO	Parliamentary Budget Office
PEFA	Public Expenditure and Financial Accountability
PER	Public Expenditure Review
PFM	Public Finance Management
PIM	Project Investment Appraisal and Management
PIMI	Public Investment Management Index
PPOA	Public Procurement Oversight Authority
QEBR	Quarterly Economic Budget Review
REO	Regional Economic Outlook
RMLF	Roads Maintenance Levy Funds
SSA	Sub-Saharan Africa
TFP	Total Factor Productivity
TINs	Taxpayers Identification Numbers
VAT	Value Added Tax
WDI	World Development Indicators

FOREWORD

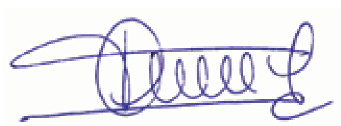
This Public Expenditure Review (PER) 2014 highlights tremendous progress that Kenya has made in three areas: First, the economy has grown by six percent since 2010; a major recovery from negative shocks experienced in previous years. And following the rebasing of GDP, Kenya has now joined the league of Lower Middle Income Countries. Second, the country is just under two years into rolling out an ambitious devolution process that has significantly transformed the way that public finances are administered. Transfers to county governments now constitute about 20 percent of total expenditure, or about 4 percent of GDP. Third, investments in infrastructure have grown considerably—now second only to education—projected to increase to half the capital budget by 2017. Kenya is certainly moving in the right direction in terms of building up its infrastructure to enhance its growth potential.

Nevertheless, numerous challenges continue to impact on the economy. The effects of increasing public debt and mounting public expenditure are beginning to be felt. The pressure to spend more that started building before the roll out of devolution is likely to prevail for a few more years. The reasons are varied and weighty: rising costs of rolling out devolution; costs of financing national security; huge infrastructure investments; funding of flagship projects to fulfill pre-election pledges; and, a hefty public wage bill, among others.

This PER examines the opportunities and constraints facing the government in public expenditure management, especially on how resources are allocated and utilized.

The PER emphasizes that the time is now for Kenya to reflect on the big decisions going forward: spending more or spending smart? In this regard, it will be important to contain the growth of administrative recurrent costs, improve execution of infrastructure projects, and provide sufficiently for recurrent operating costs.

It is our hope that this report will make a useful contribution towards the ways in which the Government of Kenya and its partners, including the World Bank, design and implement policies and programs. In so doing, we hope to continue to maximize the unique opportunities now available to Kenya through better allocating and utilizing its financial resources, with the ultimate aim of achieving the country's ambitious development goals.



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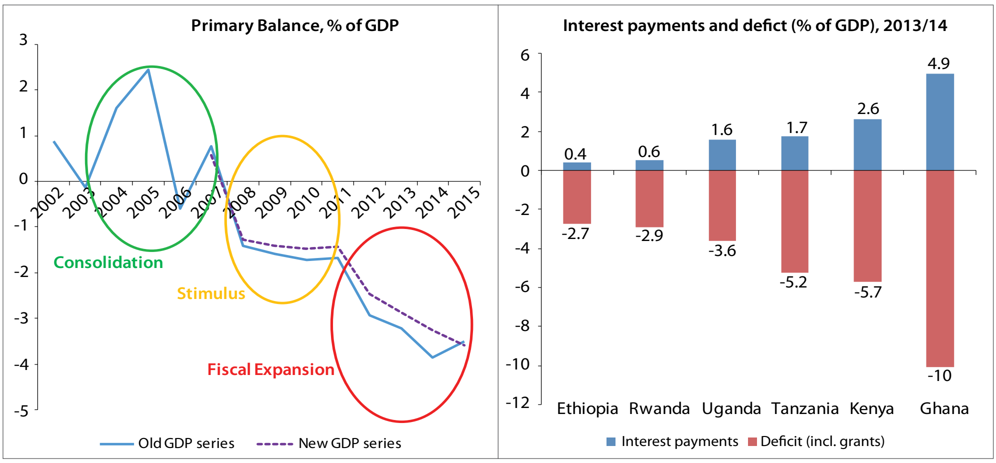
EXECUTIVE SUMMARY

A. FISCAL PRESSURE STARTED BUILDING BEFORE THE ROLL OUT OF DEVOLUTION

Kenya is currently in an expansionary phase of its fiscal policy reflected in a widening primary deficit (Figure 0.1). The fiscal framework is marked by a significant fiscal expansion over the last three years, 2011/12 to 2013/14. The fiscal stimulus implemented in 2009/10 increased aggregate spending by 2 percent of Gross Domestic Product (GDP). However the envisaged fiscal retrenchment at the end of the program did not materialize and fiscal expansion continued with the general election in 2013. Aggregate expenditure averaged 25 percent and revenue at 18 percent of GDP. The fiscal deficit financed through debt is reflected in the doubling of the primary deficit (commitment basis) now in the range of 3.3 percent of GDP, and the rising stock of public debt from 37 percent to 43 percent of GDP (net of deposits), of which about half—22 percent—was external debt in 2013/14. The fiscal developments have seen an increase in the share of debt service in total spending from 13 percent to 15 percent of recurrent spending, equivalent to 2.6 percent of GDP. Kenya's debt service is higher among East Africa Community (EAC) peers, 2 percentage points above Ethiopia and Rwanda, and 1 percentage point higher than Uganda and Tanzania (Figure 0.1).

Figure 0.1: Kenya's fiscal stance is broadly expansionary and debt service remains the highest among the EAC peers



Source: The National Treasury Quarterly Economic Budget Review (QEBR) reports

The recent fiscal expansion can be attributed to multiple sources of pressure which are expected to prevail in the medium term. Fiscal pressure is emanating from the buildup of administrative expenses associated with the roll out of devolution, the necessity to enhance security expenditure, the commitment to sustain investments in roads and energy to reduce the infrastructure deficit and reduce the cost of doing business, the funding of new flagship projects in fulfillment of the Jubilee government's pre-election pledges, and the rising wage bill at both levels of government. In addition to borrowing, part of fiscal pressure has been accommodated through a cut back in operations and maintenance spending from 8.5 percent in 2010/11 to 6 percent of GDP in 2013/14.

Remarkable progress has been made in increasing the share of development expenditure in total spending but recurrent spending pressures are eroding the gains. The share of development spending declined from 7.4 percent of GDP in 2011/12 to 6.6 percent in 2012/13, at the same time, recurrent spending increased from 16.3 percent to 17.6 percent of GDP. Public sector wage bill remains a concern for the government and it has increased from 6.6 percent of GDP in 2012/13 to 7.1 percent (National and County governments combined) in 2013/14. Nevertheless, the composition of development reflects infrastructure investments as priority.

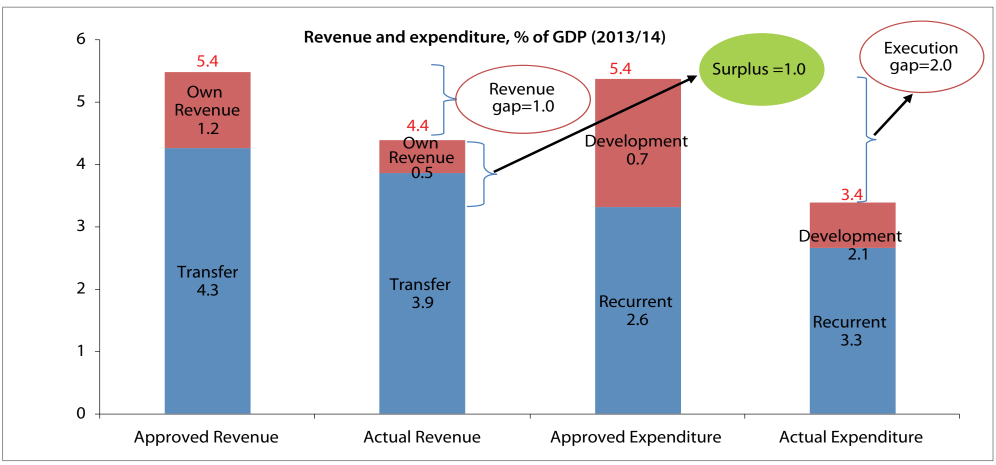
Kenya is moving in the right direction in terms of building up its infrastructure to enhance its growth potential. However, the infrastructure investment drive needs to be done in a way that is both efficient and sustainable, and timely action is key. Fiscal pressure could actually be much higher if budget execution levels are higher, both at subnational levels and in donor-financed projects, and if cut backs in spending on O&M had not been reduced.

The current expansionary stance has apparently not created significant inflationary pressures because the economy is still performing below its potential. However, the prevailing conditions may not last for long and there is a risk that should inflationary pressures build up and rising international interest rates lead to a reversal of capital flows, Kenya's fiscal position could deteriorate.

B. COUNTY GOVERNMENTS ARE EXPERIENCING CHALLENGES

Sub-national governments have taken over the delivery of devolved services starting with an expenditure layout of 5.4 percent of GDP or 20 percent of total expenditure in FY14. Transfers to county governments are budgeted at 4.3 percent of GDP (comprising of the equitable share, donor funded projects, conditional grants to Level 5 hospitals, and the Equalization Fund) and are projected to remain at the same level during the Medium Term Expenditure Framework (MTEF) period (2015-2017), while national government expenditure averages 22 percent of GDP. County government budgets had an initial revenue projection of 1.2 percent of GDP, bringing the total subnational expenditure outlay to 5.4 percent of GDP (Figure 0.2).

Figure 0.2: Budget execution remains a challenge particularly at sub-national level



Source: Staff computation based on Controller of Budget data

Administrative costs and the wage bill are crowding out fiscal space for development. The first year expenditure outcomes reveal four areas of concern: (i) administrative spending has built-up rather quickly; wages and salaries consumed 50 percent of county budgets, (ii) there is concern about weak budget execution, as aggregate counties executed 63 percent of their budget and ended up with a surplus equivalent to 1.0 percent of GDP; (iii) revenue forecasts are ambitious, with limited revenue raising efforts and, actual revenue collected by the counties was 43 percent of the targeted revenue and; (iv) only ten counties allocated at least 30 percent of their budget to development spending.

In the short run, the budget execution gap, and the shortfalls in county revenue collection collectively undermine national service delivery targets as well as the potential benefits of devolution. These gaps suggest that county spending on service delivery and equity could fall below pre-devolution spending, which may imply that national policy objectives on devolution reforms may not be met. Additionally, the 57 percent shortfall in revenue collection at county level increases the fiscal pressure on fiscal transfers from the central government.

C. FIVE UNDERLYING FISCAL CHALLENGES WHICH REQUIRE URGENT ATTENTION

1. The rising share of infrastructure spending is consistent with medium-term growth objectives but it is undermined by low execution and declining operations and maintenance budget

Investments in infrastructure have been sustained and are projected to increase to half the capital budget by FY 2017, but the efficiency of these investments has declined reflected in total factor productivity and contribution of investment to growth. The rising share of spending on energy and roads reflects the commitment to improve Kenya's competitiveness and provide the much needed growth stimulus. Nevertheless, the recent decline in the efficiency of these investments is curtailing their potential dividend. The declining efficiency of investments can be attributed to three key factors among others:

a. Although the budget outlay for infrastructure has increased, the execution has declined in the recent years, standing at 43 percent in 2013/14 down from over 70 percent in 2011/12.

b. The budget provision for recurrent operations and maintenance has declined from 8.5 percent of GDP in 2010 to 6.1 percent in 2013/14. In this scenario completed facilities remain un/underutilized.

c. Project implementation slows down because of insufficient exchequer releases of the approved budget allocations thus projects end up with long gestation periods with cost overruns and accumulated arrears.

2. *High recurrent administrative expenditure and weak revenue mobilization could undermine the devolution objective of improving service delivery.*

Country governments inherited costs and liabilities which leave limited fiscal space for emerging development priorities. The FY13/14 budget outturn shows that on aggregate, wages and salaries accounted for about half of the expenditure by county governments (46 percent), 30 percent on administrative recurrent expenses and 21 percent on development. Furthermore, the aggregate picture masks significant disparities in expenditure composition, and only ten counties attained the 30 percent threshold share of development spending in total expenditure.

3. *Intra sectoral budget allocations undermine equity and efficiency of spending*

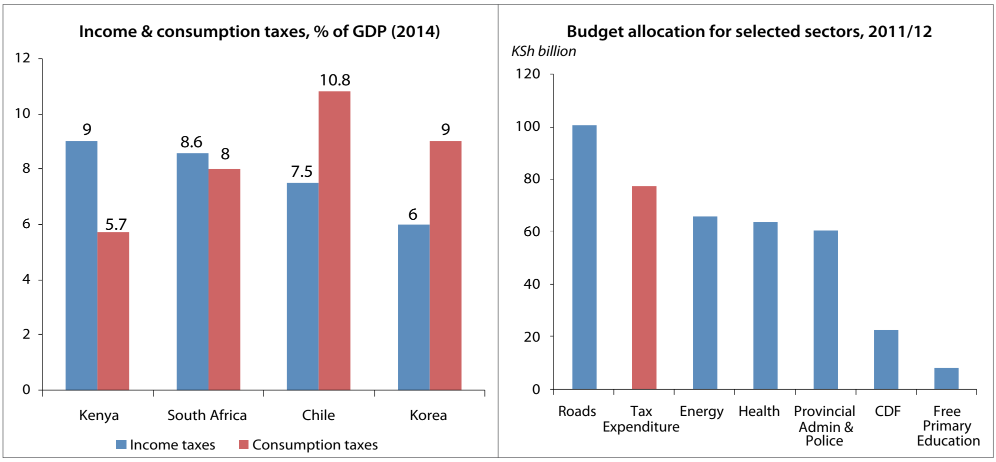
Sector allocations reflect priorities in vision 2030 and the five year medium term plan. The Medium Term Plan (MTP II) and Vision 2030 identify infrastructure investments as a priority, to reduce the cost of doing business and increase competitiveness. The budget outlay reflects this priority, notwithstanding low levels of execution. However, a closer review of health and education sectors shows that within sector composition undermines efficiency and equity objectives. Benefit Incidence Analysis (BIA) of health care spending shows that high end curative care is pro-rich while primary health care is pro-poor. In the health budget curative spending receives the highest allocation, 40 percent of total expenditure, compared to 26 percent allocated to preventive health care. In the education sector, tertiary education receives 40 percent of the total budget and primary education allocation accounts for 20 percent of the total. Benefit Index Analysis (BIA) for the sector shows that primary education is pro-poor and university education is pro-rich.

4. *The high share of 'off budget' donor funds undermines strategic prioritization*

Development partners finance about 40 percent of Kenya's development through country systems; additionally, there is a significant share that is 'off budget'. Donor priorities are well aligned with government priorities with 57 percent of the portfolio allocated to infrastructure. However this source of funding presents three challenges to fiscal management: first, 'off budget' funds undermine strategic prioritization, and this is particularly a challenge in the health sector. Second, 'on budget' donor funding records very low disbursement levels averaging 51 percent in the last 4 years and thus undermines budget execution and budget credibility. Third, the 'project' approach in donor funding does not take into account future recurrent cost requirements, thus undermines efficiency of investment.

5. Forgone revenues through tax incentives and administrative weakness undermine the robustness of Kenya's tax system. Kenya's tax system is heavily dependent on income taxes which account for 50 percent of tax revenue (9 percent of GDP) as consumption taxes underperform at 5.7 percent of GDP, generating 25.5 percent of revenues. In comparison with some selected countries, Korea, Chile and South Africa, Kenya's income driven tax system is quite evident (Figure 0.3). At the same time, forgone revenue through misaligned tax incentives is estimated at 2.62 percent of GDP which is higher than public expenditure on health (1.4 percent of GDP). The two challenges suggest that Kenya's system could be more robust and ease the pressure to borrow.

Figure 0.3: Kenya's tax system driven by income taxes and tax expenditures are high



Source: OECD database (2014), National Treasury QEBRs reports, and IFC Incentives report (2013)

D. THREE PRIORITY ACTIONS FOR CONSIDERATION

1. *Contain the growth of administrative recurrent costs at both levels of government.*

Contain administrative spending at county level to ensure that parallel costs at national level are being reduced. Going forward it will be important to contain spending on recurrent administrative costs and also to ensure that parallel costs at national level are being reduced, as planned.

2. *Improve the efficiency of investments, increase provision for Operations and Maintenance (O&M)*

Improvements in the way projects are evaluated, selected, prioritized and managed could catalyze productivity gains. Improvement in policy coordination is a low hanging fruit which can easily be achieved. A good example is the need for quick resolution of disputes related to taxation of externally funded projects. Such disputes often delay project implementation for long periods of time. Reforms and institution strengthening will be required to address remaining challenges: (i) delays in project implementation which increase the gestation period and cost overruns and; (ii) the weak link between budget formulation and project implementation on one hand and forecasting of future running/recurrent costs. Significant improvements will be required in the way projects are evaluated, selected and prioritized for inclusion in the budget.

3. *Advance revenue reforms and ensure policy consistency.*

Rising fiscal pressure underscores the need for a robust revenue system. Kenya's strong revenue performance is concentrated in a narrow base of a few large taxpayers. Furthermore, after rebasing of GDP the tax revenue ratio now stand in the range of 17 percent of the GDP. There is scope to increase revenue performance at both levels of government. In this regard five areas are key: (i) strengthen tax administration at both levels of government; (ii) deepen automation to reduce the compliance burden; (iii) broaden the tax base; (iv) reduce tax expenditures and; (v) step up revenue mobilization efforts at sub national levels. This will ensure better utilization of tax sources and to ease pressure for increases of subnational transfers from the national government.

In this regard, the findings from this review suggest the following actions for consideration:

Table 0.1: Summary of Main Recommendations

Recommendation	Possibilities
Institute measures to increase efficiency of investments	1. Strengthen project appraisal, selection and management in all sectors and at both levels of government.
	2. Balance new investments with sufficient provisions for future running costs.
	3. Institute measures to closely monitor and manage the execution of projects particularly in the infrastructure sector.
Increase fiscal space for development spending at both levels of government	1. Fiscal rules could provide firm thresholds for some recurrent type expenditures, for instance foreign travel.
	2. Review the current formula vertical revenue sharing formula and consider separating recurrent and capital transfers.
	3. Improve fiscal data accuracy and availability to support policy dialog on expenditure analysis, and fiscal surveillance.
Advance revenue reforms at both levels of government	1. Strengthen tax administrative capacity and systems, including the revision of out of date cadaster information
	2. Deepen automation to reduce administrative costs and compliance burden and loopholes for leakage.
	3. Reduce tax expenditures, including tax incentives, which are not a key determinant of investment location.

INTRODUCTION

The PER FY13 identified four fiscal pressures in the management of fiscal policy. These include; pressure emanating from devolved system of government and fulfilling pre-election pledges, pressure from rising wage bill, pressure from slow growth in revenue, and pressure to at least maintain spending at previous government system level to avoid disruption of services.

The review also highlighted three risks: weak absorption capacity especially of development spending; in particular related to Public Investment Management (PIM); under performance in revenue collection particularly Value Added Tax (VAT); and inefficiency of public expenditure coupled with weaknesses in Public Financial Management (PFM).

The review concluded that these fiscal pressures could undermine the recent gains in fiscal management notably, the rising share of development spending, the composition and management of debt level within sustainable limits, and also the recent improvements in budget execution.

This review builds on PER 2013 and tracks fiscal outcomes since the onset of devolution. The review is structured as follows: Chapter one provides an overview of the macroeconomic context and the evolution of Kenya's aggregate fiscal framework, focusing on the recent trends in the fiscal deficit and how it has been financed, revenue performance, public expenditure trends and composition, and budget execution. Chapter two delves into efficiency of development spending while Chapter three takes a closer look at county level fiscal performance and the second generation PFM reforms in a decentralized framework. Chapter four covers revenues and tax administration, while Chapter five covers the medium term prospects. Chapter six presents summary and conclusions.

Chapter 1

MACROECONOMIC CONTEXT

Kenya has enjoyed four years of stable growth averaging 6 percent. After a series of negative shocks experienced in the country in 2008/2009, growth momentum picked to an average of 6 percent between 2010 and 2013. For the first time in Kenya's history the political electoral cycle of 2013 did not disrupt growth and the country recorded a growth rate of 5.7 percent, the highest in an election year. The growth momentum is projected to increase and reach 6 - 7 percent in the medium term to 2017.

Kenya rebased its GDP in 2014 which increased the size of the economy by 25 percent to US $55.2 billion. The rebasing exercise improved Kenya's ranking by the size of the economy from 12th to 9th in Africa, now ahead of Ghana, Ethiopia and Tunisia. GDP per capita increased from US $994 to US$ 1,246 in 2013 thus, Kenya now joins the league of Lower Middle Income Countries (LMIC).

Growth has been broad based but the rising share of agriculture in GDP and the contraction of the share of manufacturing is typical of economic progress. The new GDP numbers show that the share of agriculture increased from 23 percent in 2006 to 30 percent in 2013, at the same time the share of services contracted from 55 percent to 51 percent. Industry has retained a share of 20 percent but manufacturing lost 2 percentage points in its contribution to GDP. The evolving change in relative shares is rather unusual and counter intuitive; in the process of development other sectors of the economy and particularly services grow much faster than agriculture, leading to a declining share of agriculture in the economy but the trend for Kenya is the reverse.

Kenya has maintained a good track record of macroeconomic management. Price volatility has been contained after the 2011 crisis; core inflation declined from 11.6 percent in 2011 to 5.1 percent in 2013 and is projected to remain within the policy target of 5 percent in the medium term. The exchange rate has been stable and the country is in a comfortable forex reserve position in excess of four months of import cover.

In the external sector, exports performance has been outpaced by the growth of imports, reflected in a current account deficit averaging 7 percent of GDP in the last five years to 2013. Exports as share of GDP have declined gradually from 13 percent in 2010 to 10 percent in 2013, while the ratio of imports to GDP also declined marginally to stabilize at 30 percent of GDP. Nevertheless, Kenya runs a balance of payments surplus shored-up by 'foot loose' short-term capital flows and a surplus in service exports. In the medium term, security threats especially to tourism and the decline in commodity prices in the global markets increase Kenya's external vulnerability.

On the demand side, private consumption contributes more than two thirds of Kenya's growth. Private consumption drives growth in Kenya; in 2013 for instance, three quarters of Kenya's growth was from private consumption. Consumption drives the demand for imports which outpaces export performance, thus the current account deficit growth drags. Investments contribution to growth falls short of the 2 percent point threshold (see Table 1.1).

Table 1.1: Economic growth is driven by private consumption

	2007	Average	
		2008-2011	2012-2014
Economic growth	6.9	4.5	5.1
Contribution to growth (share)/[1]			
Private consumption	4.1	3.2	5.3
Government consumption	1.1	0.9	0.6
Investment	1.3	1.9	1.7
Net exports	0.4	-1.5	-1.7
Fiscal (% of GDP)			
Revenue (incl. grants)	19.4	19.8	19.5
Expenditure	20.9	23.2	24.7
Primary deficit	0.6	-1.5	-2.9
Overall deficit	-1.8	-3.3	-5.4
Public debt	36.6	36.1	39.5

Source: The National Treasury, QEBR reports and KNBS National Accounts
/[1] Last column accounts for 2012-2013

The aggregate fiscal envelop increased during the last three years and expenditure now stands at 25 percent of GDP. Fiscal pressures have raised the aggregate expenditure envelop by 5 percentage points to 25 percent of GDP but growth in revenues has been sticky and stagnated at 18 percent of GDP, and covers about 70 percent of expenditure. The budget deficit, which averages about 5 percent of GDP, is financed through a combination of domestic and foreign borrowing. External grants stand at 0.5 percent of GDP and only half of these grants are reflected in the executed budget.

Kenya's tax base is narrow, concentrated on a few large tax payers. The country has a narrow tax base largely dependent on income taxes, which contributes 40 percent of total revenue (8 percent of GDP), and VAT at 25 percent of total revenue (4 percent of GDP). The decline in international trade taxes from about 2.5 percent to about 2 percent of GDP is expected as the economy opens up and the country implements international trade agreements. This discussion is taken in greater detail in the rest of the report.

The roll out of devolution will see a change in the composition of spending. The aggregate framework reflects a discernible change in the composition of spending. Transfers to county governments now constitute about 20 percent of total expenditure (about 4 percent of GDP). The transfers to counties was realized through a combination of fiscal expansion and cut back in operations and maintenance, and development spending. This discussion is also taken up in greater detail in the rest of the report. Table 1.2 shows the macroeconomic indicators.

Table 1.2: Macroeconomic indicators

Main Macroeconomic Indicators	2009	2010	2011	2012	2013	2014
Real Economy						
Nominal GDP (current LCU, billions)	2863.7	3169.3	3726.1	4254.8	4757.5	5,280.8
Nominal GDP (current US$, billions)	2863.7	40.0	42.0	50.4	55.3	60.6
GDP growth (annual %)	3.3	8.4	6.1	4.5	5.7	5.2
Export real growth (%, yoy)	-10.3	15.4	11.1	6.5	-5.8	3.6
Import real growth (%, yoy)	-10.4	20.4	19.5	12.9	2.0	2.9
Private consumption growth (annual %)	4.6	7.5	6.3	5.7	8.2	6.5
Gross fixed investment (% of GDP)	19.3	19.9	19.9	21.0	19.6	19.9
GDP per capita (US$)	929.1	977.8	999.3	1,164.9	1,244.5	1,331.2
GDP per capita growth (annual %)	0.6	5.7	3.4	1.8	3.1	2.5
Fiscal Accounts (fiscal year ends in June)						
Total revenues, (% of GDP)	18.2	19.4	19.4	18.8	18.8	19.4
Expenditures, (% of GDP)	22.3	24.0	23.5	23.7	23.7	25.9
Recurrent (% of GDP)	16.3	16.9	17.2	16.3	17.5	17.6
Development (% of GDP)	6.0	7.1	6.4	7.4	6.6	7.1
Overall fiscal balance excluding grants (% of GDP)	-4.0	-4.6	-4.2	-4.9	-5.8	-6.4
Overall fiscal balance including grants (% of GDP)	-4.4	-5.8	-3.4	-4.5	-5.7	-6.2
Primary fiscal balance (% of GDP, including grants & cash basis)	-2.4	-3.7	-1.2	-2.5	-2.4	-3.5
Total public debt, net (% of GDP)	35.4	36.6	39.1	37.0	38.5	43.1
External public debt (% of GDP)	20.2	18.9	21.0	19.4	18.7	21.6
Money and Prices						
Inflation, consumer prices (annual %, end of year)	10.5	4.5	18.9	3.2	7.2	6.6
Core inflation	-	0.9	11.6	5.5	5.1	4.4
Inflation, consumer prices (annual %, period average)	5.3	4.5	14.0	9.6	5.7	7.2
Treasury bill rate (%, period average)	7.4	3.6	8.7	12.8	8.9	9.1
Nominal exchange rate (period average)	77.4	79.2	88.8	84.5	86.1	87.1
Real exchange rate index (2003=100)	70.4	73.9	68.1	66.8	62.9	62.0
Balance of Payments						
Current account balance (current US$, billions)	-1.7	-2.5	-3.3	-4.3	-4.8	-4.4
% of GDP	-4.5	-6.3	-7.9	-8.5	-8.7	-7.3
Overall balance (% of GDP)	2.1	0.4	-0.1	2.5	1.2	3.2
Exports (% of GDP)	12.2	13.1	13.8	12.3	10.5	9.9
Imports (% of GDP)	27.8	31.0	35.3	33.2	30.9	29.0
Merchandise exports (current US$, billions)	4.5	5.2	5.8	6.2	5.8	6.0
of which: main export (i.e. tea)	0.9	1.2	1.2	1.2	1.2	1.1
Merchandise imports (current US$, billions)	10.3	12.4	14.8	16.7	17.1	17.6
Services, net (current US$, billion)	1.9	2.5	2.6	3.6	3.6	4.1
Workers' remittances, net (current US$, billions)	0.6	0.6	0.9	1.2	1.3	1.4
Foreign direct investment (current US$, billions)	0.1	0.1	0.1	0.1	0.3	0.3

Source: Staff computations based on KNBS and the National Treasury data

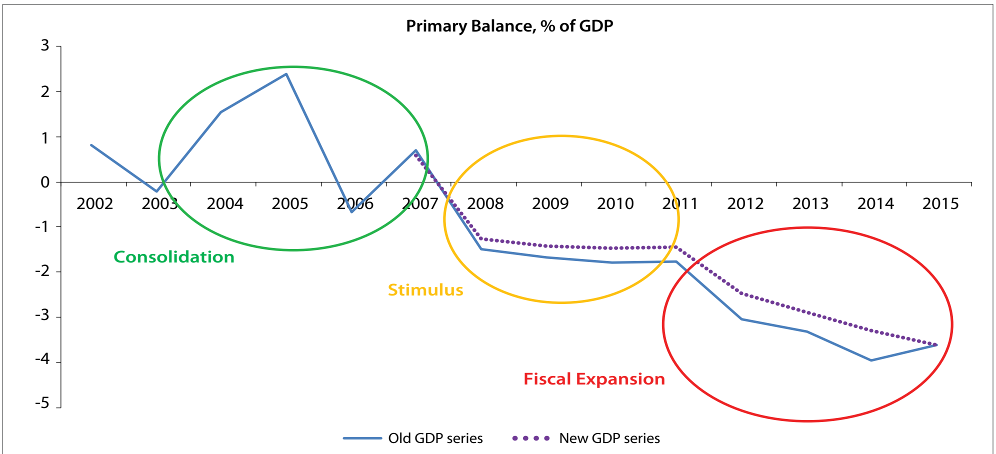
1.1 Evolution of the aggregate fiscal framework

There has been significant fiscal expansion during the last three years which has depleted the fiscal buffers built during the last decade. Kenya's overall expenditure reached 25.9 percent of GDP in 2013/14. The recent expansion emanates from the roll out of devolution which has seen a quick build-up of administrative expenses, increased security spending, the roll out of new flagships contained in the Jubilee manifesto and the rising wage bill. Revenue performance averaged 17.6 percent of GDP in 2011/12 to 2013/14. Nevertheless, the composition of spending reflects commitment to fund infrastructure but the low execution of infrastructure projects undermines its potential impact.

Fiscal policy is expansionary: Sunset from the fiscal stimulus did not materialize

Three phases are discernible in Kenya's fiscal policy; the fiscal consolidation phase from 2003-2007, fiscal stimulus in 2008-2010, the fiscal expansion since 2011 (Figure 1.1). Kenya implemented a fiscal stimulus between 2008 and 2010 to counter the economic downturn from the negative global and domestic shocks. The fiscal response increased aggregate public spending by 2 percent of GDP, mainly in development spending. The expansion was achieved through domestic borrowing which increased the primary balance from a surplus of 0.6 percent during consolidation period to a deficit of 2.4 percent during the stimulus period and to the prevailing expansion marked by primary deficits in excess of 3.0 percent of GDP.

Figure 1.1: Kenya's fiscal position remains under pressure

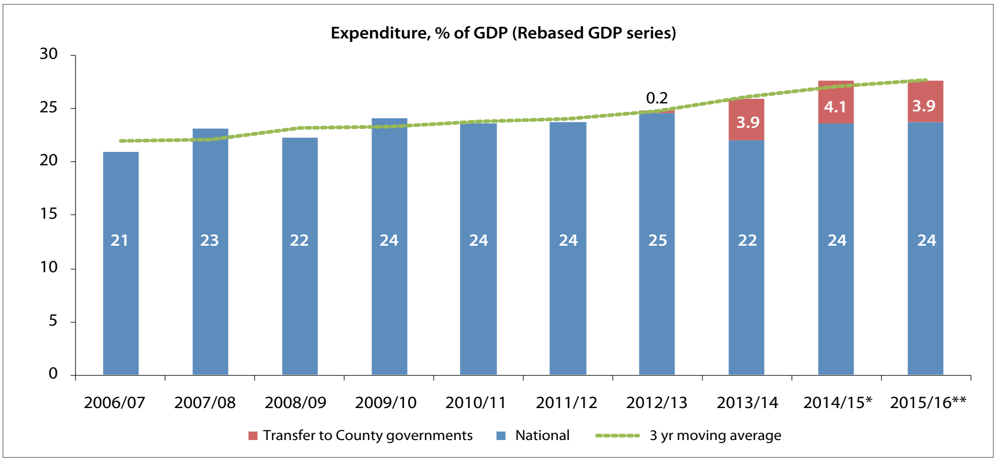


Source: The National Treasury, QEBR reports

The planned sunset from the fiscal stimuli did not materialize and fiscal pressure has persisted. In 2013 Kenya rolled out a complex four tier general elections, back to back with the roll out of devolution. These constitutional provisions have become a source of persistent fiscal pressure.

National government expenditure has not declined even after releasing some functions to county governments, and has remained at pre-stimulus level of 22 percent of GDP. Total expenditure increased from 22 percent in 2006/07, to 24.8 percent of GDP in 2012/13, and now stands at 25.9 percent (Figure 1.2). Transfers to county governments are equivalent to 3.9 percent of GDP reflecting the post-election fiscal expansion. Additional pressure at the center is emanating from increased security spending and the implementation of new flagship projects contained in the Jubilee manifesto, and the commitment to sustain investments in infrastructure, notably in roads and energy.

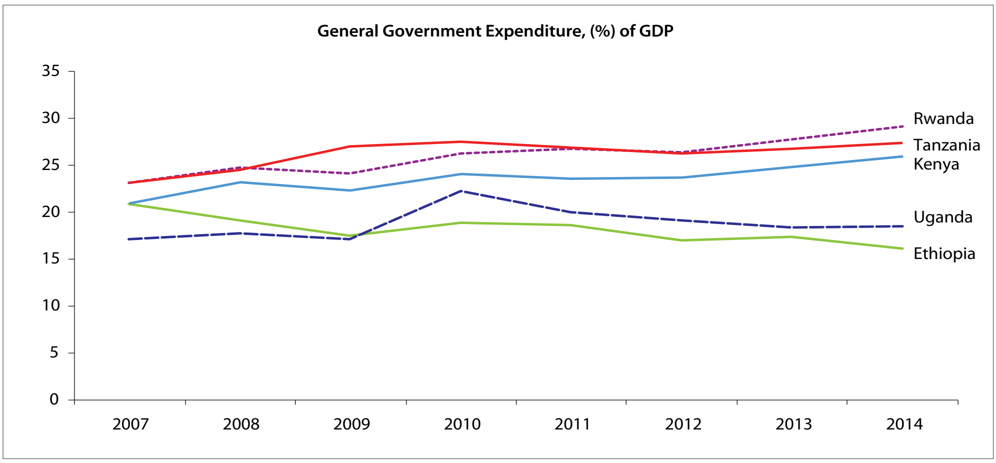
Figure 1.2: National government expenditure has remained at pre-devolution levels



Source: The National Treasury, QEBR reports

The current level of spending as a share of GDP puts Kenya at par with regional peers. The recent GDP rebasing places Kenya's level of expenditure at par with regional peers. Kenya's government expenditure is relatively lower than Rwanda's and Tanzania's and averaged 23.5 percent of GDP in 2007 to 2014 (Figure 1.3). Government spending for Rwanda and Tanzania averaged 26 percent of GDP. Ethiopia and Uganda have the lowest government spending averaging 19.1 percent of GDP and 18.5 percent respectively in the same period.

Figure 1.3: Kenya's public spending is at par with the regional peers

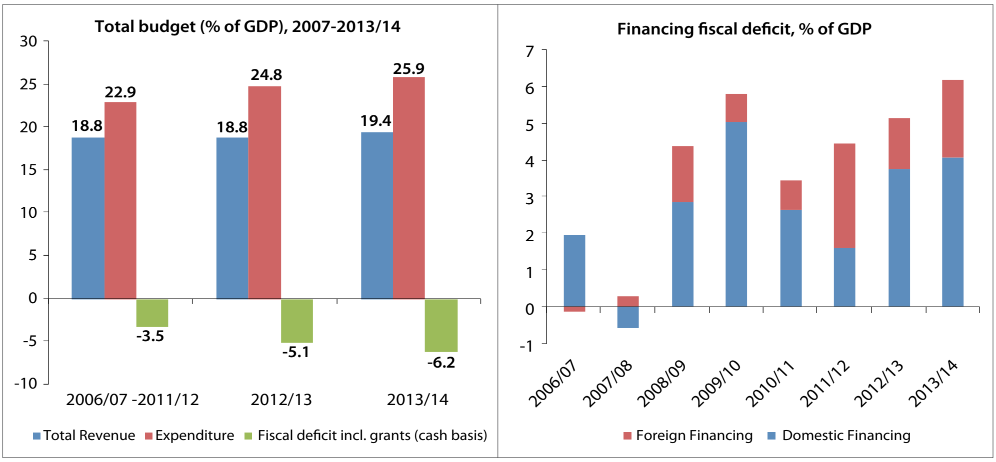


Source: IMF, AFR Regional Economic Outlook (AFR REO) and Kenya National Treasury

Expenditure growth outpaced the growth in revenue

Revenue averaged 18 percent of GDP hence fiscal expansion has been achieved through debt. Total revenue has recorded slow growth rising by only 0.6 percentage points from 18.8 percent of GDP in 2012/13 to 19.4 percent in 2013/14 (Figure 1.4). Expenditure on the other hand, increased by 1.1 percentage points in the same period resulting to the government's reliance on borrowing to finance the budget deficit. Fiscal deficit (including grants) continued to worsen, from 4.5 percent of GDP in 2011/12 to 6.2 percent in 2013/14 (Figure 1.4). The deficit was financed through a combination of domestic and external borrowing. Domestic borrowing increased from 1.6 percent of GDP in 2011/12 to 4.0 percent in 2013/14. Foreign financing on the other hand rose from 1.4 percent of GDP in 2012/13 to 2.1 percent in 2013/14. The heavy domestic financing has seen a commensurate increase in debt service equivalent to 2.4 percent of GDP. The stock of debt has also increased from 38 percent to 43 percent of GDP. However, some of the proceeds from the recent Eurobond (US$ 1.2 billion) will retire some of the expensive domestic debt to provide some reprieve.

Figure 1.4: Fiscal deficit now being financed through foreign borrowing



Source: The National Treasury, QEBR reports

1.2 Evolution and composition of public debt

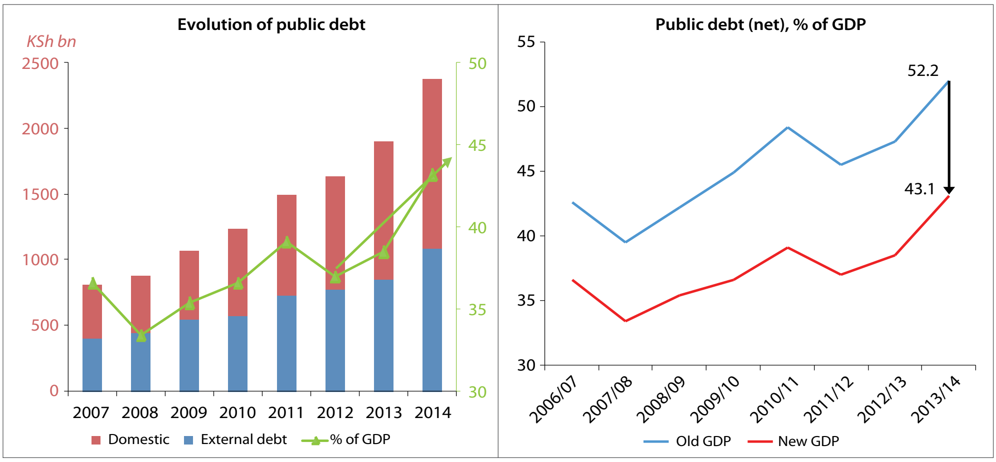
Kenya's public debt increased from 38 percent of GDP in 2012/2013 to 43 percent in 2013/14. Despite the increase most of the indicators remain favorable: (i) debt remains below the fiscal anchor threshold of 45 percent of GDP; (ii) it is within sustainable limits and; (iii) there is no evidence of crowding out private sector from the credit market, (iv) nevertheless, the Eurobond will ease some of the pressure from the domestic credit market; (v) but debt service has increased to 2.4 percent of GDP. Overall Kenya remains at low risk of debt distress.

Public debt is within the Medium Term Debt Strategy's targets (MTDS) thresholds.

The recent fiscal expansion was achieved through additional borrowing. Public debt expanded both in absolute terms and as a share of GDP (Figure 1.5). Total public debt (net) in nominal terms amounted for KSh 2.4 trillion, comprising KSh 1.1 trillion in foreign debt and KSh 1.3 trillion in domestic debt, equivalent to 43.1 percent of GDP as total public debt. This is an increase from 38.5 percent of GDP in 2012/13. Foreign debt increased to 21.6 percent of GDP in 2013/14, 3 percentage points higher than the previous year. The increase emanated from the successful sale of a sovereign bond equivalent to US$ 2 billion in June 2014.

Total public debt level declined significantly after the GDP rebasing in September 2014 (Figure 1.5). The KNBS revised the national accounts statistics based on 2009 estimates, and this has seen nominal GDP for 2009 grow by 20.5 percent while for 2013 it grew by 25.3 percent. Therefore, the current public debt after rebasing declined from 52 percent of GDP to 43.1 percent in June 2014. At this level, public debt is within the government threshold of 45 percent.

Figure 1.5: Total public debt trend in Kenya



Source: The National Treasury (QEBR) and KNBS National Accounts data

A significant share of external debt is concessional. The average concessional debt as a share of total external debt stood at 73 percent during 2000-2010.[1] However, the ratio has been declining since 2011; it reached 65.7 percent in 2012 and fell to 61 percent in December 2013.[2] This high percentage of concessional debt is indicative of minimum risks on interest payments and overall loan repayment. Furthermore, a large share of external debt comes from multilateral creditors; multilateral debt dominated at 60 percent of total external debt for the period 2009 - 2014 (Table 1.3).

Table 1.3: Composition of public debt by creditors, KSh billion

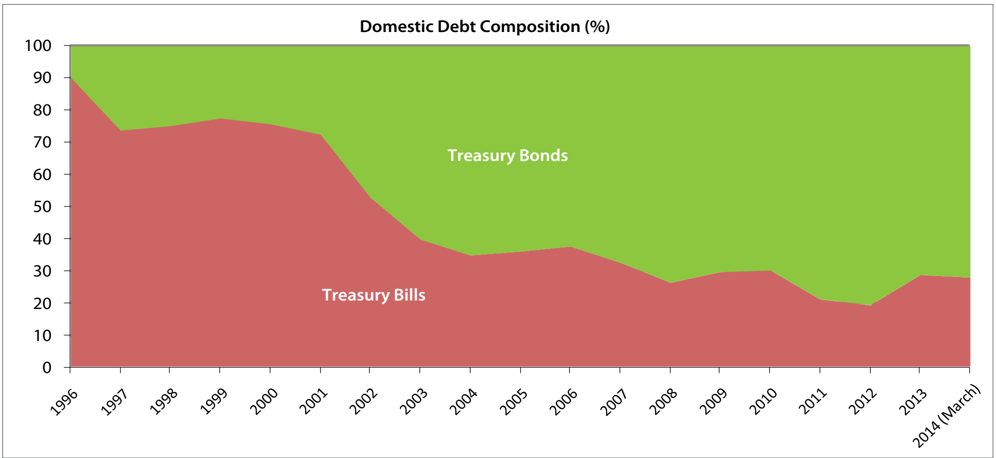
	2009	2010	2011	2012	2013	2014*
Bilateral	185.9	196.3	257.0	246.2	257.6	294.1
Multilateral	331.1	352.3	440.9	463.0	511.8	593.7
Commercial banks and suppliers credit	23.8	20.5	25.0	65.4	74.1	22.8
International sovereign bond						175.3
Total external	540.9	569.1	722.9	774.6	843.6	1085.9
Banks	290.6	401.8	418.1	459.3	563.5	682.9
Non-banks	230.4	258.5	346.2	399.6	487.1	601.4
Total domestic	521.0	660.3	764.2	858.8	1050.6	1284.3
Grand total	1,061.9	1,229.4	1,487.1	1633.4	1,894.1	2,370.2

Source: The National Treasury, QBER (4th Quarter 2013/14)

The domestic money market has been a major source of government finance. Domestic debt doubled from KSh 521 billion in June 2009 to KSh 1,050.6 billion in June 2013. Subsequently, a large share of total debt (61 percent) is denominated in local currency[3] therefore mitigating the risk of debt distress from exchange rate depreciation. Additionally, a large share of domestic debt stock is acquired through sale of long-term instruments (Figure 1.6). Treasury bonds increased from KSh 595.7 billion in June 2009 to KSh 744.2 billion in June 2013, while treasury bills rose from KSh 150.1 billion to KSh 296.6 billion during the same period.

1 *Using WDI data on concessional debt (Percent of total external debt). Figure*
2 *for December 2013 comes from Medium Term Debt Strategy (MTDS) released in February 2014*
3 *MTDS, The National Treasury.*

Figure 1.6: Composition of domestic debt by major debt instruments



Source: The National Treasury (QEBR)

Debt remains sustainable

The latest Debt Sustainability Analysis (DSA) jointly conducted by IMF and World Bank[4] shows that all indicators are well below indicative thresholds (Table 1.4). The net present value of external debt to GDP averaged 14.9 percent for the period 2013-2015 against a 50 percent threshold; debt service to revenue was estimated at 6.9 percent during the same period. This is partly attributed to concessional nature of external borrowing preferences (at 61 percent of total debt at the end of December[5]) in addition to stable macroeconomic performance.

Table 1.4: Debt sustainability indicators

	2010	2011	2012	2013	2014	2015	Threshold
External Debt							
NPV of debt to GDP	..	..	14.2	13.6	15.6	15.6	50
NPV of debt to exports	..	..	64.7	70.1	87.4	89.9	200
NPV of debt to revenue	..	..	75.6	71.4	77.5	76.0	300
Debt service to exports	3.9	3.7	3.9	6.4	10.6	5.6	25
Debt service to revenue	4.5	4.6	4.6	6.5	9.4	4.7	22
Domestic Debt							
Debt to GDP				23	26	23	
Debt to revenue				124	132	95	
Debt service to revenue				9	8	8	

Source: DSA (September 8th, 2014)

Kenya is at low risk of debt distress

The MTDS projected limited risks regarding exchange rate based on the fact that a large share of public debt was denominated in domestic currency at 61 percent compared to 39 percent of total public debt denominated in foreign currencies. On repayment risk, Kenya's public debt exhibits low risk for external debt with an average time for maturity of 11.2 years while domestic debt is associated with medium risk (Table 1.5). This is due to a reduction in maturity period for domestic debt from 5.2 years in June 2013 to a projected level of 4.9 years in June 2014.[6]

4 *In September 2014.*
5 *MTDS, The National Treasury.*
6 *National Treasury MTDS report.*

Table 1.5: Risks to public debt according to MTDS

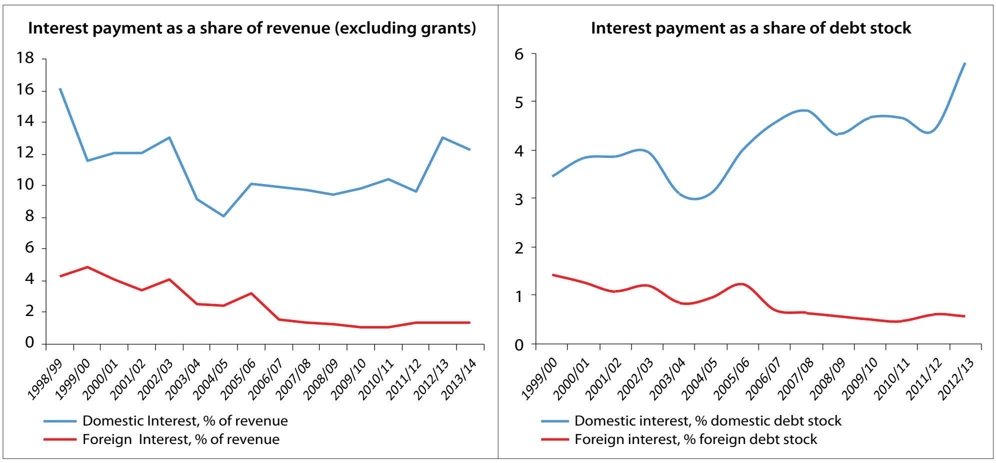
Indicators	Ex ante risks	Ex ante cost
Currency composition (39% Foreign currency and 61% KSh)		
External mostly concessional	Exchange rate risk	Low
Domestic	No exchange rate risk	High
Maturity profile (Average time to maturity = 8.6 years)		
External, mostly concessional (ATM = 11.2 years)	Low refinancing risk	Low
Domestic (ATM = 4.9 years)	Medium refinancing risk	High
Interest rate composition (Fixed = 98%, float = 2%)	Low interest rate risk	

Source: The National Treasury, MTDS (February 2014)

Domestic debt service has increased in relative and absolute terms

However, domestic interest payments pose a substantial burden to the economy (Figure 1.7). Domestic interest payments account for over 80 percent on average of total interest payment due partly to a large stock of domestic debt relative to external debt. On the contrary, external debt interest payment has been flat, not exceeding 1.4 percent of expenditure since June 2007. This is attributed to the concessional nature of a large share of external debt. Furthermore, the wider gap between domestic and foreign interest payment indicates that it is more expensive to borrow from domestic market compared to foreign borrowing. Government policy to develop domestic money market through sales of bills and bonds was successful but at a higher cost. Domestic interest payments as a share of total domestic debt stock increased from 4.8 percent of domestic debt in June 2007 to 5.8 percent in June 2013; whereas foreign interest payment as a share of foreign debt stock declined from 0.7 percent to 0.6 percent during the same period.

Figure 1.7: Domestic debt is associated with higher interest rates than foreign debt



Source: The National Treasury (QEBR)

No evidence of crowding out

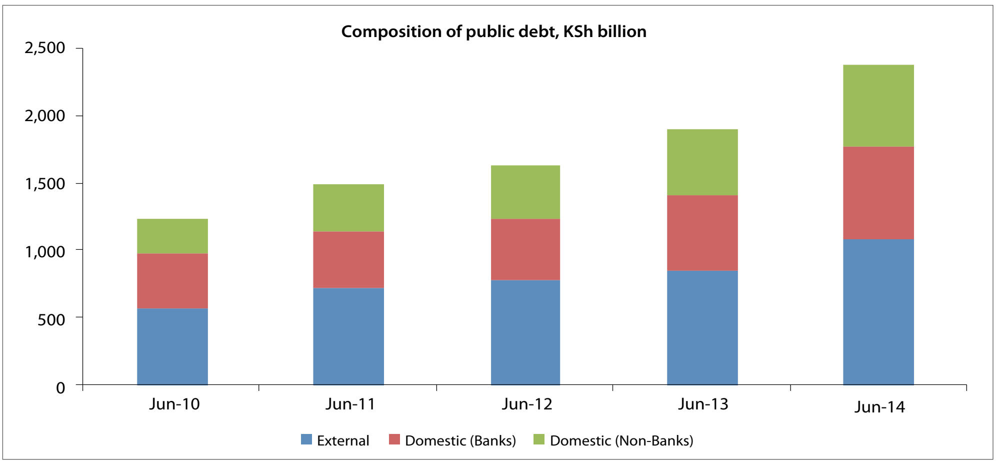
Increased domestic public borrowing over the past few years is unlikely to have 'crowded-out' banks' lending to the private sector (Figure 1.8). While total domestic public debt in nominal terms almost doubled between June 2010 and 2014, it was foreign sources and domestic non-bank investors that financed three quarters of the new public debt. Public borrowing from domestic debt rose by 70 percent, compared to 130 percent for non-bank domestic investors and 90 percent for external borrowing.

Credit growth to the private sector has remained robust and banks' liquidity is high (Figure 1.9). The share of credit to the private sector in GDP rose from 26 percent of GDP in 2009 to 31 percent in 2012. In the same period, credit was growing faster than deposits, though the loans to deposit ratio remains at a prudent level of just under 80 percent. Banks' excess reserves have been rapidly growing, and faster than deposit growth.

At the same time, banks are willing to put more of their excess liquid assets in government securities. Since 2008, both T-bill and T-bond issues have been traditionally oversubscribed and the rate of oversubscription has been going up. Banks' interest in long-term government securities peaked in 2012 (oversubscription of over 200 percent) as yields rose up due to rising inflation (Figure 1.10). The uncertainty surrounding inflation and monetary policy made government securities a preferred choice compared to lending to the private sector.

An indirect effect of public borrowing on banks' credit to the private sector is through the interest rate channel (Figure 1.11). Yields between T-bill rates and banks' lending rate tend to move in similar direction (correlation between the two is 0.77), with T-bills exhibiting a more volatile trajectory. Nevertheless, the volatility in both has been driven by changes in inflation (with a lagging effect). At the same time, the interest rate spread has been relatively stable at around 10 percentage points—with some peaks in 2012—which suggest that lending rates are primarily defined by the cost of borrowing and the factors that determine interest rate spread. Interestingly, though inflation has been brought down to below 10 percent, deposit, lending, and T-bill rates remain at above historic averages which is probably a result of inflation expectations.

Figure 1.8: Increased domestic public borrowing did not crowd-out lending to the private sector



Source: Central Bank of Kenya (CBK)

Figure 1.9: Banks' liquidity is high and credit growth to the private sector is robust

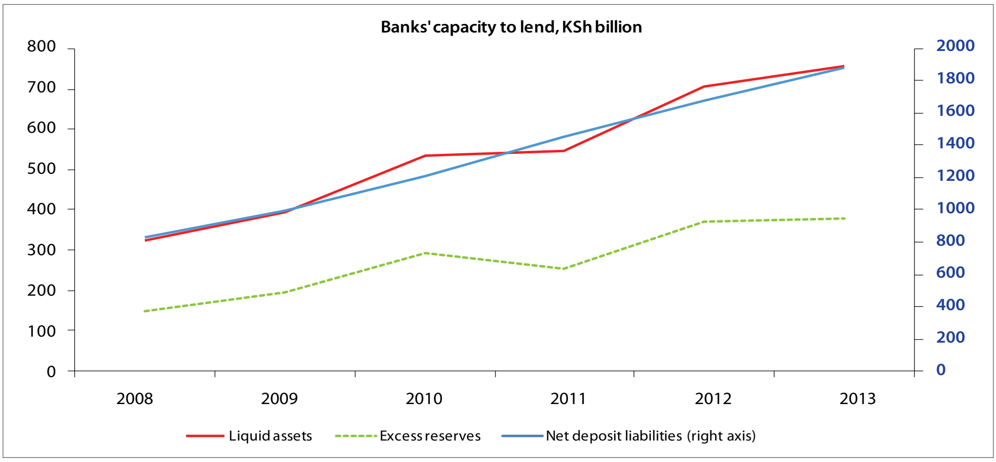


Figure 1.10: Oversubscription in government securities

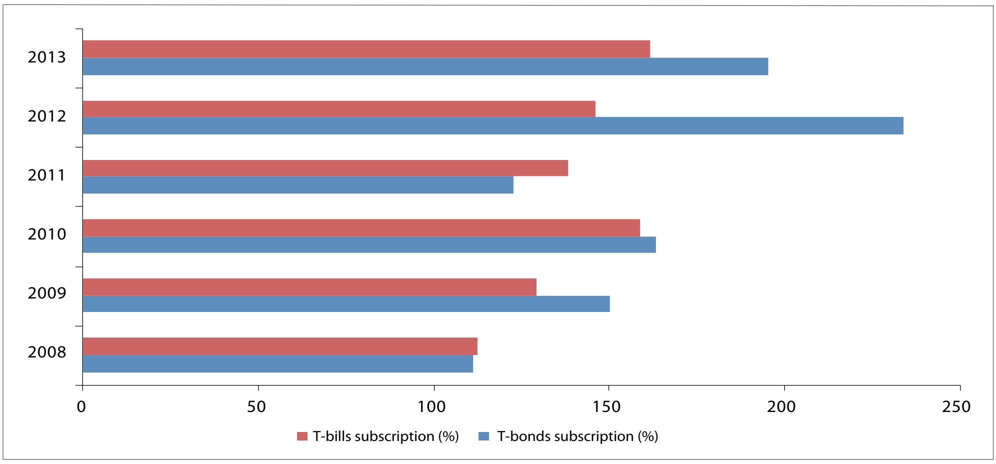
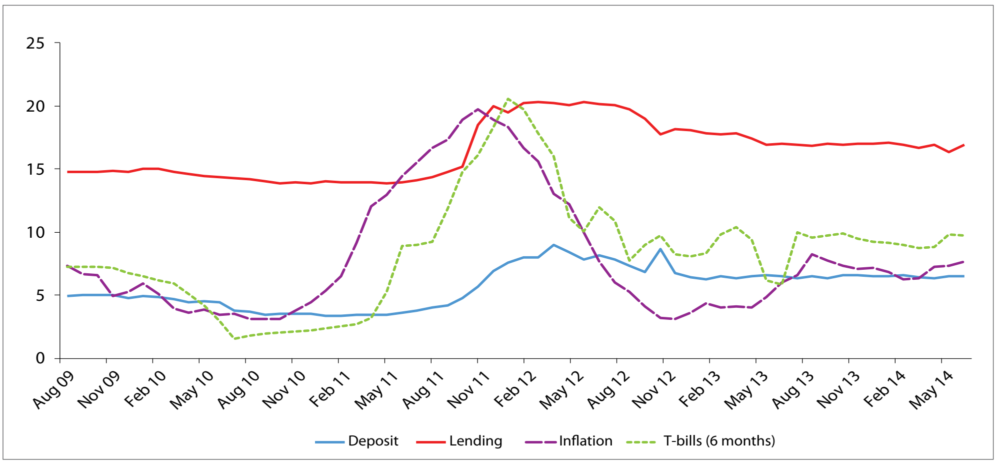


Figure 1.11: Bank's deposit & lending rates and 6 months T-bills rate (monthly average, %)



Source: Central Bank of Kenya (CBK)

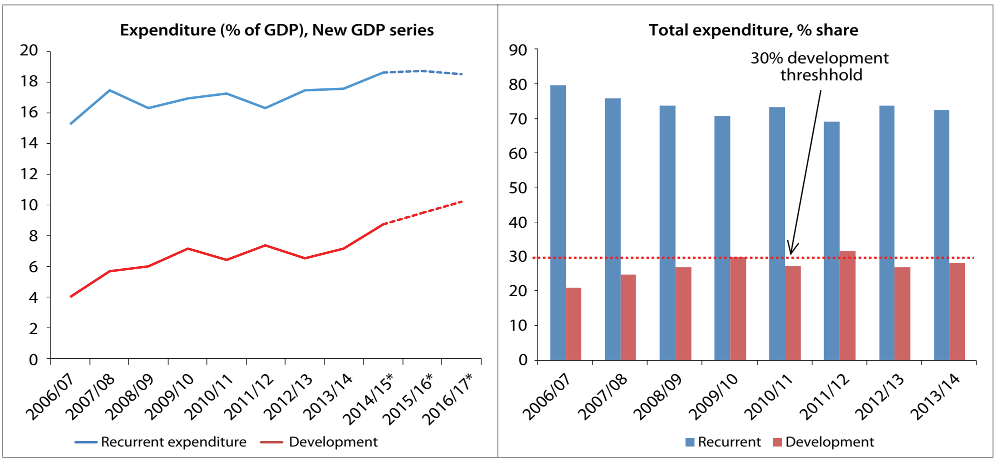
1.3 Composition of expenditure

This section reviews the composition of expenditure. The review makes four key observations: (i) it is becoming harder to attain the 30 percent share development expenditure at both levels of government; (ii) ex ante budget allocations reflect commitment to infrastructure development in line with MTP II and V2030; (iii) but ex ante budget execution reflects a different reality in spending priorities and; (iv) expenditure composition within sectors suggests there is scope to increase efficiency and equity of spending.

Recurrent spending pressure is crowding out development spending

The gap between recurrent and development spending continues to widen. The PFM Act 2012 provides for development spending at a minimum of 30 percent of total expenditure. The expenditure trends from 2007 to 2012 show a rising share of development expenditure in total spending. But the rising pressure on recurrent spending is now reversing these gains. Recurrent expenditure which has always been more than double the development spending, increased from 16.3 percent of GDP in 2011/12 to 17.6 percent in 2013/14[7] (Figure 1.12). Development spending declined from 7.4 percent of GDP in 2011/12 to 6.6 percent in 2012/13 but the promise holds and in 2013/14 allocation increased to 7.1 percent of GDP, demonstrating government's continued efforts to fund infrastructure investments. The overall development expenditure growth averaged 10 percent in the period 2007/08 to 2013/14. Development projects expenditure has increased from 3.1 percent of GDP in 2007 to 4.5 percent in 2013/14.[8]

Figure 1.12: Widening recurrent and development expenditure gap



Source: The National Treasury, QEBR reports
*Notes: *Estimates; **Projections*

Ex ante spending priorities are aligned with development plans

The composition of expenditures is in line with government's own priorities. Kenya's development objectives are stipulated in the government's Vision 2030 and the medium term priorities established under the MTP II (2013-2017). The government aims at enhancing both the scale and pace of economic transformation through infrastructure development and investing in key social and economic sectors. In this regard, infrastructure sector is identified as a key driver in promoting trade and economic growth in Kenya through lower transportation and energy costs, increasing speed of access, and promoting Information Communications and Technology (ICT) development, among others.

7 *Total recurrent expenditure includes 15 percent of GDP recurrent spending at the National level and 2.65 percent recurrent spending at the County level.*
8 *The rest of development spending is categorized as A-in-A and payment of guaranteed loans.*

Infrastructure takes the largest share of development spending; budget allocation for the sector was 4.9 percent of GDP in 2013/14. Total infrastructure budget allocation amounted to 21.5 percent of the total budget in 2013/14. Infrastructure sector budget allocation has increased in nominal terms from a modest KSh 50 billion in 2005/06 to about KSh 244 billion in 2013/14, equivalent to 4.9 percent of GDP and second largest share of the total sector budget after education sector (Figure 1.13). Infrastructure spending is mainly directed to roads and energy subsectors. These two subsectors account for over 75 percent of the total infrastructure budget.

Education sector still accounts for the lion's share of the total spending at 5.8 percent of GDP or a quarter of the total budget for the last five years. In 2013/14 overall budget allocation for the education sector amounted to KSh 290.6 billion; an increase from KSh 202.6 billion in 2011/12. Over 60 percent of the spending is mainly on teachers' salaries. Focus on quality of education coupled with transition to secondary and tertiary education is required in this sector to ensure relevant skills that match labor market needs thus enhancing labor productivity. Public administration and governance take third and fourth place each with expenditure allocation of 3.6 percent and 2.6 percent of GDP respectively.

Figure 1.13: Education & Infrastructure sectors account for almost 50% of the total budget

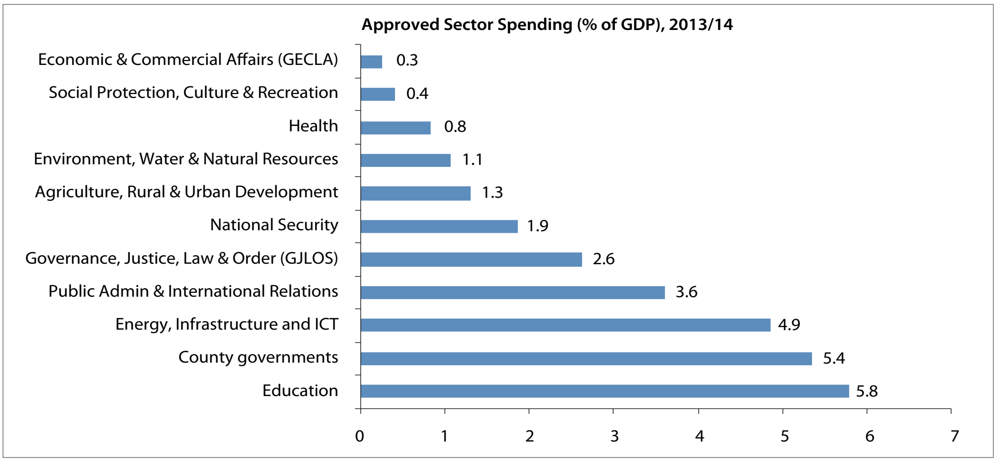
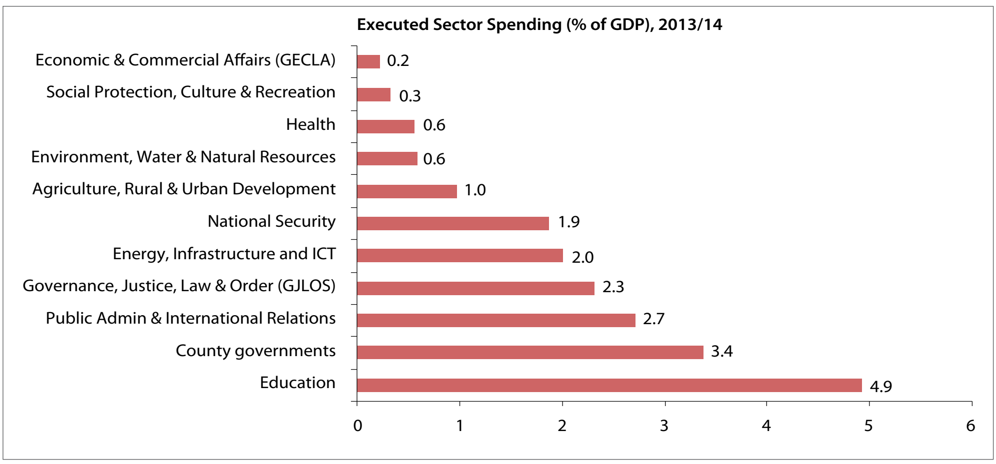


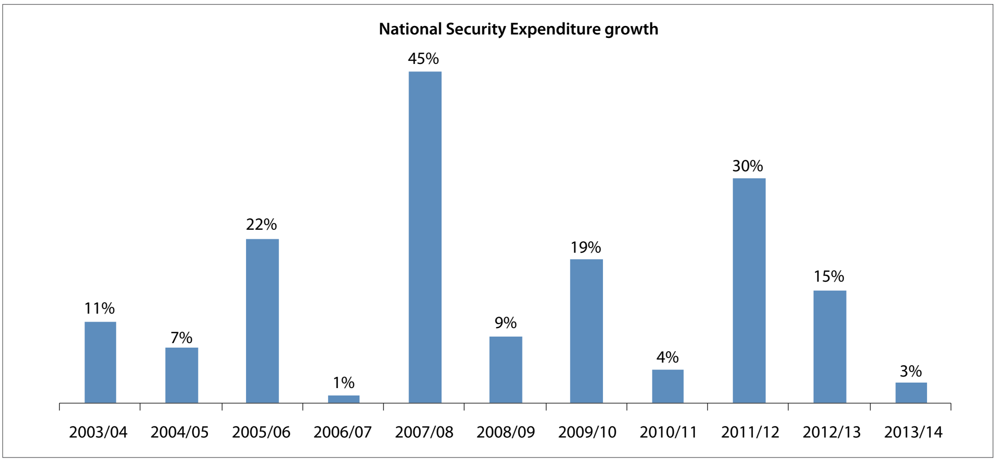
Figure 1.14: ... but budget execution especially for infrastructure investments continue to lag



Source: Staff computations based on Controller of Budget (CoB) data

Essential security spending is competing for much needed fiscal space. Key among the concerns raised by Kenyans during the 2014/15 budget cycle was enhancing the security situation in the country. National security spending has tripled since 2005/06, from KSh 30.7 billion to KSh 93.8 billion in 2013/14, which is equivalent to about 1.9 percent of GDP, with largely 100 percent budget absorption (Figure 1.15).

Figure 1.15: Increasing expenditure on national security



Source: Staff computation based National Treasury and CoB data

Other productive sectors remain less prioritized. These sectors include Agriculture and Rural Development; Environment, Water and Natural resources; and Economic and Commercial Services (Trade, Tourism and Industrialization). Total spending for each of these sectors accounted for 1.0 percent of GDP, 0.6 percent, and 0.2 percent of GDP in 2013/14 respectively. Health on the other hand is now split between national and county governments.

Ex post, budget execution reflects a different reality in spending priorities

Budget implementation remains a challenge, particularly for development spending. Development budget execution which had begun to improve in the last decade has declined and averaged 60.8 percent in 2011/12 and 2012/13. This trend continued with execution rate dropping to 52 percent in 2013/14 (Figure 1.16). However, execution of recurrent budget remained over the 90 percent mark but it declined to 87 percent in 2013/14.

Unless budget execution improves expenditure increases to infrastructure will remain cosmetic. Actual expenditure on infrastructure dropped to 2 percent of GDP compared to a 4.9 percent allocation, the sector ranking drops to 4th, after education, public administration and governance (Figure 1.17). Total infrastructure budget execution amounted to 77 percent in the period 2005/06 to 2012/13 with the latter fiscal year recording the least execution rate of 65 percent (Figure 1.17). The trend deteriorated with an execution rate for the sector reaching only 41 percent in 2013/14; KSh 100.9 billion (2 percent of GDP) was utilized out of the KSh 244 billion allocation (4.9 percent of GDP). Social and governance sectors continue to record higher execution rates surpassing the 80 percent mark. While budget allocation across sectors continues to increase, actual spending in some sectors is declining (Figure 1.18).

Figure 1.16: Execution of development budget remains a challenge

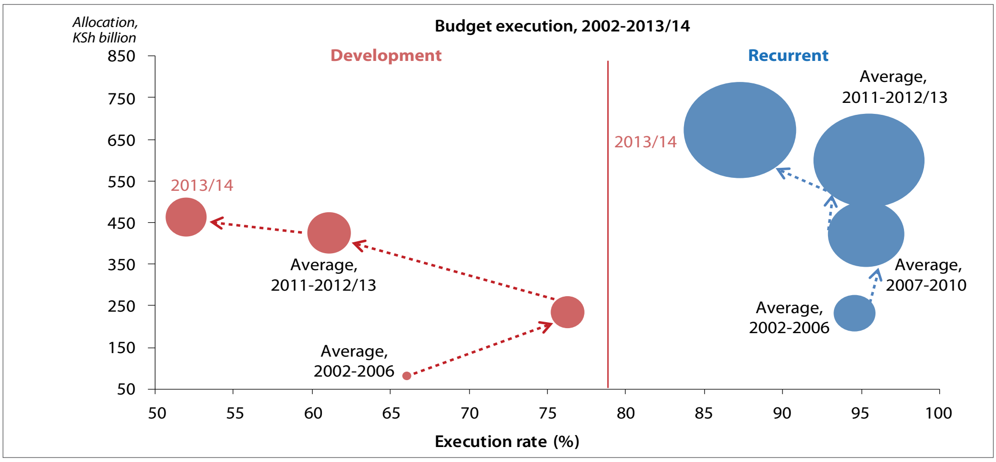


Figure 1.17: Budget execution in the infrastructure sector can be improved

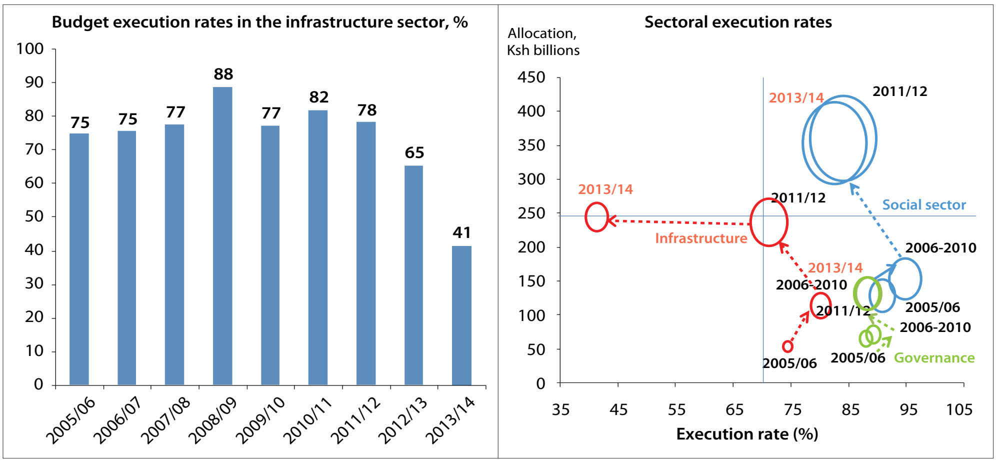
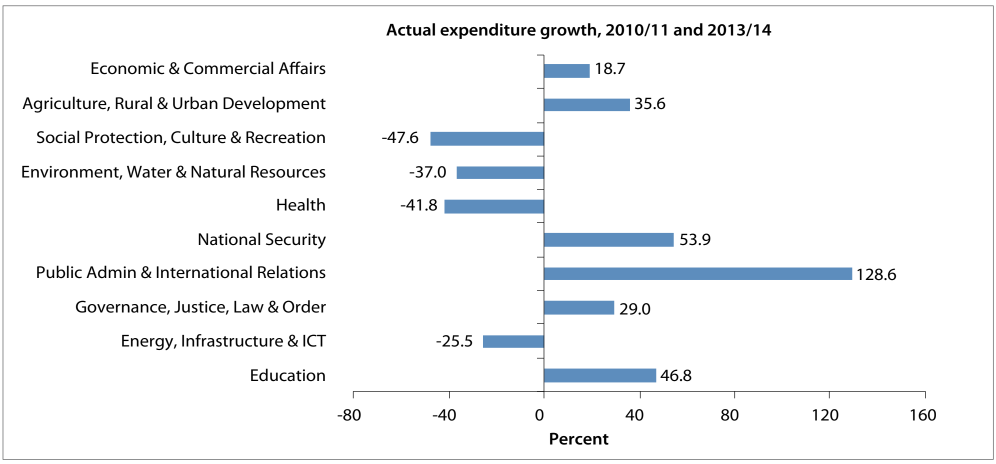


Figure 1.18: Actual expenditure growth is lagging in some sectors

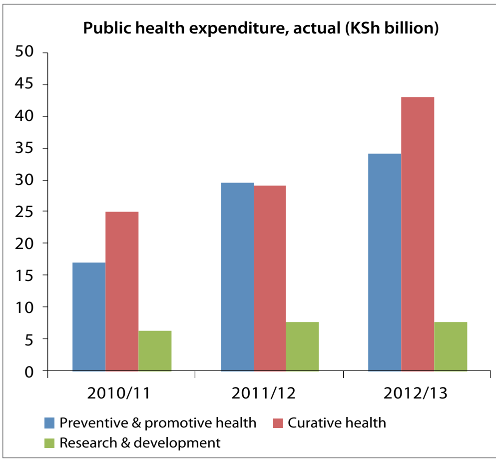


Source: Staff computation based on KENAO Appropriation Accounts and COB data

There is scope to increase efficiency and equity of spending within sectors

Public health expenditure has increased in nominal terms growing almost 5 times since 2002 to 2012/13. It increased from KSh 15.4 billion in 2002/03 to KSh 72.3 billion in 2012/13. Large share of this spending is mainly on high-end curative health contrary to the government's policy of promoting preventive health care (Figure 1.19). Curative health continues to receive the highest share of the total health sector budget (Figure 1.19). For the government to achieve its main objective of providing primary health care for the citizens, then more resources need to be directed towards this course particularly preventive health. Many donors characterize this sector and finance about a third of the total health spending mainly focused on a few diseases and largely off-government systems (Figure 1.20). (see Health Sector Review Policy Note for further details).

Figure 1.19: Health sector spending is mainly on curative health.



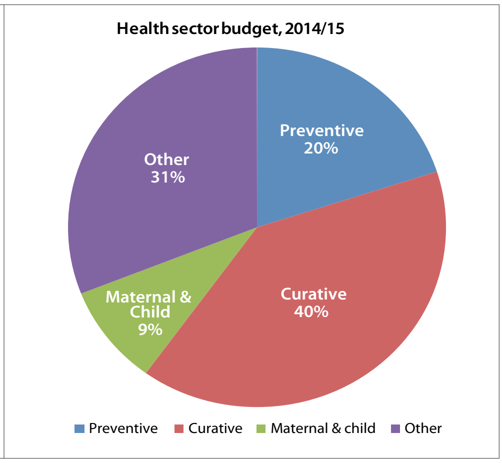
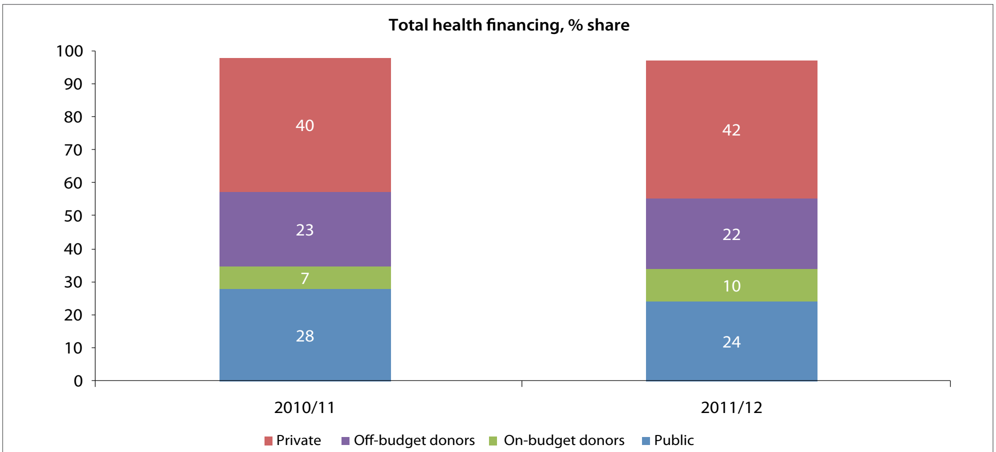


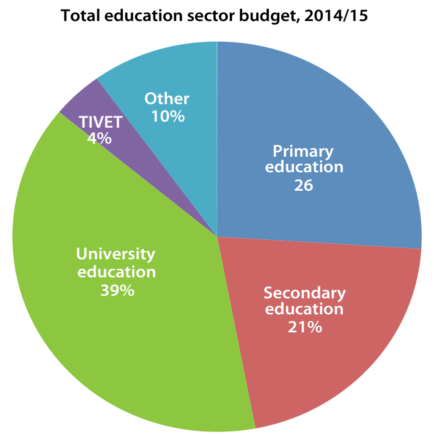
Figure 1.20: Donors finance about a 1/3 of total health sector spending but a large share is off-budget



Source: The National Treasury and Development Partners for Health Kenya (DPHK) data

Education Sector continues to receive the highest share of the total budget. However, intra-sectoral composition in this sector can benefit from rationalization in order to enhance efficiency and equity. The education budget allocation in 2014/15 is skewed in favor of tertiary education at over 40 percent of the total sector budget which compares unfavorably to 26 percent allocated to primary education (Figure 1.21).

Figure 1.21: Current expenditure composition in education could undermine efficiency and equity budget



Source: Staff computation based the National Treasury data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Chapter 2

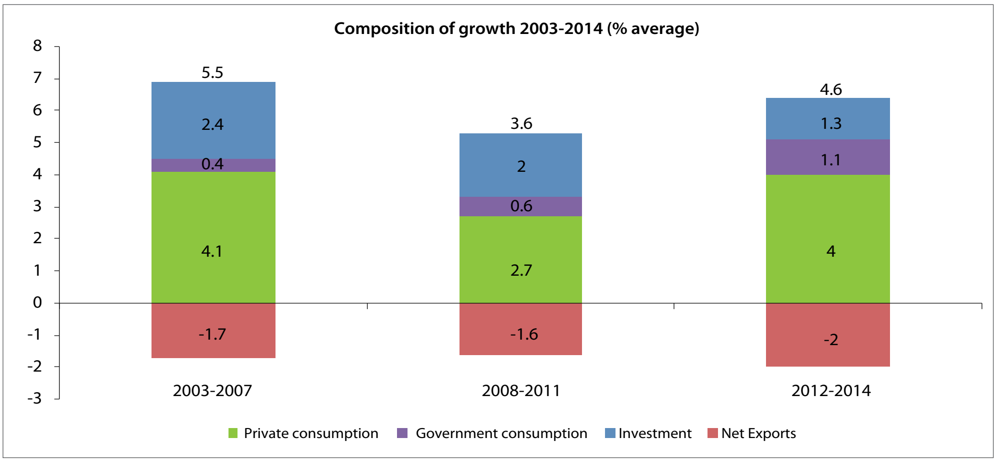
EFFICIENCY OF DEVELOPMENT SPENDING

This section reviews the efficiency of the current budget strategy which has seen a significant increase in development spending in real, absolute and relative terms. Notably, after a decade of investment in infrastructure, the pattern of Kenya's growth has not changed. Growth is still largely driven by private consumption. The review highlights three factors which undermine the efficient of current and past investments notably; (i) the decline in the budget provision for operations and maintenance, (ii) the decline in budget execution rates which is closely linked to and; (iii) weaknesses in Project Investment appraisal and Management (PIM). These areas require urgent attention for Kenya to reap the benefits of the recent investments. Adequate provision for operations and maintenance will require real growth in revenues that is above economic growth rate.

2.1 Trends in productivity growth

Kenya's growth is still driven by consumption but long run productivity growth can only come from investment. Kenya recorded an average growth rate of about 4.6 percent in the recent years. The striking feature of the recent growth is that contribution of public consumption to growth increased. The composition of growth during the three growth periods 2003-07, 2008-11 and 2012-14 shows that investment contribution to growth has declined to 1.3 percentage points in the recent years, compared to 2.4 percentage points during the high growth period 2003-07 (Figure 2.1). The declining contribution of investment to growth coincides with rising government investment, which raises the question of efficiency of ongoing investments.

Figure 2.1: The recent decline in investment contribution to growth is a source of concern



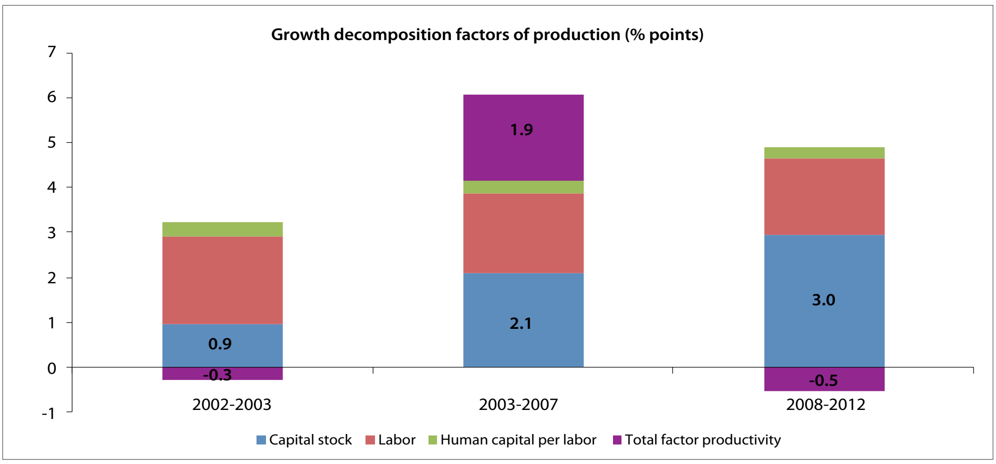
Source: Computation from Economic Surveys, various issues

The budget strategy can be interpreted as government response to recommendations from various reviews which identified the infrastructure deficit as the main bottleneck to Kenya's competitiveness. The 2011 infrastructure diagnostic review for instance, concluded that to close Kenya's prevailing infrastructure deficit in year 2006 required annual investments equivalent to 11 percent of GDP. The review also observed that the investment requirements could be reduced by half through efficiency gains. (Garmendia and Shkaratan, 2011). The 2009 Country Economic Memorandum made similar recommendations.

Government investment priorities clearly reflect the commitment to close the infrastructure gap. The analysis in part I reflects a sustained increase in infrastructure investments, particularly roads and energy. The current medium term budget strategy shows that the share of infrastructure spending in the development budget will increase from 45 percent in 2014/15 to 51 percent in 2016/17. Current investment levels translate to about 4.2 percent of GDP and although it stills falls short of the 11 percent estimate, it is still a commendable effort in light of the limited fiscal space and the need for fiscal consolidation.

Physical capital is driving growth but productivity enhancements have stalled. The decomposition of growth by factors of production shows that the contribution from physical capital has increased. The recent increase in public investment is consistent with the contribution of physical capital to growth. Figure 2.2 shows that between 2002/03 capital stock contributed 0.9 percentage points to growth, which increased to 1.9 percent in 2003-007 and more recently to 3.0 percentage points. But productivity enhancements have stalled, declining from 1.9 percent to -0.5 percent.

Figure 2.2: Capital stock



Source: Glenday PER background paper

The declining efficiency of capital can be attributed to several factors. The decline could be due several factors which are closely related and mutually reinforcing. These factors include: (i) weak budget implementation which means that development projects have long gestation periods and cost overruns; (ii) challenges in investment appraisal, selection and management; (iii) underutilization of existing capacity, which is closely linked to and; (iv) inadequate budget provisions for Operations and Maintenance (O&M). These challenges merit further investigation on the next PER.

2.2 Recurrent operations and maintenance: A measure of efficiency

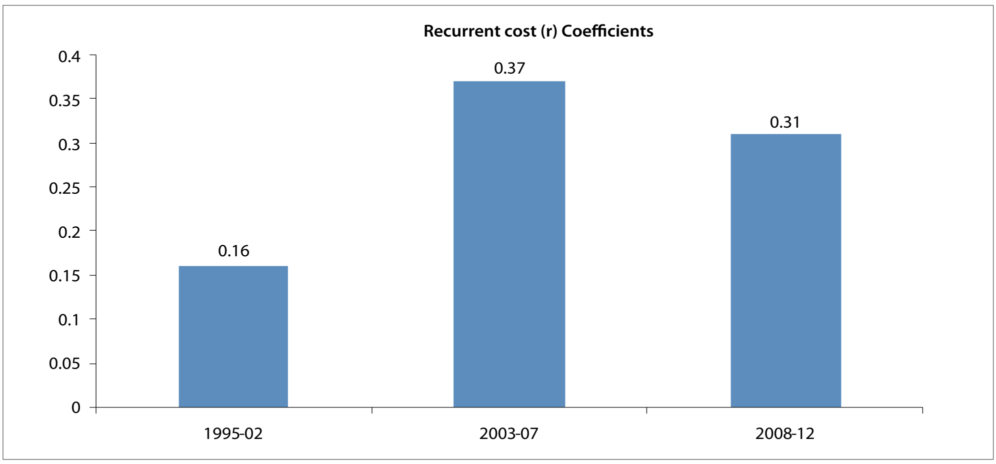
The efficiency of new investments depends on achieving the right balance between new investments and the maintenance of existing capital. Operations and maintenance funding can be defined as the annual expenditure required to sustain a constant stream of real service over the future and includes labor and operating costs and routine maintenance and rehabilitation. At the very least recurrent operating costs should be steady or rising. And although there are no standard thresholds benchmarking can be used to assess whether the provisions are broadly sufficient.

Recurrent cost (R) coefficients can be used to measure efficiency of investments. One indicator of the adequacy of operations and maintenance sufficiency is the ratio of capital expenditure to combined capital and current spending, R coefficient. The recurrent operations and maintenance expenditure required to sustain delivery per unit of investment in a service delivery facility is expressed as the R coefficient. An alternative definition is the annual expenditure required to sustain a constant stream of real service over the future, to sustain productivity of investment. R coefficients can be used as one way of testing if there is a recurrent cost problem that could undermine the efficiency and effectiveness of new investments. However, the R coefficient is not easy to measure where detailed investment appraisal data is not available. The often used approach is to estimate the implicit R coefficient, details are provided in Annex 1.

A significant share of public sector investment are not self-financing thus require additional O&M budget provision to operate efficiently for the life of the project. A good example in Kenya is roads, which require adequate budget provision for operations and maintenance; airports on the other hand can be self-financing.

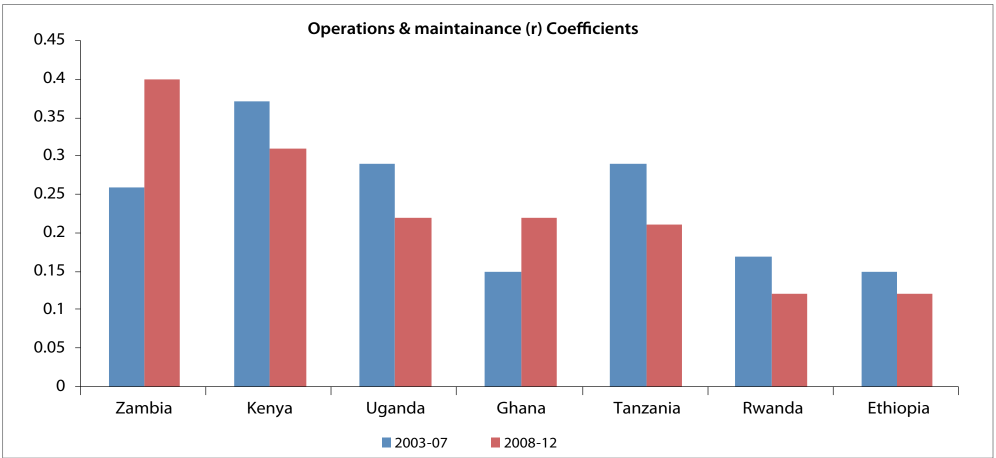
R coefficients should be steady or increasing. Figure 2.3 shows the recurrent cost coefficient estimates for Kenya; the coefficient increased to 0.37 in 2003-2007 from a low base of 0.16 in 1995-02. However the coefficient declined in the recent period 2008-12. This trend is worrying in the light of rising capita investments which require commensurate increase in provisions for operations and maintenance. Figure 2.4 benchmarks Kenya's r coefficients against selected countries. The figure shows that Kenya's levels are not too low but it is the decline that should be circumvented through increased budget allocations for operations and maintenance.

Figure 2.3: Recurrent cost coefficients declined in the recent years



Source: Glenday PER background paper

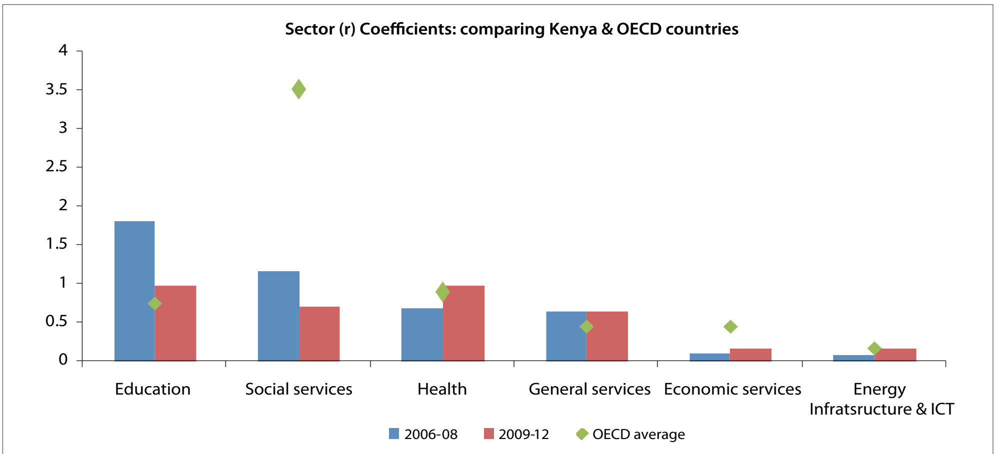
Figure 2.4: Comparing recurrent cost coefficients in different countries



Source: Glenday PER background paper

R coefficients vary from one sector to another, and by level of development. Annual R coefficients are higher in social sectors like education and health, and in sectors with high rates of deprecation. Figure 2.5 compares sectoral R coefficients in Kenya and the averages for OECD countries. The results are mixed; R coefficients are higher in education and social services but declined between 2006-08 and 2009-12. The coefficient in education is much higher than in OECD countries, the recent increase in the health sector aligned the sector with the provisions in OECD countries. There is a marginal increase in the infrastructure sector.

Figure 2.5: R coefficients by sector reflect a mixed performance



Source: Glenday PER background paper

The recurrent cost problem is not new in Kenya, The recurrent cost problem also arises when the economic value of the new assets falls below its costs so it does not generate expected benefits. CDF projects in health and education sector provide good examples where hospitals and schools have been built without provisions for teachers and health personnel to run the facilities see Box 2.1.

Box 2.1: The recurrent cost problem is real

"*Mr Sambu:* Thank you Mr Speaker Sir, for giving me time to support the vote of the Ministry of Health. Mr Speaker Sir, I would like to urge this Ministry to employ health workers who have been trained in the various medical training colleges. These are mainly nurses, clinical officers and lab technicians. As it came out during question time, health centers and dispensaries have been built in many constituencies through the CDF money but they are now lying unused. **In my constituency there are 20 such facilities which are ready but they are lying unused**. This is because they do not have staff and equipment. They are also not receiving any drugs from the ministry. Because we are told that they are not registered."

Source….Kenya National Assembly Hansard, 7th August 2007 page 2994

"The 110KVA generator worth KSh 4.3 million was bought by Bomachoge Constituency Development Fund to alleviate power constraints at the medical facility. A modern theatre built and equipped by donor funds has been lying unused due to lack of a reliable source of power after the existing generator stalled forcing patients to be referred to Kisii Level Five Hospital and private facilities in the region."

Source: www.bomachoge-chache.or.ke/projects/2-health

In Kenya the recurrent cost problem can also be traced to: (i) the dual budget process which separates capital and recurrent budgets; (ii) a significant share of the development budget is funded by donors, which in addition to low execution levels, tends to be development oriented with no provisions for future recurrent cost implications; (iii) weakness in the public investment appraisal and management system and; (iv) the stand alone funds like the Constituency Development Fund (CDF) could also create a recurrent cost problem.

It will be important to watch out for recurrent cost problems as devolved units, which largely depend on transfers, embark on new investments which are not self-sustaining, and the sub-national governments have limited capacity to generate their own revenues.

Improve investment appraisal, selection and management

Kenya has a low aggregate PIMI score of 1.65 out of 4 which might explain the declining productivity of capital. Existing literature suggests that inefficiencies in the public investment process dampens the accumulation of productive capital. Dabla-Norris *et al* (2011) argue that public investment is prone to high inefficiencies which emanate from cost overruns, benefit shortfalls, waste and low completion rates. Other sources of inefficiency accrue from the way projects are selected, appraised, managed and ultimately how they are evaluated. Dabla-Norris *et al* (2011) constructed a Public Investment Management Index (PIMI) for a sample of 72 countries. In the sample, Kenya ranked 36 with an aggregate index of 1.65 out of 4, compared to South Africa with aggregate index of 3.5 (see Figure 2.6). The weakest aspect in public investment process would appear to be in project selection, followed by appraisal.

Box 2.2: Operations and maintenance spending: the nuts and bolts of service delivery

Underfunding of operations and maintenance can be as result of several factors or a combination thereof. Furthermore different sectors have different recurrent operating costs which require to be well understood.

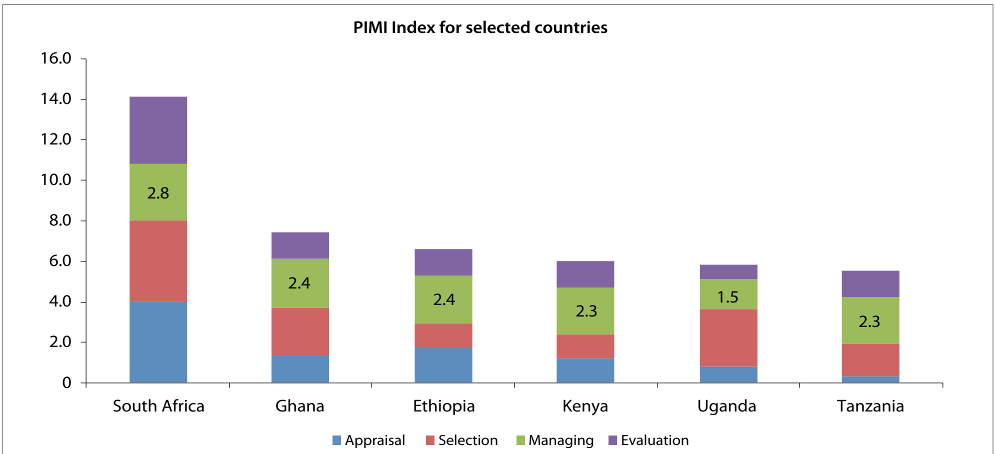
a. The obvious source can be gross underfunding of O&M in a sector or project either as a result of budget misallocations or an overall revenue shortage or failure to forecast the availability of future revenues or investing despite the lack of forecast revenues to support the operations of a project.

b. Even if the total recurrent cost allocation is adequate, given the significant differences in O&M financial support required by different services, some services may be over and others underfunded through budget misallocations across service sectors. For example, some countries established earmarked road maintenance funds to boost road repairs and rehabilitation to ameliorate the problem of persistent pot-holed roads arising from persistent under allocations to road maintenance.

c. Misallocations of O&M expenditures within sectors can also occur and undermine service delivery. An important class of this problem arises in situations where employee compensation absorbs too high a share of the O&M budget such that spare parts, repairs, supplies, utilities and related items are underfunded and hence undermine the productivity of the project. In addition, within the staffing budget, an inappropriate mix of skills may be funded. These over and inappropriate hiring problems have been the target of civil service reform programs in many countries.

d. A final variant can arise out of funding arrangements where a government agency receives capital funding from one source and current funds from another. A common issue has been the "development project bias" of international donors, often leaving project operations underfunded. In addition, the context of decentralized governments where sub-national governments receive significant transfers from the center, these transfers may be below the O&M funding requirements of the facilities they are expected to operate to deliver services.

Figure 2.6: There could be scope to increase efficiency in spending



Source: Dabla- Norris et al (2011)

Some of the reasons behind the low PIMI scores

Policy coordination between government departments is a key challenge and delays project implementation. The implementation of the VAT Act 2013 and the Petroleum Development Levy are good examples in this regard. These policies are intended to enhance revenue collection but coordination between the policy and its implementation slows down the implementation of externally funded projects. Treatment of VAT in donor funded projects is unclear. The case of roads and energy projects funded through IDA is presented in Box 2.3.

Box 2.3: The case of energy; VAT Act 2013 & railway development levy have caused delays in the implementation of energy projects

The case of Energy: The World Bank is currently financing two Projects in the Energy Sector in Kenya, with a total budget of KSh 67 billion:

- Kenya Electricity Expansion Project (KEEP)—US$ 330 million. (Olkaria geothermal generation, transmission and distribution capacity expansion and electricity access); and
- Eastern Electricity Highway Project (EEHP)—US$ 441 million. (Construction of a high voltage transmission interconnector between Ethiopia and Kenya and associated converter stations).

These two projects now have a tax bill totaling US$ 137.3 million which was not part of the financing agreement. Following the implementation the VAT Act 2013 and Railway Development Levy (RDL) the goods imported under donor funded projects are taxable (except in respect of generation projects which are VAT exempt. The taxes payable for goods imported under the two projects is estimated at US$ 137.3 million. Imposition of the RDL and VAT on goods imported for the two projects is inconsistent with the signed Financing Agreements for both projects (KEEP signed in May 2010 and EEHP in December 2012) which provide that the projects are tax exempt.

The taxes have created a large funding gap in the projects, which has to be paid by the Government/implementing entities. The implementing agencies on their part argue that they do not currently have budgetary allocations to pay the taxes.

Goods imported by the project have been pending in Mombasa for the last four months. The taxes and levies have caused delays to the implementation of projects. As an example, goods imported by one of the substation works contractors under the KEEP (ABB) have been pending clearance at the port of Mombasa for the last four months (since February 2014).

Yet investments in energy remain a priority.

Transport Sector: This sector has also been adversely affected by the introduction of the VAT and RDL taxes.

Budget ceilings for externally funded projects result in 'in- year' inadequate budgetary allocation, penalties and interest charges for delayed payments: Insufficient funds hold down implementation of the projects. The National Treasury may wish to issue clear guidelines on how the budget relating to donor funded projects, not dependent on tax collections, should be approached so as not to delay implementation or pay interest on delayed payments yet funds are available.

Insufficient provision of GoK counterpart contributions, (where required in financing agreements), to fund some project activities. Projects in the IDA portfolio provide a good case study of the challenges in project management arising from weak policy coordination see Box 2.3.

Sustainability of new investments requires real growth in revenues. A comparison of the growth in capital expenditures on one hand and revenue and current expenditure on the other could point to challenges in the funding of O&M. Sustainability of investment requires that tax revenues grow faster than the economy to sustain service delivery from government investments. Aid dependency is one of the risk factors to sustainability of new investments.

Box 2.4: Other possibilities for increasing the efficiency of capital

a. Exploit user charges where possible to make investments financially and economically feasible. This could include the use of PPP arrangements.

b. Change mix of capital investments towards projects that have more rapid impact on growth such as roads or other economic service infrastructure that (i) relieve clear shortages or bottlenecks, (ii) have quick and significant impacts on lowering the costs of doing business of farmers or industry, and (iii) have low recurrent cost requirements compared to projects that have a slower impact on growth and a high recurrent cost requirement such as primary education facilities. This sector mix can be reversed once growth is regained.

c. Ensure all projects are expected to generate positive net economic benefits (which also requires that they are financially sustainable) to avoid the fiscal drag that arises from economically unproductive projects.

d. Review and restructure existing public productive assets, including liquidation of unproductive marketable assets (vehicles, buildings, non-strategic land, etc.) to enhance output performance or release funds from unproductive uses.

Source: Glenday (2014) PER background paper

Chapter 3

DEVOLUTION – FISCAL SUSTAINABILITY ISSUES

This section provides an overview of fiscal developments of county governments. The review makes the following observations: (i) budget execution has been weak so counties ended up with positive balance; (ii) administrative costs have built rather quickly; (iii) limited revenue mobilization is driving the push for higher levels of transfers, and; (iv) only ten counties allocated at least 30 percent of their budgets to capital expenditure.

3.1 Introduction

The implementation of fiscal decentralization provisions of devolution is probably one of the most complex public finance reforms. Work on political, functional and financial expansion at one tier and realignment of the same areas across all tiers is a very difficult undertaking. New sets of institutional arrangements to ensure sector policy coordination and fiscal efficiency within and across tiers of government need to be developed; the sequencing of reform often to be staggered, with capacity increase to come before down-sizing on other tiers. It is in such context, that the objectives of devolution: (i) address deeply entrenched disparities between regions and correct skewed development; (ii) improve equity in access to social and economic services at sub-national level and; (iii) progressively work towards equalizing opportunities for all Kenyans, are to be achieved.

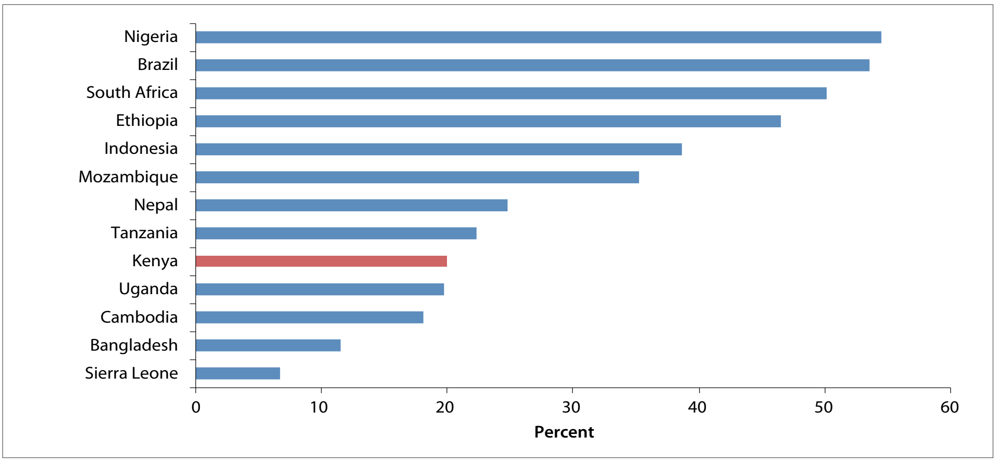
Fiscal decentralization is a core element of Kenya's devolution. The objectives of the Kenyan devolution reform were clear at the outset by allocating important service delivery responsibilities and funding to a new government tier, a clearer functional assignment with potentially fewer overlapping functions was to be established, ensuring accountable and equitable service delivery to the Kenyan population. Similar to other 'big bang' reforms, the implementation of devolution remains 'work in progress' for years (even decades), where countries gradually establish the subnational capacity to undertake the services, fine-tune functional assignments across tiers, and hence fine-tune the grant arrangements to finance these functions.

In their first year of devolution, 2013/14, county governments' approved expenditure outlay amounted to 5.4 percent of GDP. The county governments targeted to collect 1.2 percent of GDP as own-source revenue while receiving national transfers approved at KSh 210 billion which is equivalent to 4.3 percent of GDP. County governments were only able to collect 0.5 percent of GDP as own-source revenue and National transfers amounted to 3.9 percent of GDP.[1] Of the total available revenue, counties overall expenditure reached 3.4 percent of GDP, leaving 1 percent of GDP as surplus.

1 *National transfers to county governments were approved at KSh 210 billion. KSh 193.4 billion comprising of the equitable share (KSh 190 billion) and conditional grants to Level 5 hospitals (KSh 3.4 billion) were transferred to county governments. Conditional grants amounting to KSh 16.6 billion (donor funded projects) and KSh 3.4 billion (Equalization fund) were not transferred.*

About 20 percent of total government expenditure was spent at sub-national level in 2013/14 which is the same level as EAC countries (Figure 3.1). The share of subnational expenditure closely mimics the levels in the region; in Uganda and Tanzania expenditure by sub-national governments account for 20 and 22 percent (respectively); while in Ethiopia it accounts for 46 percent of total expenditure. However, these countries have been implementing devolution for several years now, Ethiopia and Uganda for more than a decade. The share of devolved funds traditionally is higher in federal countries, with Nigeria, Brazil and Ethiopia as examples. Figure 3.1 shows the share of devolved funds in total spending for selected group of countries.

Figure 3.1: The share of devolved funds is at the same level with EAC countries



Source: The National Treasury, Controller of Budget, and http://www.localpublicsector.org

3.2 Fiscal pressures and broader fiscal sustainability issues

Such a comprehensive and significant devolution of expenditures, as funded to a large extent by national government transfers, call for increased attention and focus of the government on emerging fiscal sustainability issues. Fiscal pressures may arise on several areas, including:

a. Expenditure management related to the creation of a new tier of government: The 47 counties, with political county assemblies, and own county administrations, to be established by taking over devolved central government functions and staff; part of the district administrative functions and staff; as well as to hire additional administrative staff and add capacity as see fit. Two questions arise:

- Will the corresponding down-sizing of administrative capacity at other government tiers take place as required?
- Will the counties be able to build up capacity and expenditure on development budget areas, in parallel with the increase in administrative functions and related expenditures?

b. Fiscal management related to service delivery—the counties to bring services closer to Kenyans and to seek higher equity in access to services. In service sectors as health, and infrastructure, the counties' share of public service delivery will be approximately 20 percent of total sector expenditures, and with the county capacity to be established partly by taking over devolved staff, and related sector revenues (fee payments). Two questions are pertinent:

- Will the counties be sufficiently equipped with sector mandates and expertise, staff, operational capacity and fund sources to ensure that the national objectives are achieved across counties?
- Will the corresponding adjustment of sector functions and staff at national government take place, as planned?

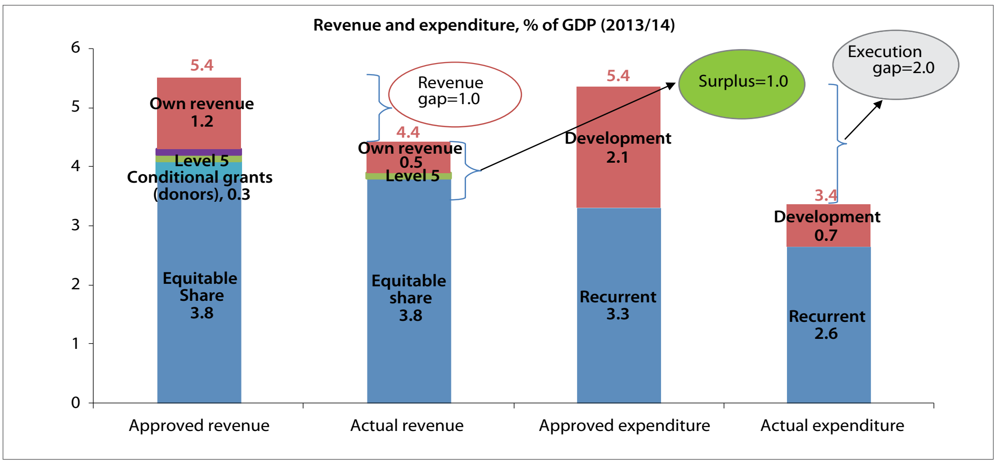
c. Counties revenue – Getting the level and composition right. With the equitable share at 15 percent of all revenues, what is the appropriate mix of additional conditional central grants and counties' own revenue, to ensure the balance between national policy objectives and local tax accountability?

The roll-out of devolution to the new counties is still in its initial stage; it is premature to assess any fiscal sustainability directly from the actual expenditure and revenue data so far. The following sections—based on fiscal data for 2013/14 provide a first impression of counties fiscal patterns.

In accordance with the 2013/14 approved budget, the spending of the counties amounts to 5.4 percent of GDP. With aggregate public sector spending projected at 25.9 percent of GDP,[2] 20 percent of all public expenditures are being undertaken by the newly-established counties. The local spending, however, is to a very large extent funded by national transfers which were approved at to 4.3 percent of GDP in 2013/14, covering almost 80 percent of the counties' total approved budget.

The 2013/14 fiscal data reveals important emerging trends; on the expenditure (Figure 3.2), (i) there is an overall budget execution gap estimated at (37 percent) of approved expenditure; (ii) administrative expenditures have built up rather quickly and; (iii) the under-spending is concentrated on development budget, where only a handful of counties allocated at least one third of their budget for development projects. On the revenue side in turn, (iv) while on the overall level, inferior to the spending gap, the overall revenue gap was mostly on own revenues, with a collection gap of 57 percent

Figure 3.2: County governments revenue and expenditure, 2013/14



Source: The National Treasury and Controller of Budget

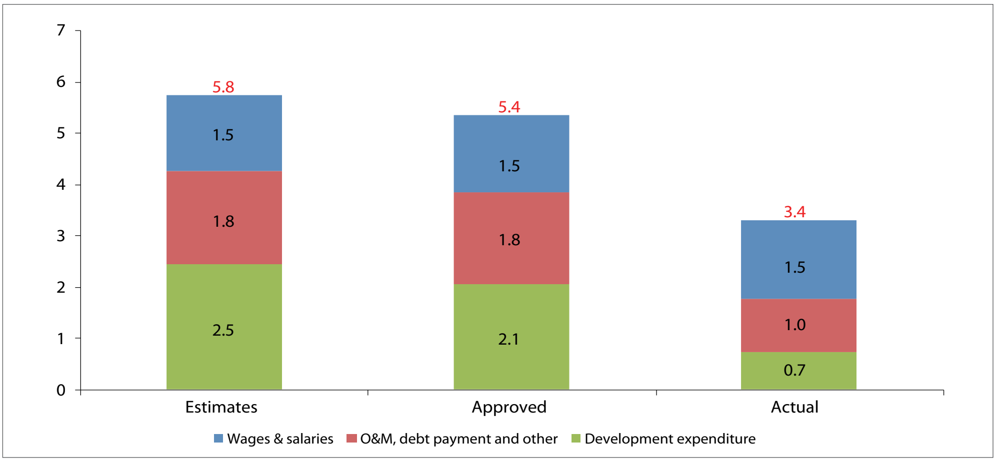
2 *Going forward the aggregate public sector expenditure may decrease, as central government's expenditures get adapted to the allocation of functions across tiers. In this perspective, it is important that the National administration establishes expenditure overviews by public policy sector, bringing together the spending of national and counties administrations.*

of the approved amount. Finally, with the overall underspending larger than the gap in revenues and; (v) the counties established positive balances in 2013/14 at 1.0 percent of GDP. These trends are discussed below.

(i) The overall expenditure execution is low

In aggregate, the counties underspent in 2013/14, arriving at an overall execution rate of 63 percent; with development spending at only 35 percent of the approved budget, while recurrent expenditures were executed at 80 percent. Wages and salaries accounted for the highest share of the total actual county spending at 1.5 percent of GDP while development spending reached only 0.7 percent of GDP (Figure 3.3).

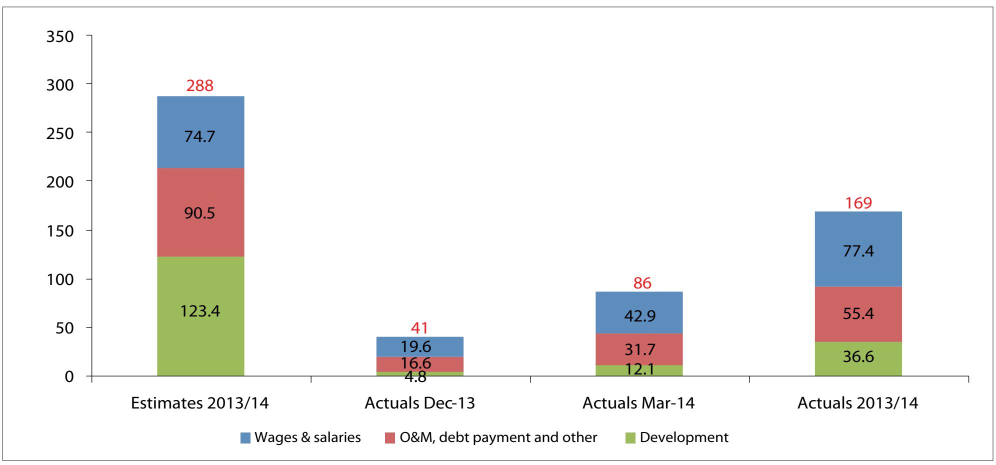
Figure 3.3: Counties expenditure (2013/14), % of GDP



Source: Controller of Budget

Wages and salaries were executed almost proportionally over the year, and with the budget execution level exceeding slightly the planned expenditures. Expenditures on O&M were doubled in Q3 as compared to Q1-Q2, and were further scaled up in the last quarter of the year. Such pattern is even more pronounced on development spending with Q1 expenditure amounting to only KSh 4.2 billion after which it almost tripled to KSh 12.1 billion in Q3 and again more than tripled in Q4 reaching KSh 36.6 billion (Figure 3.4).

Figure 3.4: Spending patterns across quarters



Source: CoB quarterly reports

(ii) Administrative costs have built up quickly

The composition of expenditure by functions appears in Figure 3.5. Expenditures to the new county assembly and county executive functions was budgeted at KSh 91.5 billion about 1/3 of the overall approved budget. As regards the approved budget allocations on service delivery, it is interesting to note that prioritization at the county level did not match the budget allocations on the devolved functions, at the time when the expenditures were part of the national government budget. In 2012/13 budget, health sector devolved expenditures were estimated at KSh 54 billion before devolution (Figure 3.6) but under the counties budget in 2013/14, the total allocation for health services stood at KSh 42.3 billion (Figure 3.5). On the other hand, on another important devolved area as agriculture, the counties have allocated KSh 15.5 billion.

Figure 3.5: Composition of the county approved budgets

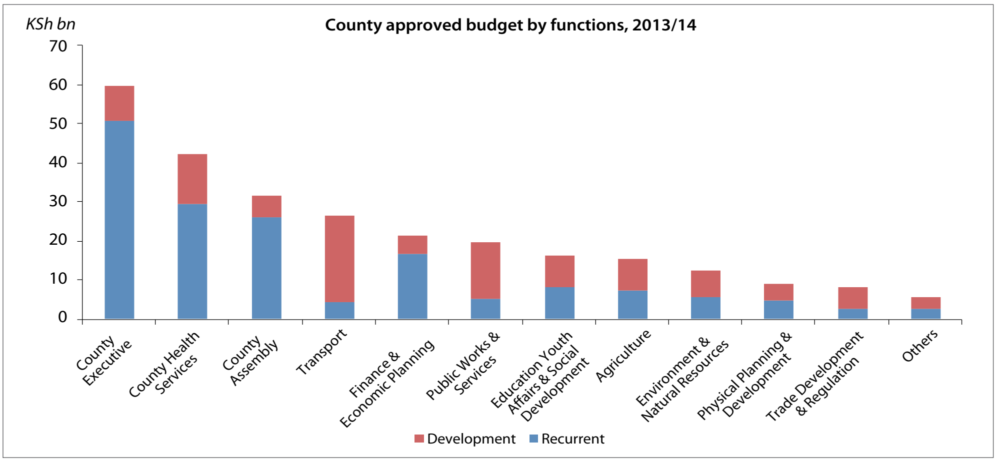
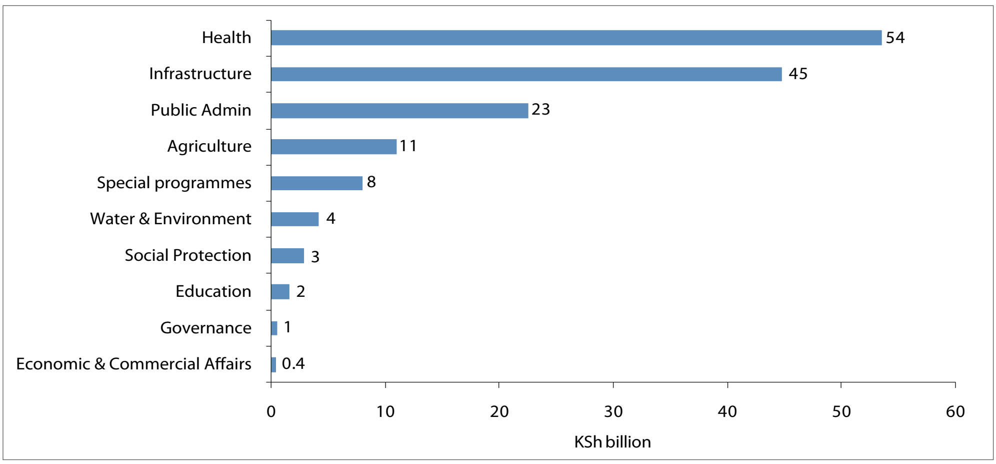


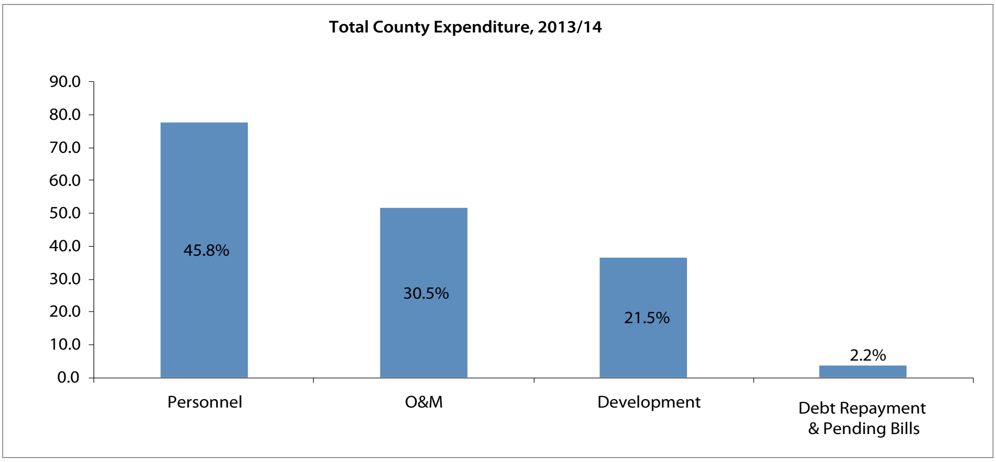
Figure 3.6: Budget allocation for devolved functions, 2012/13



Source: The National Treasury budget estimates (2012/13) and IFMIS data (2013/14)

Counties expenditure patterns in this initial year of devolution show that recurrent expenditures exceeds by far the spending on development. The approved budget allocation on recurrent and development was 62 percent and 38 percent respectively in 2013/14, and by the end of the fiscal year, only 22 percent of actual spending took place on development areas (Figure 3.7). Recurrent expenditures have built-up much faster, reflecting to some extent the administrative apparatus of the county executive and the county assemblies.

Figure 3.7: Recurrent expenditures have built-up rather quickly

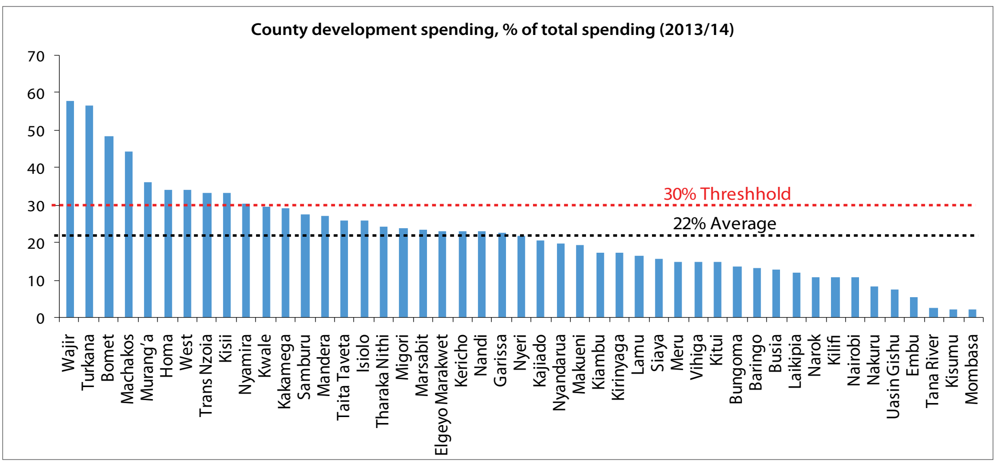


Source: CoB quarterly reports

(iii) Only a handful of counties reached the 30 percent threshold of development spending

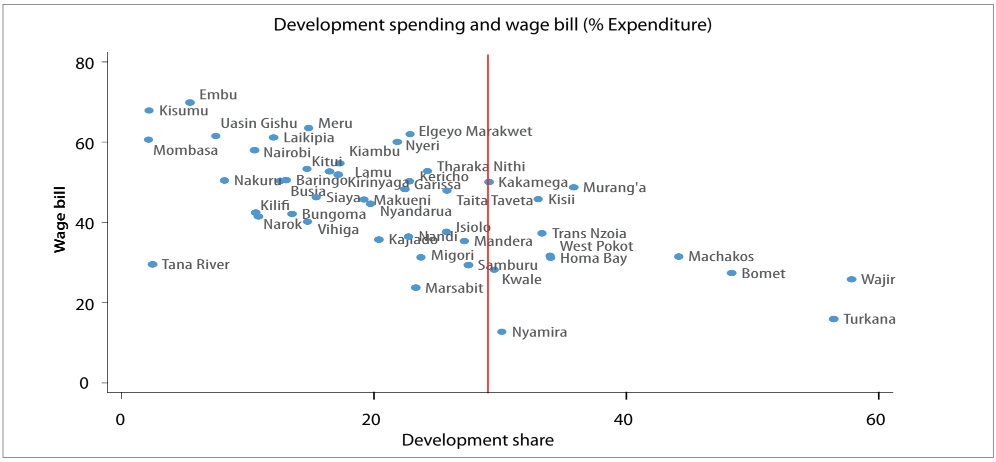
The major under-spending on development expenditures is more worrisome. Figure 3.8 indicates that almost half of the counties are spending less than the average 22 percent of actual spending on development which implies that the counties delivery of services may be negligible in core service sectors. Only 10 counties reached the 30 percent development spending threshold. Development spending is therefore low and counties will largely dependent on the national government to mobilize development activities.

Figure 3.8: Only 10 counties achieved the 30% development spending threshold in 2013/14



Source: CoB quarterly reports

Figure 3.9: Majority of counties underspent on development while a large share of expenditure went to wage bill, 2013/14

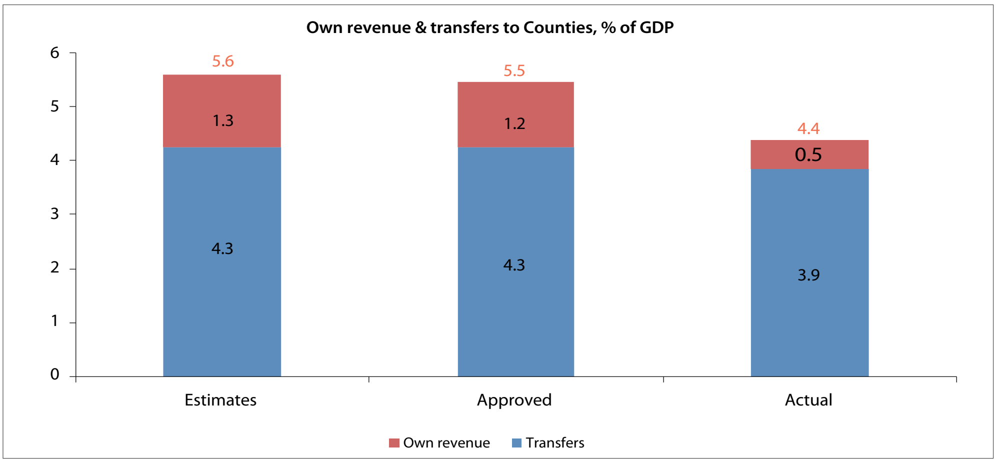


Source: Controller of Budget

(iv) Revenue collection shortfall, particularly on own revenues

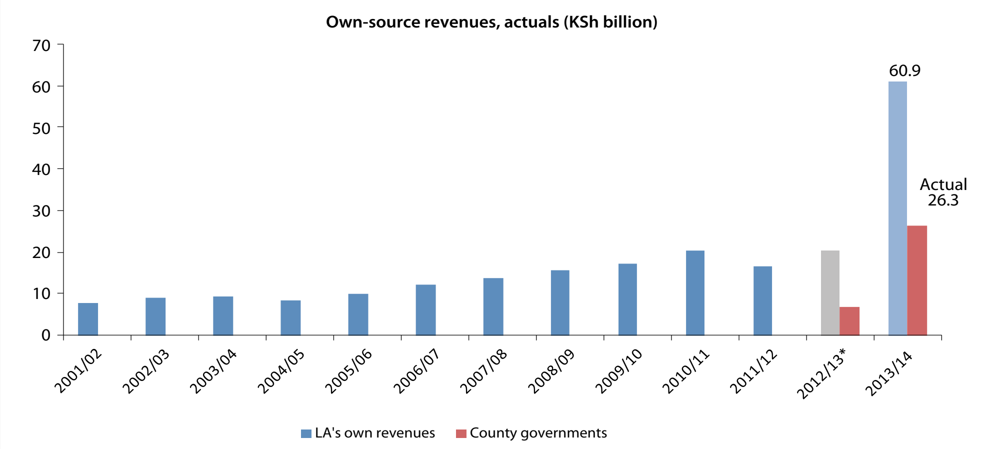
Counties' own-revenue collection is low, reaching only 0.5 percent of GDP compared to 1.2 percent of GDP annual target in their initial year of operation (Figure 3.10). This translates to 43 percent fiscal effort by counties in revenue mobilization. While the counties collected revenues well below the target, it is noteworthy though that the actual revenues represent an improvement from previous years' collection by the defunct local authorities (Figure 3.11). As indicated in Figure 3.11, 3.9 percent of GDP were released to county governments as national transfers compared to 4.3 percent of GDP annual target—KSh 20 billion constituting of the equalization fund (KSh 3.4 billion) and donor funded projects (KSh 16.6 billion) were not released to the county governments.

Figure 3.10: Counties own-source revenue mobilization remains low



Source: CoB quarterly reports

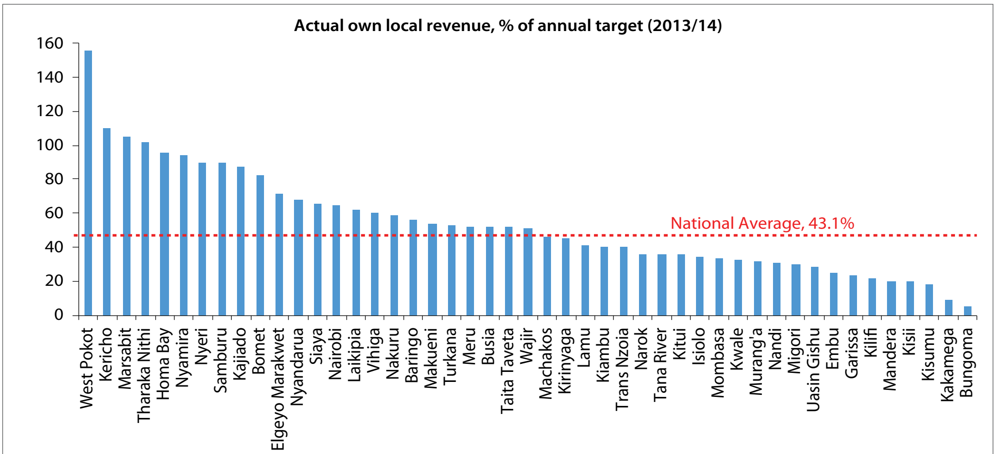
Figure 3.11: ... though slightly higher compared to the defunct Local Authorities



Source: LATF reports (Various years) and CoB quarterly reports

Counties' actual own-revenue collection deviates significantly from the target when looking across counties. The actual revenue collection effort, vis-a-vis the approved, by counties is shown in Figure 3.12. The counties are centered around the average, 43 percent, with a large group well below the average, but also with a number of counties achieving and surpassing the target. While this is positive in itself, the overall low level of revenue collection, together with a large group well below average indicate that the revenue requirements for the counties to meet service and equity targets are very unevenly distributed.

Figure 3.12: Large group of counties is well below the actual average revenue collection

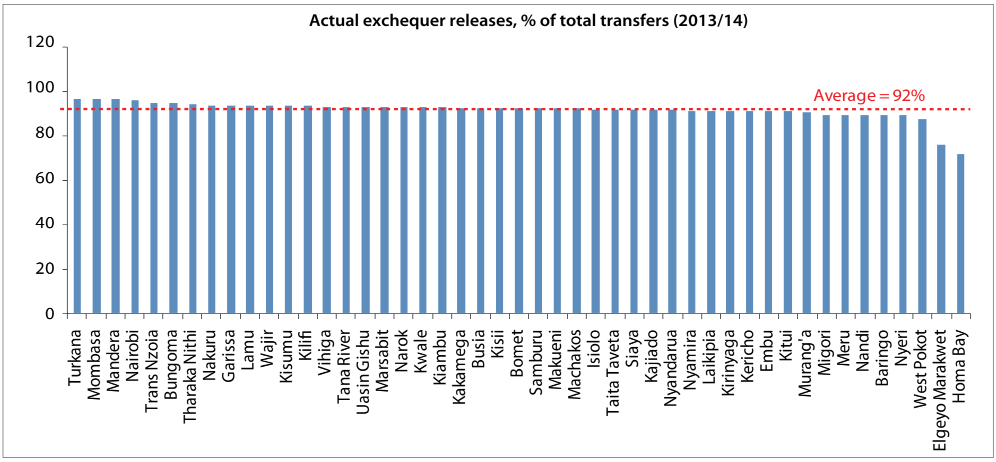


Source: CoB quarterly reports

Insufficient own tax efforts by the counties put pressures on the national government to increase transfers. As indicated, the revenue collection rate of the counties was at 43 percent of annual target. The revenue foregone, due to insufficient fiscal efforts by the counties, represents a fiscal pressure of a relatively important size on the national government to increase transfer going forward.

In terms of transfers, the counties had received around 91 percent of approved transfers at the end of the fiscal year. The 2013/14 approved budget for the counties implied a total grant transfer of KSh 213.4 billion, with KSh 190 billion as equitable share and conditional grants of KSh 23.4 billion. By end of the fiscal year, KSh 193.4 billion, or 91 percent of the total approved transfer, had been released to the counties. Figure 3.13 shows that the receipt of transfers from the national government is very evenly distributed across the counties, with the majority of counties centered around the average.

Figure 3.13: Exchequer releases are evenly distributed across counties



Source: CoB quarterly reports

The positive balance as a share of actual expenditure exceeds 60–100 percent in a number of counties, and with around 1/3 of counties above the average of 40 percent. Figure 3.14 and Figure 3.15 show some initial analyses in trying to understand how the surplus was established. In Figure 3.14, the transfers as a proportion of overall revenue are correlated with the surplus, and there is indication that counties with higher share of (unspent) national transfers were holding back in own revenue collection, due to the positive balance being established. In Figure 3.15, the importance of the surplus as a share of the overall expenditures correlates well with the low rate of execution of development budget—counties with low development budget execution may tend to have built higher surpluses. While recognizing the infancy of the devolution process, it is an area where further fiscal analysis and monitoring may seem important, in particularly the level and allocation of the CRA.

Figure 3.14: Proportion of surplus in expenditures and transfers in revenue across counties

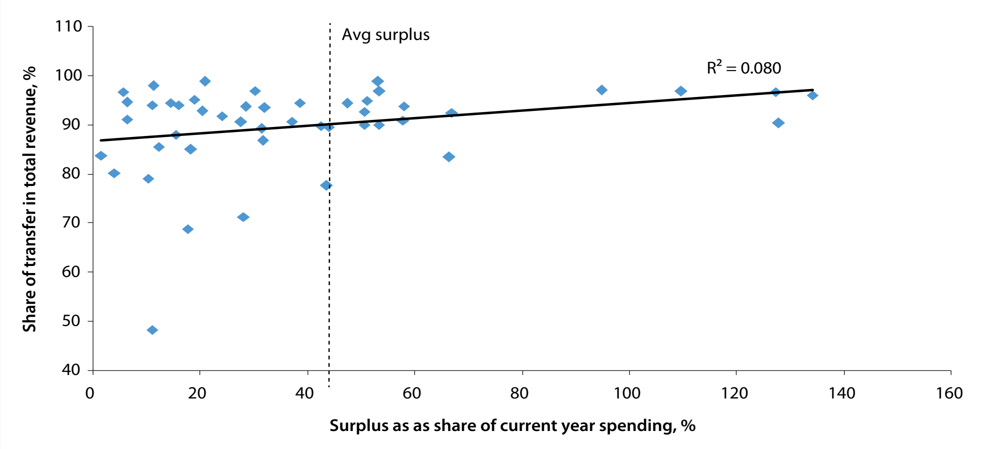
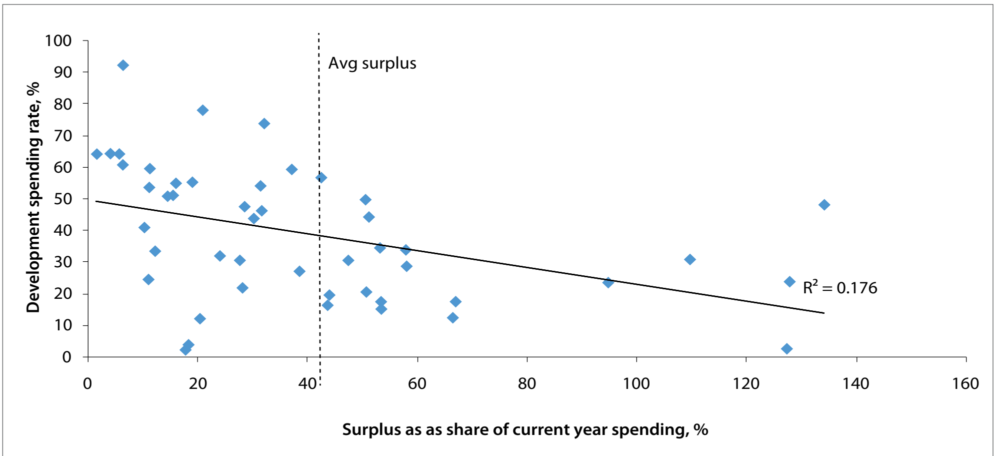


Figure 3.15: Proportion of surplus in expenditures and execution of development budget across counties



Source: Staff computation based on CoB data

3.3 Summary and conclusion

In aggregate, the main findings can be summarized as follows: In addition to general concerns on weak budget execution, the county spending on service delivery and equity areas is significantly below pre-devolution spending, with significant variances across counties, which may imply that national policy objectives on devolution reforms may not be met; administrative spending has built-up rather quickly, reflecting the costs to setting up the administrative infrastructure and the operation costs related to county assembly and county executive functions, going forward it will be important to contain spending on these areas, in particular to ensure that parallel costs at National level are being reduced, as planned; and the counties revenue mobilization efforts are significantly under targets, with large variances across counties, which, in addition to issues on uneven utilization of subnational revenue sources, increases the fiscal pressure on fiscal transfers from the national government.

The counties closed the books in 2013/14 by a positive balance of 1.0 percent of GDP. With the underspending at around 2.0 percent of GDP and a revenue gap at 1.0 percent, the counties established a positive balance of around 1.0 percent of GDP. This represents around 40 percent of the funding needed for the 2014/15 expenditures (assuming that the counties budget execution remains at the level of 2013/14), and with very large variances across counties. This raises a need for considerations on near-term fiscal adjustments, to address issues on eventual further reduction in own revenue mobilization and the very low spending on development budget, at the aggregate level and by counties.

In the short-to medium-term, a core structural question on the level and equity of service delivery spending is suggested addressed. This would involve estimates of the fiscal requirements, in addition to the CRA, to reach the targeted equalization of service delivery, and how to compensate and incentivize the counties to reach such targets. Addressing these questions would also involve efforts to complete the transition of functional assignments on core sector areas as health, water, agriculture, and infrastructure investment.

3.4 Second generation PFM reforms: Progress and prospects in a decentralized framework

This subsection discusses some of the unique factors that undermine the credibility of county budgets and their quality of their execution in Kenya. It looks back at PFM reforms initiated before the Constitution 2010 and how challenges existing then seek to be addressed through the new PFM legal and institutional framework. One year into devolution and four years into the establishment of the new PFM framework, both new and old challenges have begun to manifest themselves in county PFM. This subsection looks at how in particular issues of political economy, hidden incentives, human and technical capacities, inter-institutional relationships and the stringent legal framework could be attributed to the poor performance of county governments in terms of budget implementation so far. In conclusion it proposes frameworks and mechanisms in which these challenges could be addressed.

Devolution is at the heart of the second generation of reforms. The 47 county governments inherited PFM systems which the national government has been trying to reform for the last decade.

The Constitution and the PFM Act 2012 provide the legal basis for second generation PFM reforms in Kenya. Although the government had achieved some results through its reform strategy implemented between 2006 and 2011, a final review of this strategy noted that the gaps and challenges that the strategy was designed to address remained at the end of the implementation period. The review further attributed the poor performance to outdated, contradictory and poorly conceptualized PFM legislation which gave effect to an overlapping, dysfunctional and non–accountable institutional framework.[3] The Constitution and the PFM Act 2012 now provide the legal basis for second generation reforms (see Annex 3) and seek to eliminate the ambiguity and the overlaps in the PFM legal and institutional framework. The Constitution and

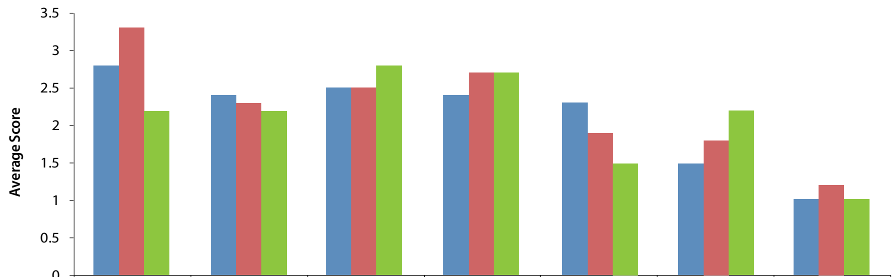
3 *Under the overall framework of the Economic Recovery Strategy (ERS) and the Kenya Vision 2030 (1st MTP) key legislations were enacted, institutions established and roles defined through the Governmental Financial Management Act (2004), Public Audit Act (2003), Public Procurement and Disposal Act (2005) and the Fiscal Management Act (year?). Key PFM offices and institutions were also established in the process such as the Accountant General and Internal Auditor General (in the National Treasury), the Kenya National Audit Office (KENAO), the Public Procurement and Oversight Authority (PPOA) and the Parliamentary Budget Office (PBO).*

the PFM Act are largely the basis for the current reform strategy under implementation (2013-2018). This subsection reviews the progress and the current prospects.

The starting point

PFM reforms have so far achieved mixed results (Figure 3.16). The three Public Expenditure and Financial Accountability (PEFA) assessments conducted of the national government's PFM framework (2006, 2008, and 2012) provide a good summary of the achievements of the past PFM reform efforts, and the results are clearly mixed. There has been progress in three areas; policy based budgeting, predictability and control of the budget, and external scrutiny and audit. The audit backlog has been cleared and the production lead time shortened. The 2014/15 will be the third year the national budget estimates will be presented in program format. Improvements during the three successive budgets reflect a learning process.

Figure 3.16: The starting point for second generation PFM reforms



	Credibility of the Budget	Comprehensiveness and Transparency	Policy-Based Budgeting	Predictability and Control in Budget Execution	Accounting, Recording and Reporting	External Scrutiny and Audit	Donor Practices
2006	2.8	2.4	2.5	2.4	2.3	1.5	1.0
2008	3.3	2.3	2.5	2.7	1.9	1.8	1.2
2012	2.2	2.2	2.8	2.7	1.5	2.2	1.0

Source: PEFA 2006, 2008 and 2012 as summarized in the Achieving Shared Prosperity Report (2013)

The credibility, comprehensiveness and transparency of the budget deteriorated during the reform period, a reversal of the progress made during the initial reform period. The ranking for account recording and reporting deteriorated throughout the reform period, starting at 2.3 and ending at 1.5 in 2012. Donor practices, however, remain the 'Achilles heel' in the PFM system, the lowest score with negligible progress over time, starting and ending at 1.0.

Are the PFM Act and the Constitution the game changers? Will the nascent county governments embrace reforms that the national government has struggled with for more than a decade?

Despite the fact that the Constitution and PFM Act have fairly stringent provisions aimed at ensuring prudent management of resources and efficient public spending (as summarized in Annex 1), county budgets are currently experiencing credibility challenges, a process that leads to their poor execution. This chapter looks into the unique factors that continue to undermine budget credibility within counties. These factors are discussed under five broad categories:

- The budget process;
- Fiscal responsibility principles;
- Political economy effects on oversight and accountability at subnational level;
- Use of incompatible PFM Systems and;
- Technical capacities.

The budget process

In the short run, the tight budget calendar will undermine the credibility of the budget particularly for country governments. While almost all counties submit their budget estimates to county assemblies by 30th April as required by the law, many counties do not adhere to other timelines for submitting other budget documents that are integral to the proper preparation or execution of county budgets (see Annex 4).

County governments prepare their fiscal strategies and budgets without details on transfers (the aggregate fiscal envelope) available to them. Counties prepare and approve their County Fiscal Strategy Papers (CFSPs) (which set out proposed expenditure ceilings for each sector) based on a resource envelope they are unaware of. This is because the statutory deadline for approval of division of revenue bills (which set out the horizontal and vertical sharing of revenue) is 30th March. For instance neither the 2013/2014 nor 2014/2015 division of revenue bills were enacted within the prescribed timelines. The 2014/15 DORA was passed at the end of July, well after county budgets were finalized.

Due to the overlapping national and county budget calendar, counties currently prepare their CFSPS without aligning them to the BPS and similarly (once counties are permitted to borrow), the County Debt Management Strategy (CDMS) is unlikely to be informed by the national debt management strategy. This is despite the fact that the BPS sets out the broad strategic priorities and policy goals that will guide the national and county governments in preparing their budgets for the following financial year and in the medium term, and that the DMS seeks to inform Parliament of the total stock of debt (national and county). (see Annex 4)

Adherence to fiscal responsibility principles

The PFM Act 2012 enshrines a number of fiscal responsibility principles (outlined in Box 3.5) but the requirements may be too stringent particularly for county governments with limited capacity. Neither National nor county governments are adhering to the fiscal responsibility principles relating to recurrent development expenditure ratios. In the case of county governments, this is for a number of reasons:

a. Inherited costs and new administrative structures. Inherited and new recurrent cost expenses, in some counties the wage bill, consume a significant share of the transfer from the national government. County governments have four categories of employees: (i) those inherited from former local authorities; (ii) those seconded from national government; (iii) newly recruited into county executive and; (iv) newly recruited in the legislative arm i.e. county assemblies. This administrative structure has seen a rapid increased in recurrent administrative costs as discussed earlier in this part.

b. Transfer formula and information asymmetry on the cost of devolved functions. The current formula was designed to 'equalize' and redress historical injustices in resource allocation process, but was however formulated without data on the cost of devolved functions. The formula thus does not take into account other considerations like: (i) inherited recurrent costs; (ii) the minimum package for service delivery; (iii) the capacity to generate own revenues and; (iv) the creation of incentives for fiscal responsibility. The formula which would achieve the equalization objective nevertheless then leaves some counties with limited fiscal space to delivery devolved services. The problem is particularly acute in urban counties. As illustrated earlier in this chapter in Figure 3.5, counties are now spending less on services such as health as the national government was spending before devolution.

c. Limited capacity in revenue forecasting and administration. County governments have limited revenue raising powers. These powers include collecting property taxes, and entertainment taxes and fees associated with trade development and regulation (including markets). Counties may impose any other taxes but only by an Act of Parliament. To respond to fiscal and political pressures from within, some county governments grossly overestimated revenues. Put into perspective on an aggregate, county governments in their 2013/2014 budgets envisaged to collect four times the amount of revenue that local authorities did just four years ago (as shown earlier in this chapter in Figure 3.11). In addition to this, in many counties the administrative structures to manage revenues (institutions, officers and systems) have not been established.

d. Enforcement of the PFM Act during the 'transition period'. Based on the Auditor General's report (January 2013 to June 2013) all county governments contravened the provisions of the PFM Act and liable to various sanctions. However, counties are still considered to be in the 'transition' and still building capacity to receive functions (and manage resources related those functions). This transition notwithstanding, the functions have been actually transferred to them. This has created a gap in accountability.

Box 3.5: Fiscal responsibility principles

- Development expenditure should be a minimum of 30 percent of the National or county government budget;
- Wages and benefits should not exceed a specified percent of revenue;
- Debt limits as set by Parliament or County Assemblies shall not be exceeded and in any case not exceed levels specified in the medium term debt management strategy;
- Level of tax rates and bases should demonstrate a reasonable degree of predictability and stability;
- Deviation from financial objectives can only be on a temporary basis and only where such deviation is caused by a major natural disaster, other significant unforeseen event; and
- National and county governments are prohibited from deviating from fiscal responsibility principles.

Source: PFM Act (2012)

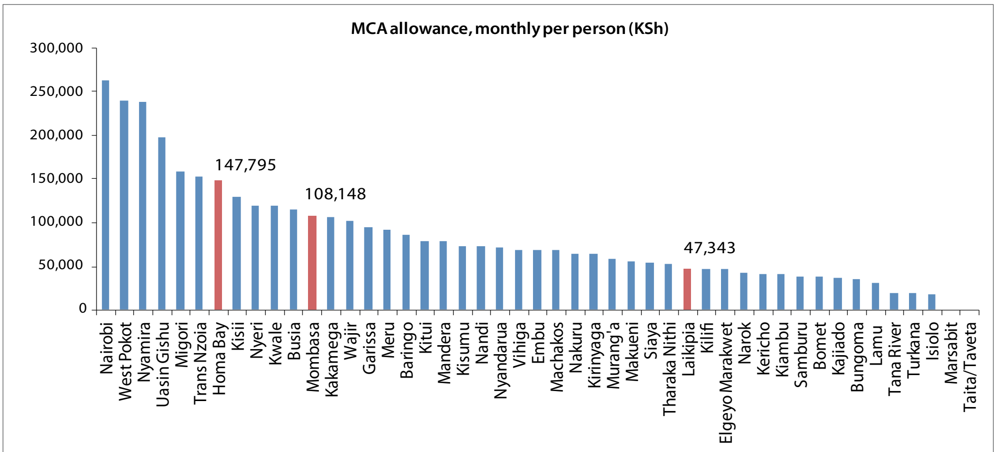
e. Through the Public Financial Management (Amendment) Bill 2014 that originated in the Senate, proposals have been made for counties to increase development/recurrent ratio to 60/40. This is however despite the fact that counties have demonstrated clearly that they are currently unable to meet the 30 percent capital budget requirement in the PFM Act as shown in Figure 3.8. Proposals such as these do not seem to take cognizance of the existing realities of devolution including inherited wage and secondly that increased capital expenditure will also require huge increases in recurrent expenditures to support operation and maintenance of the heavy capital investments.

Political economy effects on oversight and accountability at sub national level

County assemblies and the Senate are the legislative arms of county governments thus have an oversight and accountability mandate. But these roles are often undermined by political economy issues which often manifest into turf wars on two fronts, first between senators and governors on one hand, and secondly, between governors and the members of county assemblies on the other. Governors live under constant threat of impeachment by their county assemblies. Political competition and horse trading delays the passing of key bills including supplementary budget estimates, the finance bills, among others. All of which affect budget execution.

The CAs are emerging as an administrative burden. In response to what is widely perceived as 'wasteful expenditure by county assemblies,' the CRA developed ceilings for expenditure between county executive committees and county assemblies. The Senate has also set ceilings on the amount of expenditure that counties can use on domestic and foreign travel. Figure 3.17 shows the monthly per capita expenditure of MCAs on sitting allowances. A number of county assemblies have exceeded their annual allocations in this regard and will therefore be forced to reallocate funds from priority areas of spending to compensate for this. All of which affects the credibility of the budget and the quality its execution.

Figure 3.17: Emerging administrative burden for County Assemblies



Source: Staff computation based on data from CoB quarterly reports

Use of incompatible PFM Systems undermine recording and reporting

Counties have two PFM systems operating concurrently; Integrated Financial Management Information Systems (IFMIS) for expenditure management, and Local Authorities Integrated Financial Operations Management System (LAIFOMS) for revenue management. The two systems are incompatible, with currently no integration between the two. LAIFOMS is a computer-supported financial management tool and IFMIS is a web based one. LAIFOMS therefore needs to be customized and integrated into IFMIS. Similarly, IFMIS would have to be customized to accommodate LAIFOMS modules including the single business permit system, land rates and plot rates system modules. Delays in this process have caused some counties to procure integrated systems to handle these functions outside IFMIS which may be perceived to be contrary to Article 190 of the Constitution and section 12 of the PFM Act. Limited use of PFM systems is also attributed to: (i) limited staff capacity to operate IFMIS and negative perception amongst users; (ii) insufficient budgetary allocations for computers and poor internal connectivity systems and; (iii) budget system being standalone with different chart of accounts. Limited use of PFM systems creates loopholes through use of manual systems which undermines recording and reporting.

Technical capacities

Poor adherence by counties to deadlines set in the Constitution and the PFM Act has been attributed to the 'lack of the necessary expertise to prepare required documents'.[4] This is particularly the case as regarding PBB. In some counties, budgets were submitted by the stipulated deadline, however, in line item format due to 'time constraints' and 'lack of clear instructions to departments'.[5] In some counties, where county budgets were at face value submitted in programme, deeper assessment reveals that while the first sections would appear as PBB, the details of the budgets are still largely line items. The Controller of Budget has already rejected a number of 2014/2015 county budgets on the basis that they are not programme based.

Poor budget implementation has been attributed to delayed appointment or inadequate staffing in the relevant departments including appointment of CECF's.[6] The Senate report also stated that in counties where chief financial officers were yet to be appointed, they notably performed worse in terms of budget implementation. Even where chief officers had been appointed, they required intensive training on the budget process including MTEF, IFMIS and the Standard Chart of Accounts as a considerable number of those recruited had private sector backgrounds.

The Controller of Budget report raises particular concerns relating to inadequate technical capacity to support county assemblies on budget preparation and legislation. These challenges have severely limited the proper interrogation of budget proposals and documents submitted alongside these budget estimates.

3.5 Recommendations

Support to the Governments overarching PFM reform strategy is necessary. It provides a framework to accelerate reforms in PFM with the overall objective of transparent, accountable and improved service delivery. It builds on the successes of the previous strategy (2006-2011) and also creates a framework for support to new systems and institutions. It also identifies and seeks to address outstanding activities from the previous strategy through prioritizing those challenges in particular relating to credibility of the budget, budget execution, accounting and reporting, electronic service delivery and IFMIS, independent audit and oversight. Above all it provides a framework for donor coordination, capacity building, change management and a framework from which to navigate through political economy issues (intergovernmental bodies and working groups).

There is enormous potential for improved revenue collection and administration generally if many of the issues raised in this chapter are addressed; however the scope of reforms required makes it incumbent on government and development partners to coalesce around providing this support. These reforms include revising out of date cadaster information, introducing automation to reduce revenue leakage, renegotiating revenue contracts and developing data bases of tax payers.[7] These reforms are capital and labour intensive and therefore while investment in staff and in technology is necessary, it may not be most pressing priority for many governors.

4 KIPPRA, Mwendwa 2014.
5 Peter Thumbi, Local Case study Mombasa.
6 KIPPRA, Mwendwa, 2014.
7 See Fiscal Risks and Revenue Sharing in Kenya March 2014.

Chapter 4

REVENUES AND TAX ADMINISTRATION

4.1 Background

Rising budgetary pressure underscore the importance of a robust tax system. First, rising investments require a sustained increase in revenue to meet future recurrent costs, in sectors where investments are not self-sustaining. Second, the pressure for more revenue is also mounting from sub-national governments that have limited revenue mandates and inelastic tax bases. The government has undertaken tax reforms for more than a decade and most recently the VAT Act 2013. This section highlights additional reforms which when undertaken can enhance revenue performance.

Kenya has had robust revenue to GDP ratio averaging 18 percent over the last 5 years which is the highest in the EAC (Figure 4.1). An econometric estimation of the relationship between GDP growth and growth in taxes (excluding new discretionary tax measures in each budget) concluded that growth in tax revenue should outpace growth in GDP; 1 percent growth in GDP should see a 1.26 percent growth in revenue in the long run, (PER, 2013).

4.2 Tax performance: Current trends

The tax performance is sustained by a narrow tax base concentrated on a few large tax payers. Kenya's tax system is heavily dependent on income taxes which account for 50 percent of tax revenue (9 percent of GDP) as consumption taxes underperform at 5.7 percent of GDP generating 25.5 percent of revenues. In comparison, Korea, Chile and South Africa income taxes account for 6 percent, 7.5 percent and 8.6 percent of GDP respectively while consumption taxes account for higher contributions at 9 percent, 10.8 percent and 8 percent of GDP respectively. VAT contributes about a quarter (4.6 percent of GDP) and the balance is from excise and import duty (Figure 4.2). In 2013/14, Kenya revenue/GDP ratio improved by one percentage points to about 19.2 percent. The growth was mainly from PAYE (0.3 percent), corporation tax (0.2 percent) and VAT (0.5 percent). Growth also emanated from non-tax agency revenue which grew by 0.4 percent mainly due to introduction of the railway development levy.

Increases in PAYE yields were mainly attributable to constitutional reforms that removed a number of tax exemptions from the political class, formed new constitutional and devolution administrative units plus targeted compliance interventions. Good performance was recorded in corporation tax due to improved profitability of many sectors in the economy. Implementation of the policy reforms in the VAT Act 2013 are expected to improve the yields of the VAT. The VAT reforms reduced the number of zero rate and exempt supplies in the VAT schedule.

Figure 4.1: Kenya's robust revenue performance is driven by income tax

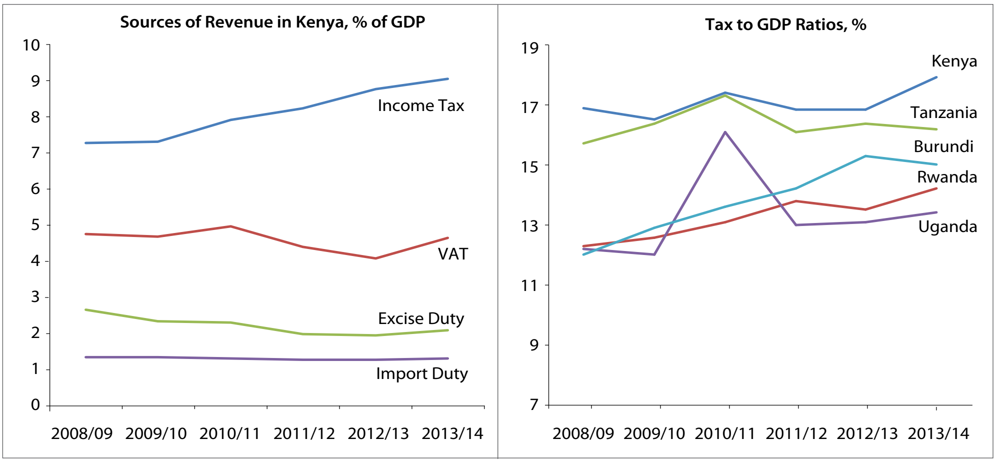
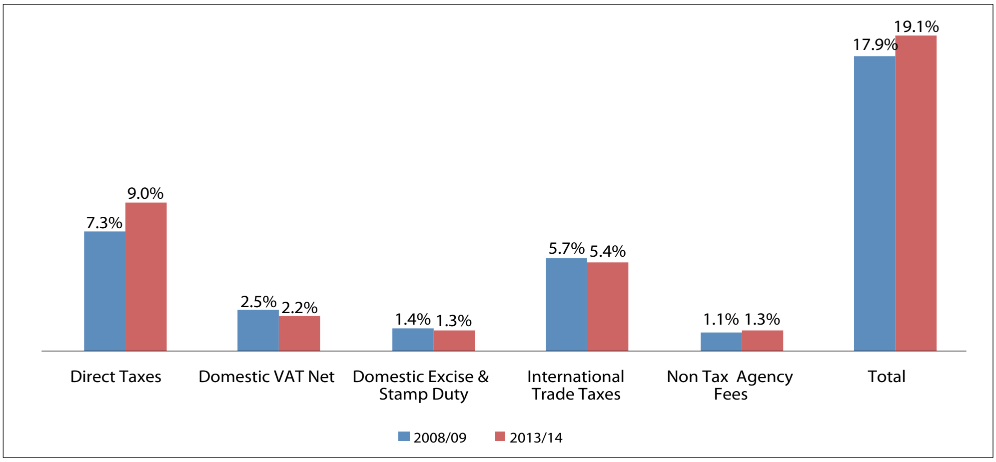


Figure 4.2: Revenues as a percent of GDP, 2008/09 and 2013/14

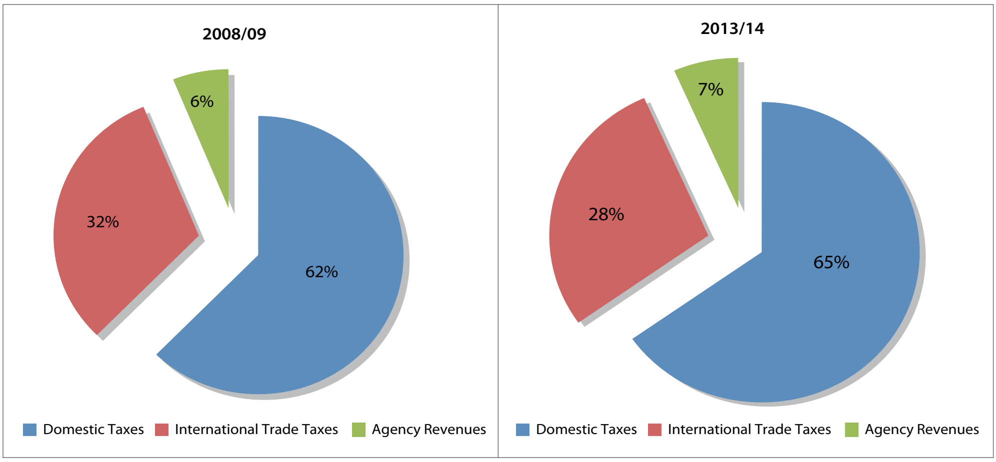


Source: Revenues from KRA database, GDP from QEBR (Q4 2013/2014)

The share of domestically generated revenues compared to international trade taxes has increased from 68 percent six years ago to 72 percent in 2013/2014 (Figure 4.3). Factors such as introduction of new revenue sources (e.g. railway development levy, excise duty on financial services, reform of VAT law), and growth in the domestic economy do account for this trend. On the other hand, customs or international trade taxes have recorded negative trends. The negative trend is mainly attributable to non-compliance (undervaluation and dumping).

Withholding taxes have declined from 1.5 percent of GDP in 2012/13 to 1.1 percent in 2013/14 of GDP with no proper explanation for the trends. Discussions with the KRA indicated that the decline is caused by government delaying payments to suppliers. However, this reasoning is negated by the fact that a delay in payment in one year can easily be offset by a settlement the following year. Recently, Kenya has announced a number of oil discoveries. The fact that exploration activities are largely sub-contracted to foreign or international suppliers implies that withholding taxes should be moving in the positive or upward direction.

Figure 4.3: Share of domestic revenues compared to international trade taxes



Source: KRA database

4.3 Can growth in revenues match the rising budgetary pressure?

Enhance taxpayer compliance

There is great potential to improve domestic revenue mobilization in Kenya through taxpayer service and compliance improvement strategies. The country still relies on a few taxpayers (0.34 percent of registered businesses) in the Large Taxpayers' Office to contribute more than 70 percent of total revenues (Table 4.1).

Table 4.1: Contribution of LTO to total tax effort, KSh million

	2010/11	2011/12	2012/13
All taxes	295,214	322,734	373,735
Interest and penalties	2,716	2,986	5,014
All DTD taxes	408,787	460,535	538,744
LTO taxes as percentage of DTD	72.9	70.8	70.3

Source: KRA database

For a working population of more than 22.2 million in Kenya, few are paying tax and there is room for improvement as shown in Table 4.2. The major causes for the low participation ratio include complicated tax systems, low tax morale in the public, informality within the Kenya economy and service or compliance strategies by KRA which are larger taxpayer segment focused.

The VAT gap is estimated by KRA at more than 20 per cent of potential VAT revenues.[2] TINs are issued to various natural persons for various reasons. These include student loan applications, driving permits etc implying that individual taxpayers are a lot less than the number supplied Although the gap has been decreasing, the KRA has to be more active and effective in broadening the tax base by reducing the non-compliance of known taxpayers and by bringing informal traders into the formal economy.

1 *TINs are issued to various natural persons for various reasons. These include student loan applications, driving permits etc implying that individual taxpayers are a lot less than the number supplied.*
2 *Assessing Kenya's Value Added Tax Compliance", Kenya Revenue Authority, June 2012*

Table 4.2: Persons registered with the KRA

Office	No. of registered Taxpayers
Large Taxpayers Office	1,138 businesses
Medium and Small Taxpayer Office	331,066 businesses
Medium and Small Taxpayer Office	6,527,058 individuals [16]

Source: KRA & IMF staff report

An attempt to drill down and use VAT compliance ratios as an indicator for taxpayer compliance still reveals room for great improvement. The data shows that KRA needs to develop and implement comprehensive taxpayer service and compliance strategies to improve the compliance ratios from 51 percent (see Table 4.3) to more than 85 percent across taxpayer segments. When this is done, then the economy will get value and benefits from the streamlined VAT Law.

Table 4.3: Monthly VAT filing statistics

VAT return filing	Paper-returns based [1]/	On-line returns [2]/	All returns	South Africa[3]	Uganda[4]
"Credit" returns filed	7,752	5,861	13,613		
"Nil" returns filed	10,127	9,402	19,529		
"Payment" returns filed	232	5,063	5,295		
Total returns filed	18,111	20,326	38,437		
Total returns not filed			36,275		
Total registered VAT taxpayers			74,712		
Filing compliance			51%	86.1%	90%

Source: IMF 'Advancing Revenue Administration Reform, Graham Harrison, B. Brimble, and S. Chapman (November 2011)
Notes: [1]/ based on returns filed for August 2011. [2]/ based on returns filed for October 2011

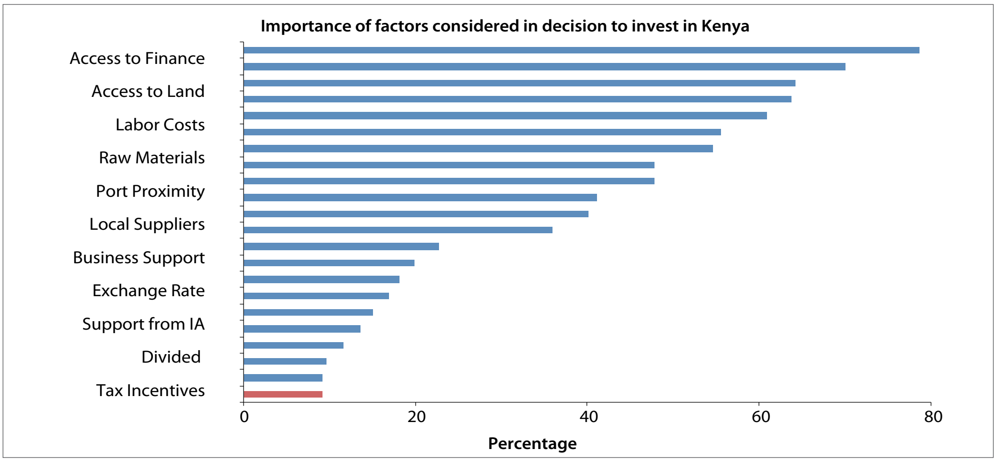
Reduce tax expenditure

Tax incentives drive tax expenditures yet this is not the most important factor for investors (Figure 4.4). The 2013 Kenya IFC incentives report conservatively[5] estimated Kenya's 2010/11 tax expenditure at about KSh 77 billion. Based on the rebased GDP, this accounted for 2.25 percent of GDP, a figure higher than the health sector budget at 1.4 percent of GDP and the EAC tax expenditures average of 2.4 percent. The Tax expenditure is close to 12 percent of Kenya's recurrent expenditure. Tax expenditures in 2012/2013 increased to about KSh 118 billion, which is equivalent to 2.62 percent of GDP. The investor motivation survey carried out by IFC ranked tax incentives least out of 11 most important factors for investors.

The administration of tax incentives requires improvement by removal of discretionary powers from the Income tax Act and production of tax expenditure budgets. Further government should consider publication of actual tax expenditures reports on an annual basis. On a positive note, the new VAT Act 2013 removed discretionary powers used to grant VAT tax incentives.

3 *The 2013 tax statistics compiled by National Treasury & SARS.*
4 *The Annual Revenue Report 2012/13 compiled by Uganda Revenue Authority.*
5 *According to KRA data on exempt income, zero rated local supplies has not been collected using the tax returns.*

Figure 4.4: Most important factors in investment decision among surveyed investors in Kenya



Source: IFC Investor Motivation Survey (2012)

Enhance tax administration

Relatively complex tax administration creates a significant burden for formal businesses in Kenya. Tax rates featured as the third (3rd) biggest problem in the Global Competitiveness Index (GCI) 2013-14 Report. In the World Bank Enterprise Survey Report 2014, tax rates were ranked 6th among the top business concerns. This depicts the multiple taxes in the economy and limited scope for using tax rates or new taxes as leverage for increasing funds available to finance public expenditure. Tax regulations were the eleventh (11th) biggest obstacle to doing business in Kenya as per the 2013/14 GCI Report. Kenya's tax procedures lag behind EAC peers and create a heavy compliance burden to the private sector. The 2014 Doing Business (DB) paying taxes indicator ranks Kenya at 166 out of 189.[6] On average, 308 hours are required for a company to comply with 41 tax payments.[7] The 2014 DB reports Kenya's effective tax rate for an SME at about 44.2 percent.

The taxation compliance burden could potentially be reduced via tax administration reforms. The full roll-out of e-filing of taxes could significantly improve tax administration, as well as allowing small and medium companies to file taxes quarterly rather than monthly.[8] Further Kenya can do well by consolidating compliance activities of taxes levied on the same base. Synergies could potentially be achieved between the payment of personal income tax, medical insurance and social insurance contributions, (for example, by unifying income definitions and compliance requirements). However, the process needs to be carefully managed taking into account the capacity of the agencies involved.

Kenya tax administration system is also comparatively inefficient in administration of refunds, especially of the VAT. The 2014 KRA IFC process mapping study indicates that 76 procedures are executed over 32 work days. Further, the elapsed number of business days for VAT refunds is 90 days. The time taken to pay refunds is relatively long when compared to South Africa (21 days). The refund backlog has grown to more than KSh 20.7 billion.[9] The hope of reducing the VAT refund problem using the new VAT Act

6 Rwanda 22, Uganda 98, Tanzania 141, and Burundi 143.
7 Rwanda 113 hours, Uganda 209 hours, Tanzania 176 hours, and Burundi 274 hours.
8 Rwanda, for example, allows small taxpayers to file and pay VAT on a quarterly basis.
9 KRA ref. TATA Chemicals Magadi Vs. CDT (LTO Petition 476 of 2013).

2013 in Kenya is quickly dwindling. In September 2014, the newly enacted VAT Act 2013 was amended to introduce withholding VAT at 6 percent on all government supplies. There was no corresponding amendment to the VAT law to allow refund of VAT if the withholding mechanism creates overpayment situations. Further, the VAT Act 2013 was not amended to waive late or no payment penalties from the registered VAT trader if the no payment or late payment is occasioned by a defaulting VAT withholding agent. The earlier scrapped practice of withholding VAT was partially responsible for the creation of the VAT refund backlog given KRA's inability to pay VAT refunds faster than they would accumulate. Much as the new withholding VAT rate of 6 percent is lower than the previous rate of 16 percent, it goes without saying that traders who operate small margin businesses will need a refund.

We recommend review of the VAT withholding mechanism by repealing section 25A of the VAT Act 2013. In case government is unwilling to relent on this scheme, we recommend that the law be revisited to remove injustices created i.e. no VAT refund for overpaid VAT and waive penalty on VAT traders whose non or late payment default is occasioned by failure of the withholding agent to remit taxes to KRA.

In 2010, KRA further segmented the taxpayer base to create a Medium Taxpayers' Office (MTO). The office has done well with performance levels above target and significant increase in the percentage of MTO collections compared to all DTD collections, see Table 4.4.

Table 4.4: Medium Taxpayers' Office (MTO) performance figures (in KSh million)

Financial Year	Collection	Target	Percentage Performance	Percentage Growth	Compliance – tax, interest and penalties	Collections as percentage of all DTD collections
2010/11	16,053	16,053	97	N.A	2,716	3.9
2011/12	28,500	28,500	116	78%	2,986	6.2
2012/13	55,316	55,316	108	94%	5,014	10.3

Source: KRA data

Ensure policy consistency

To deliver on government core mandates of improving taxpayer compliance and tax revenue yields, facilitate international trade while protecting Kenya's borders against illegal trade, Government is proposing further reforms on organization and functions of KRA. The reform proposal includes splitting KRA into two separate, autonomous and interdependent services: the Inland Revenue Agency and the Customs Services Agency. The stated goal of the reform is to improve trade facilitation and to increase efficiency in border control, revenue collection and support regional integration of customs services within the East African Community. Customs is very critical to the Kenya economy. Currently Customs collects about 30 percent of the total revenue for Kenya and processes more than 1.5 million import/export transactions. The reform must be done systematically with caution in order not to jeopardize the existing revenue collection abilities of both customs and domestic taxes. Critical to the reforms, will be adequate attention to the following activities:

- Strengthening customs core functions such as revenue collection, border control and protection. This entails extensive investment in infrastructure, technology plus operating/capital budgets;
- Implementing targeted programs to cause radical cultural changes needed to sustain interdependent organizations as well as execute the new mandate;
- Adopting a phased and measured approach to the reform and;
- Continuous improvement in capacity to manage taxpayer compliance in the domestic taxes department.

Chapter 5

MEDIUM TERM FISCAL OUTLOOK AND STRATEGY[1]

5.1 What if economic growth does not meet expectations?

Kenya's economic outlook is favorable to the anticipated changes in fiscal policy. Following two decades of income stagnation, Kenya's economy began a structural transformation at the turn of the century that culminated with 6.9 percent growth in 2007. Since 2007, the economy went through some turbulent times—it was hit by several shocks—so GDP growth slowed down and become more volatile. However, 2013 marked a political change and macroeconomic stability, hence economic growth is expected to be faster and sustainable.

Nevertheless, the macroeconomic outlook on which the medium-term expenditure plan rests is ambitious and subject to numerous risks. The medium-term fiscal framework presented in the 2014 Budget Policy Statement (BPS) envisages growth to pass the 6 percent mark in 2015 and to come close to 7 percent by 2017. This scenario rests on the premise that the economy was growing below potential over the past five years as well as slower than regional and other comparators. While it is true that Kenya's economic performance over the past decade does not seem particularly shiny in a regional and broader context, catching up with above 6 percent per annum sustained growth will require a change in the economic model. Namely, the exogenous growth stimuli of the pre-global crisis period, such as booming trade, cheap supply of money, and rapid growth in Kenya's key destination market, have receded since the global crisis and are not projected to return to their earlier peaks over the medium-term. Hence, investment and productivity enhancements in the domestic economy would have to bear the responsibility of accelerating growth.

The downside risks to fiscal policy may be larger than what is assumed in the BPS. While the BPS points out the relevant risks to the macro economic outlook, it does not attempt to quantify those risks (in terms of GDP growth and fiscal deficit) nor does it provide for alternative fiscal scenarios in case risks materialize. The last two BPS were overly optimistic on the GDP growth forecast for the forthcoming year.

Lower than projected GDP growth or weaker than anticipated tax administration, will result in revenue gap that will either lead to increasing debt or cutting expenditures. Under a scenario of lower growth in line with the World Bank projections of the Kenya Economic Update, edition 10, the revenue gap will expand from KSh 15 to KSh 68 million between 2014/15 and 2016/17. This will in turn raise the deficit by 0.3 percent of GDP in the current year, 0.6 percent in 2015/16 and 1.0 percent in 2016/17 which implies an increase rather than a decrease of the fiscal deficit over the medium-term (Table 5.1).

1 The Medium Term Outlook (projections) is based on the previous (old) GDP series before rebasing.

Table 5.1: Macro-fiscal alternative scenarios

	2014/15	2015/16	2016/17
BPS scenario: GDP growth (%)	6.1	6.6	6.9
Tax revenue (KSh million)	1,169	1,329	1,507
WB scenario: GDP growth (%)	4.7	4.7	5.3
Tax revenue (KSh million)	1,154	1,288	1,439
Revenue gap (KSh million)	15	41	68
Fiscal deficit increase *(% of GDP)*	0.3	0.6	1.0

Source: Staff computation based on data from The National Treasury BPS (2014) and KEU (June 2014)

If the projected GDP growth does not materialize, fiscal authorities would have to choose between cutting expenditure and increasing the deficit, that is public debt. Both alternatives will have implications on the achievement of the objectives of fiscal policy, including on economic growth. Anticipating and preparing for an alternative revenue scenario may lower the negative effects of adjusting to the revenue gap.

Expenditure cuts will become both easier and more difficult. As the fiscal framework envisages allocating about KSh 246 billion on average to counties over the MTEF period, decisions on expenditure cuts by the national authorities are likely to become politically more difficult due to pressures from counties. At the same time, if the national and county authorities adhere to the 70-30 allocation of recurrent versus development spending, the increased share of development spending will create more flexibility for expenditure adjustment (as new projects can be postponed and ongoing ones can be delayed/extended). However, significant share of development spending is financed from donor funds rather than taxes, so cuts would not be relevant for these.

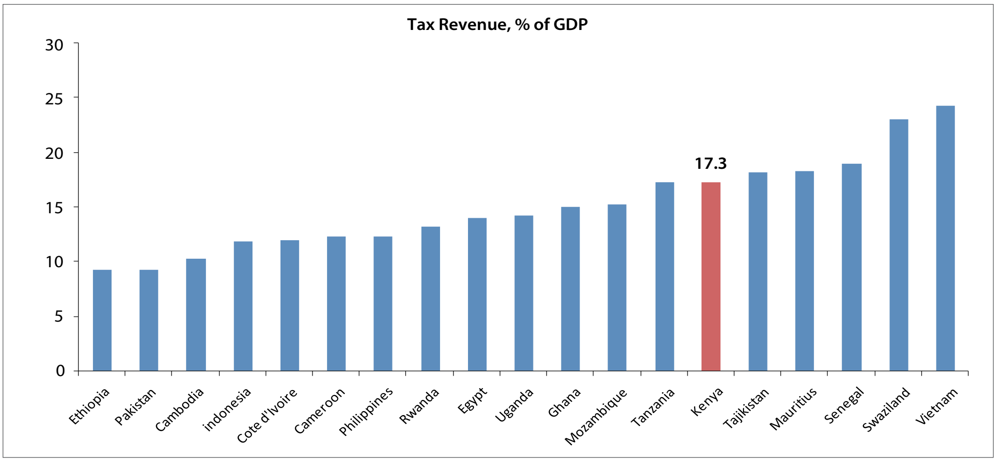
From a growth perspective, the optimal strategy for expenditure cuts involves prioritization along the lines of whether spending is growth enhancing or not. Ideally, the authorities should maintain the locus on increased development spending as it increases the economy's potential and contributes to meeting the target for investment-to-GDP ratio (the BPS macro framework forecast investment to rise from 20.9 percent of GDP in 2012/13 to 25.2 in 2014/15 and onwards). Limiting the wage bill (salaries plus allowances and benefits) would strengthen long-term fiscal sustainability while maintaining the ambitious infrastructure program. If scaling down of public investment plans becomes necessary, a system for prioritization of public investment should be put in place that uses objective factors in public investment management.

Raising public borrowing to fill a potential revenue gap is another alternative, and again the costs of this strategy should also be fully accounted for. The BPS aims to bring down public debt below 50 percent of GDP by the end of financial year 2016/17. However, if the alternative growth scenario from above materializes, filling the revenue gap through borrowing would bring public debt up. Nevertheless, the latest World Bank—IMF Debt Sustainability Analysis (of September 2014) shows that public debt would remain at sustainable levels, i.e. at low level of debt distress risk, even if the GDP growth rate drops by up to 3 percentage points. The US$ 2 billion Eurobond issue further eases the pressures for financing the fiscal deficit.

On the revenue side, the key medium-term challenge, in addition to accelerating growth, is how to increase revenue collection. The Medium Term Plan II envisages a massive increase in infrastructure, as well as social spending. At the same time, the new introduction of Capital Gains Tax under the new Finance Law (2014) is expected to see increases in revenue collection beginning 2014/15. Additionally, expenditure is expected to increase marginally over the medium term; from 25.9 percent of GDP in 2013/14 to about 28 percent in 2016/17.[2] Theoretically, these two objectives could be reconciled through greater private sector engagement in infrastructure investment. However, achieving this would depend on strengthening the public private partnerships framework as well as other aspects of the business environment that will raise the interest of private investors.

Kenya's tax revenue collection is averaged 17 percent of GDP in the last 5 years; hence, the need for opportunities to enhance revenue generation. However, for SSA standards, Kenya is quite successful in terms of collecting revenue. The tax revenue to GDP ratio is higher than in many Asian developing countries, including Pakistan, Cambodia, or Philippines (Figure 5.1).

Figure 5.1: Kenya's tax revenue collection is relatively high

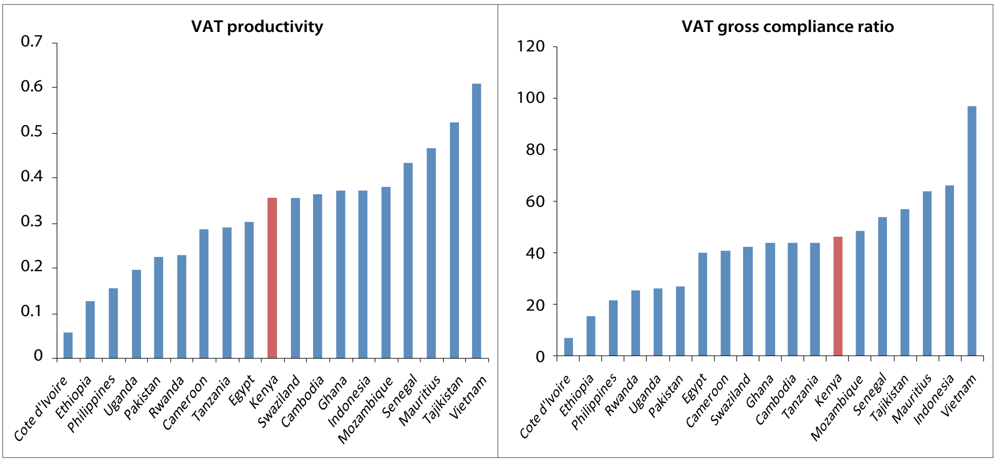


Source: Staff computation based data from http://egateg.usaidallnet.gov/collecting-taxes

Nevertheless, one area with room for improvement is VAT collection. Looking at VAT productivity and gross compliance ratio—which measure actual collection against potential—place Kenya, is in the middle of a group of similar developing countries (Figure 5.2). The new VAT law brought improvements in VAT administration and portion of the potential gap was already captured in 2013/14. The above indicators use benchmark countries solely on the main VAT rate and given that legislations draft various levels of exemptions and additional VAT rates, the recommended step for the Kenyan authorities would be to conduct a tax gap analysis that would assess more precisely the tax gap and point to the areas that could benefit of interventions.

2 *Based on the New GDP series* .

Figure 5.2: VAT productivity and gross compliance ratios (2012/13 data)



Source: Staff computation based data from http://egateg.usaidallnet.gov/collecting-taxes

On the expenditure side, the main structural shift over the medium-term is the 70-30 split between recurrent and development spending. Moving to such a split is particularly different in an environment of declining spending since recurrent expenditure are typically less discretionary and politically more difficult to trim. The BPS rightfully identifies the wage (and benefits) bill as one of the key spending categories that should be trimmed over the medium term (from 6.1 percent of GDP in 2012/13 to around 5.1 percent in 2016/17). Nevertheless, pressures arising from the devolution process (new hiring and benefits at county level and uncertainty in transfer of public workers from national to county administrations) have further inflated the wage bill.

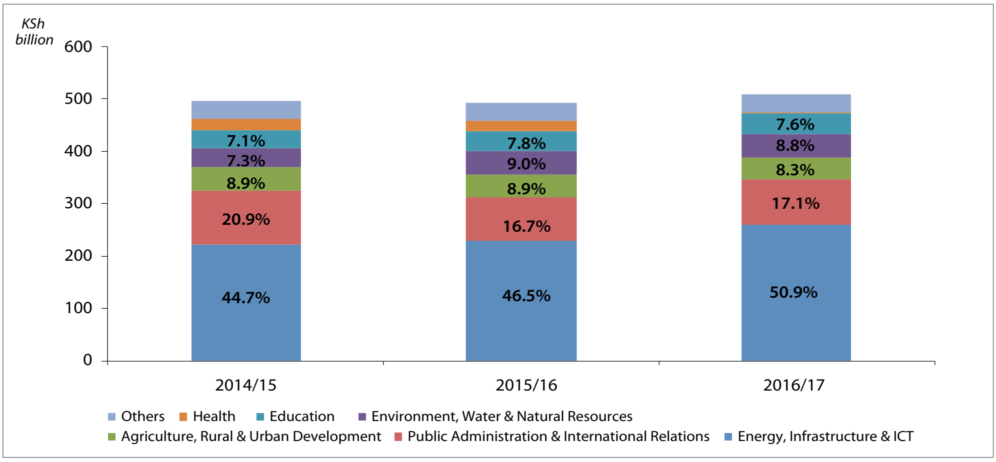
The next challenge is how to prioritize development spending given that the available resources cannot match the list of projects identified in the MTP II. The MTP II contains a list of flagship projects that require KSh 8,596 billion[3] (180 percent of GDP) in over the 2013-18 period. While there is a desire for the private sector to cover a significant share of these investment needs, it is likely that the burden will fall to large extent on the public budget. Hence, prioritizing investment is critical. The BPS puts emphasis on energy and infrastructure investment as these two have continuously been raised as key obstacles to business expansion and investment. It is worth noting though that these investments will also raise maintenance costs that need to be properly planned in subsequent budget years. An alternative way to cover for the increased maintenance is through revenue generating mechanisms such as introducing pay tolls on the new roads. At the same time, health spending is expected to be reduced in 2016/17 which goes against the objective to improve health outcomes which are particularly dismal in Kenya (Figure 5.3).

Improving budget execution remains a key challenge for implementing the public investment program. Development spending has traditionally had the weakest execution over the years, and this has been particularly true for donor financed investment projects. Absorption of donor grants averaged around 70 percent over the past few years and that of project loans was even lower, at 50 percent. As the budget will continue to rely on donor funds for more than a third of development spending, hence, understanding and addressing the root causes for the weak execution should be considered a priority.

3 *Includes only flagship projects in the MTP II whose costing exceeds KSh 100,000 Million.*

Moreover, as donor-financed projects are considered as priority, for implementation as well as for providing government co-financing, it is particularly important to align them with the national priorities as stated in the MTP II and other government strategies.

Figure 5.3: Medium term sector development budget



Source: Staff computation based on 2014/15 budget printed estimates

Services
Equipment
Allowance
Purchase
Maintenance
Supplies
Office
Budget
etc
Travel
Expenses
Transport
Computers
Buildings
Furniture
Costs
Motor
Vehicles
Accommodation
Allowances
Lubricants
Materials
General
Telephone
Electricity
Printing
Facsmile
Fuel
Refined
Charges
Contracted
Telex
Airline
Communications
small
Phone
Mobile
Food
Staff
Dues
Clothing
Catering
Cleansing
Publishing
Campeigns
Maintenance
Magazines
Professional
Periodicals
Machinery
Awareness
Seminars
Subsistance
Non-Residential
Drinks
Mileage
Gifts
Basic
Plant
Advertisement
Water
Trade
office
Public
Sewarage
Boards
Stations
Non-Resident
Membership
Fittings
Accomodation
County
Courier
Subscription
News
Civil
Railway
pencils
Uniforms
Sanitary
including
Fees
Insurance
Postal
equipment
papers
Domestic
receptions
Daily
Bus
Papers
Conferences
Training
Printers
Software
Subscriptions
Medical
Accessories
Appliances
Salaries
Committees
Infrastructure
Networks
Bodies
Works
Executive
House
Gifts

Chapter 6

SUMMARY AND CONCLUSION

Kenya's fiscal policy is broadly expansionary at about 25.9 percent of GDP in 2013/14. The main drivers behind the fiscal expansion include the buildup of recurrent administrative expenses associated with the roll out of devolution, the necessity to enhance security expenditure, the need to sustain investments in infrastructure to reduce the cost of doing business, the funding of new flagship projects in fulfillment of the Jubilee government manifesto and the rising wage bill at both levels of government.

There is no evidence of inflation and crowding out from the recent fiscal expansion because the economy is still performing below its potential. However, when the recent investment start paying off and economic performance peaks to full potential, there is a risk that inflationary pressures would start build up and in the event that rising international interest rates lead to a reversal of capital flows, Kenya's fiscal position could deteriorate. Government spending priorities reflect commitment to close the infrastructure gap but the efficiency of spending has declined in the recent years. Improving budget execution remains a key challenge for implementing the public investment program. Development spending has traditionally had the weakest execution over the years, and this has been particularly true for donor financed investment projects. Absorption of donor grants averaged around 70 percent over the past few years and that of project loans was even lower, at 50 percent.

County governments are expected to spend 5.4 percent of GDP in the first year of operation, 4.3 percent from transfers from national government and 1.2 percent as own revenue. The review suggests the county spending on service delivery and equity areas is significantly below pre-devolution spending, with significant variances across counties, which may imply that national policy objectives on devolution reforms may not be met. The 2013/14 county fiscal data reveals important emerging trends including: (i) an overall budget execution gap estimated at (37 percent) of approved expenditure; (ii) administrative expenditures have built up rather quickly crowding out other spending, reflecting the costs to setting up the administrative infrastructure and the operation costs related to county assembly and county executive functions; (iii) under-spending concentrated on development budget, where only a handful of counties allocated at least one third of their budget for development projects; (iv) a revenue collection gap (at 57 percent of the targeted amount), which reflects unrealistic revenue forecasts on one hand and weak administrative capacity on the other; and (v) the counties established positive balances in 2013/14 at 1.0 percent of GDP.

By way of recommendations the review suggests:

Constrain the growth in recurrent administrative spending and eliminate duplication of devolved functions at national government level. Going forward, it will be important to contain spending on administrative costs, in particular to ensure that parallel costs of devolved functions at national level are being reduced as planned and the counties revenue mobilization efforts are enhanced. These actions will ease the fiscal pressure on fiscal transfers from the national government. To increase the level of development spending at subnational level, the current formula could be revised to separate recurrent and development transfers.

Provide sufficiently for operations and maintenance and improve budget execution:

Improve the way projects are evaluated, selected and managed, taking into account future running costs. Some of the possibilities in this regard include reviving the PIMI unit at the ministry of Planning and Devolution and in planning units in line ministries; and subsequently build the capacity within these units in all aspects of project appraisal selection and management. In this regard, Chile provides a good practice case study in the area of project evaluation selection, selection and implementation.

ANNEXES

Annex 1(a): Estimating Implicit R coefficients for financial sustainability

The ratio of capital expenditures to the combined current and capital expenditures can be used to derive a financial sustainability criterion (***FSC***) to constrain or guide capital expenditure budgets over the medium term. From (2), capital expenditures as a share of combined current plus capital expenditure (***CCR***) for a sector and for all sectors should remain at or below a cut levels for the sector and for all sectors where these cut off levels are established based on comparator countries with good capital budgeting and growth track records and/or based on the planned and forecast parameters for the "***r***-coefficients", economic depreciation rates and capital asset growth rates as follows:

$$CCR = \frac{Capital\ Expenditure}{Current\ plus\ capital\ \ expenditure} \leq FSC = \frac{g_K + \delta}{r(1+(1+c)g_K) +\ (1-\delta)g_K}\ \ or\ CCR^* \quad (2)$$

Where: ***FSC*** = financial sustainability criterion

- ***CCR**** = comparator country ratio
- g_K = annual growth rate in capital stock = $g + \varepsilon$
- g = annual economic growth rate
- ε = incremental growth in the capital stock if capital intensity in production is increasing
- δ = economic depreciation rate
- c = real increase in recurrent cost over year from real increases in input costs such as real wages but reduced by productivity gains. Assumed to be negligibly small over medium term
- r = "***r*** coefficient" or the ratio O&M costs including economic depreciation per year per unit of productive capital assets in the sectors

To act as a financial sustainability criterion (***FSC***), the ratio of capital expenditure to combined expenditures over needs to be maintained at or below a cut level for a sector and for all sectors where these cut off levels are established based on comparator countries with good capital budgeting track records and/or based on the planned and forecast parameters for the "***r***-coefficients", economic depreciation rates and capital asset growth rates in (B5).

An alternative way of expressing (2) is to estimate the implicit ***r***-coefficient based on the observed ratio of capital expenditures to combined capital and current expenditures (***CCR***) or

$$\hat{r} = \frac{(g_K+\delta) - CCR(1-\delta)g_K}{CCR(1+(1+c)g_K)} \quad (3)$$

To act as an ***FSC***, the implicit ***r***-coefficient ($\hat{r}$) needs to be compared with some efficient estimate (r^*) based on detailed analysis of the O&M costs of service delivery in specific sectors as discussed in Annex B to check that ($\hat{r} \geq r^*$). Ideally, ***r***-coefficients are the preferred approach to analyzing sustainable O&M funding as they are independent of the growth rate while ***CCR***s are very sensitive to the growth rate.

Annex 2(b): Incremental Capital Output Ratio (ICOR) for different countries

COUNTRY	1990 - 1999	2000 - 2011
Eritrea	3.16	35.50
Cote d'Ivoire	4.15	27.12
Gabon	8.44	11.59
Seychelles	5.29	11.50
Guinea	7.01	10.79
Madagascar	7.60	7.94
Lesotho	14.22	7.60
Togo	5.94	7.54
Algeria	16.31	7.45
CAR	6.17	7.14
Somalia	-7.24	6.94
Gambia	6.46	6.83
Swaziland	4.73	6.67
Mauritania	4.90	6.62
Congo	34.77	6.60
Cape Verde	6.19	6.39
Morocco	8.38	6.16
Senegal	5.97	6.06
Tunisia	4.86	5.90
Botswana	4.17	5.68
Niger	4.70	5.68
Comoros	10.99	5.62
Sao Tome and Principe	34.65	5.59
Cameroon	11.98	5.35
Mauritius	5.25	5.31
South Africa	11.72	5.03
Benin	3.32	5.00
Namibia	4.69	4.79
Kenya	7.11	4.69

COUNTRY	1990 - 1999	2000 - 2011
Burundi	-16.84	4.54
Djibouti	11.81	4.12
Zambia	42.17	4.05
Mali	4.40	4.01
Malawi	6.27	3.84
Egypt	3.95	3.81
DRC Congo	-1.50	3.68
Burkina Faso	4.44	3.68
United Republic of Tanzania	5.59	3.62
Guinea-Bissau	23.85	3.16
Chad	3.35	3.14
Ghana	3.28	3.13
Uganda	2.30	3.02
Liberia	24.56	2.92
Sudan	2.29	2.70
Mozambique	3.16	2.69
Ethiopia	2.43	2.68
Equatorial Guinea	3.20	2.46
Rwanda	5.23	2.18
Sierra Leone	-1.00	1.61
Angola	17.58	1.26
Nigeria	3.95	1.03
Libya	5.81	-9.14
Zimbabwe	1.58	-27.06
South Sudan		
Average		

Source: Garmendia and Shkaratan (2011)

Annex 3: Summary of provisions in the PFM Act (2012) based on thematic areas

Thematic Areas	National	County
PFM Institutional Framework	**National Assembly** Review BPS, Approve Budget Estimates, Determine division of revenue and pass the division of revenue Bills, Oversight of national government finances, ensure adherence to principles of public finance and fiscal responsibility principles and approval of national government public funds.	**County Assembly:** Review CFSP, approve county budget estimates (including urban areas and cities), approves revenue allocated to urban areas and cities, oversight over county public finances, adherence to fiscal responsibility principles and principles of public finance, establishment of other county public funds.
	Cabinet: Approval of BPS and BROP, Review annual budget estimates for national government (excluding Parliament and the Judiciary) and submission to national assembly, approval of establishment and dissolution of State Corporations and investments.	**County Executive Committee:** Approval of CFSP and CBROP, review annual budget estimates for county governments and submission to county assemblies, approval of establishment and dissolution of County State Corporations and investments; Establishment of County Emergency Fund (with the approval of the County Assembly).
	Cabinet Secretary Finance: Raise loans on behalf of national government, designate persons to execute loan documents, designate receivers and collectors of revenue, issue debt instruments on behalf of national government, designation of accounting officers (except Judiciary and Parliament), submission of a debt management strategy to Parliament, establish other national public funds and designate administrators of public funds and issue guarantees for county government loans.	**County Executive Committee member Finance:** Raise loans on behalf of county governments (subject to national government guarantee, designation of persons to execute loan documents, designate receivers and collectors of revenue, submission of a debt management strategy to county assembly, designation of county accounting officers, establish other national public funds and issue debt instruments on behalf of counties.
	National Treasury: Overall responsibility for macro-economic management, preparation of annual budget estimates for national government and coordination of implementation of budgets, preparation of BPS and CBROP, enforce fiscal responsibility principles at the national level, prepare pre and post budget reports, administer the consolidated, equalization and contingencies funds, prepare budget and fiscal reports and submit them to Parliament, oversee cash and banking for national government, prepare the division of revenue bills and strengthen the financial and fiscal relations between national and county governments.	**County Treasury:** Overall responsibility for financial and economic affairs of County Governments, preparation of annual budget estimates for county governments and coordination of implementation of those budgets, preparation of CFSP and CBROP, developing the county annual development plan, enforce fiscal responsibility principles at the national level, prepare pre and post budget reports, administer the county revenue and county emergency funds, prepare budget financial and fiscal reports and submit them to County Assembly, oversee cash and banking for the county government and review budget estimates for urban area and cities and submit them to the county assembly for approval.
	Accounting Officer: Accountable to national assembly for financial management of respective entities and accounting for money appropriated by Parliament, execute loan documents, manage assets and liabilities and reallocate funds (within limits).	**Accounting Officer:** Accountable to county assembly for financial management of respective entities and accounting for money appropriated by County Assembly, execute loan documents, manage assets and liabilities and reallocate funds (within limits).
	Receivers and Collectors of Revenue: Responsible for receiving and accounting for national government revenue, receivers have powers to authorize public officer to be a collector of revenue, KRA national government collector of revenue.	**Receivers and Collectors of Revenue:** Responsible for receiving and accounting for county government revenue, receivers have powers to authorize public officer to be a collector of revenue, Cabinet Secretary Finance has powers to appoint KRA national government collector of revenue.

Thematic Areas	National	County
	Commission on Revenue Allocation:[1] Recommendations on the basis for equitable sharing of revenue vertically and horizontally and submits recommendations to national government and national assembly, develops marginalization policy.	**Commission on Revenue Allocation:** Recommendations on the basis for equitable sharing of revenue horizontally and submits recommendations to county government and county assembly.
	Intergovernmental Budget and Economic Council: Consultative forum between national and county governments on financial and economic issues including borrowing and guarantees, budgets, development plans, cash disbursements, regulations to the PFM Act and division of revenue.	**County Budget and Economic Forum:** Forum for consultation among county governments on plans, budgets, county economy and financial and fiscal affairs.
	Controller of Budget:[2] Authorize withdrawals from the consolidated fund equalization fund and any other public fund as provided in law and submit budget implementation reports to national government.	**Controller of Budget:** Authorize withdrawals from the county revenue fund and any other public fund as provided in law and submit budget implementation reports to county governments.
	Auditor General[3] Responsible for Audit of all accounts of national governments, national government funds, authorities, commissions and independent offices, Judiciary/Court, accounts of the national Assembly and senate, political parties funded from public funds, public debt and other institutions prescribed by law or funded using public funds. Audit reports submitted to Parliament.	**Auditor General:** Responsible for Audit of all accounts of county governments, county government funds and authorities, accounts of the county Assemblies and other institutions prescribed by law or funded using county public funds. Audit reports submitted to county assembly.
	Public Sector Accounting Standards Board: Prepare and publish standards of generally accepted accounting principles for use of national and county governments.	
	Public Debt Management Office: Independent Agency of National Treasury to oversee management of public debt and borrowing and issuance of debt instruments for national and county governments.	
	Parliamentary Budget Office: Provide advice to committees of the National Assembly and Senate on budgetary information, studies and analyses of budget and other PFM issues.	
	Senate (committees): Determination of the DRB and CARB, considers bills concerning county financial matters and makes recommendations, determines basis for sharing revenues among counties, makes recommendations (to Senate) on improving management of county finances.	
	Parliament: Prescribe the terms in which national government may borrow and issue guarantees to county governments.	

1 Provided for under Article 216, 217 and 218 of the Constitution and the CRA Act 2011
2 Provided for in Article 228 of the Constitution
3 Provided for in Articles 226 and 229 of the Constitution

Thematic Areas	National	County
Macro-Fiscal Policy and Planning	**BPS** – medium term fiscal strategy document. **BROP** - reporting requirements including updates on macroeconomic and fiscal forecasts contained in BPS Pre and post –election reports.	**CFSP** - medium term fiscal strategy document. **CBROP** - reporting requirements including updates on macroeconomic and fiscal forecasts contained in CFSP.
	National Debt Management Strategy: 15th February of each financial year-submission to Parliament of debt management strategy where Cabinet Secretary shall make a statement on state with medium- liability and potential liability as well as plans to deal with those liabilities. The strategy should be published and publicized and copies sent to the CRA AND IBEC.	**County Debt Management Strategy:** and 28th February of each financial year-submission to County Assembly of debt management strategy where County Executive Committee Member responsible for Finance shall make a statement on state with medium- liability and potential liability as well as plans to deal with those liabilities. The strategy should be published and publicized and copies sent to the CRA AND IBEC.
	Fiscal Responsibility Principles: Development expenditure should be a minimum of 30% of NG budget; wages and benefits not to exceed a % of revenue; national public debt maintained at a sustainable level approved by Parliament and not to exceed level specified in the Medium Term Debt Management Strategy and level of tax rates and tax bases reasonable degree of predictability.	**Fiscal Responsibility Principles:** Development expenditure should be a minimum of 30% of CG budget; wages and benefits not to exceed a % of county revenue; county public debt maintained at a sustainable level approved by County Assembly; level of debt not to exceed a level set by county assembly annually and level of tax rates and tax bases reasonable degree of predictability.
	Deviation from Financial Objectives: Only on a temporary basis and only where such deviation is caused by a major natural disaster, other significant unforeseen event or where there is a change of government (since the adoption of the Fiscal strategy paper). National and County Treasuries are also required to provide reports to Parliament.	**Deviation from Financial Objectives:** Only be on a temporary basis and only where such deviation is caused by a major natural disaster, other significant unforeseen event or where there is a change of government (since the adoption of the Fiscal strategy paper). County Treasuries to provide reports to County Assemblies.
Budgeting	Each year: • **Budget Circular** issued by NT by the 30th August; • **BROP** prepared and approved by Cabinet by **30th September;** • **Submission of BROP** to Parliament within **7 days after approval;** • **By 31st December—CRA recommendations** on vertical and horizontal sharing of revenue; • **BPS, DARA and CARA** submitted to Parliament by 28th February; • **Debt Management Strategy** submitted by 15th February; • **Approval of DARA and CARA within 30 days** after being introduced to Parliament; • **Budget Bills (except Finance Bill)** submitted to National Assembly by 30th April; • **CECF Comments on estimates of Parliament and Judiciary to National Assembly by 15th May;** • **Approval of Appropriation Bill and Presidential Assent by 30th June**; and • **Finance Bill** approved within **90 days of passing of the appropriation Bill.**	• **Budget Circular** issued by CT by the **30th August;** • CEC Finance to **submit development plan** to county assembly by 1st September; • **BROP** prepared and approved by County Executive Committee by 30th September; • **Submission of BROP** to County Assembly within 7 days after approval; • **CFSP** submitted to County Assembly by 15th February; • **Debt management strategy** submitted by 28th February; • **Approval of DARA and CARA within 30 days** after being introduced to Parliament; • **Budget Bills (except Finance Bill)** submitted to National Assembly by 30th April; • **Cash flow projections for the next financial year** submitted to CoB, IBEC and NT by 15th June; • **Approval of Appropriation Bill and Presidential Assent by 30th June**; and • **County Finance Bill** approved within **90 days of passing of the appropriation Bill.**

Thematic Areas	National	County
Treasury Management and Budget Execution	Separate accounts at CBK for consolidated fund, equalization fund and contingencies; Limit of contingencies fund KSh 10 billion; NT to authorize opening, operation and closing of national government entities; NT to establish Treasury Single Account, national government entities (except state corporations) to prepare and submit annual cash flow plans and forecasts to NT, IBEC and CoB; Accounting Officers to relocate funds within limits; supplementary budgets only for money spent under Article 223 and with parliamentary approval within 2 months and accounting officers to write of losses within prescribed limits , manage assets, authorize payment of cash advances.	CT to establish Separate accounts at CBK or other bank approved by CEC Finance for county revenue fund; separate account for contingencies fund; Limit of county emergency fund limited to 2% of county government revenue; CT to authorize opening, operation and closing of national government entities; CT to establish Treasury Single Account, national government entities (except county state corporations) to prepare and submit annual cash flow plans and forecasts to CT; By 15th June each county government will consolidate annual cash flow projections and submit to the CoB, NT and IBEC; Accounting Officers to relocate funds within limits; supplementary budgets only for money spent under Article 223 and with parliamentary approval within 2 months and accounting officers to write of losses within prescribed limits, manage assets, authorize payment of cash advances.
	Overall national government borrowing subject to debt limit set by Parliament.	County Government borrowing subject to debt limit set by County Assembly and must be guaranteed by National Government.
Accounting Recording and Reporting	NT to prepare consolidated annual financial statements and submit to AG with copies to CoB and CRA within 4 months of the end of the FY; NT to consolidate all entity quarterly reports to NA with copies to CRA, AG not later than 45 days after each quarter.	CT to prepare consolidated annual financial statements and submit to AG with copies to CoB, NT and CRA within 4 months of the end of the FY; CT to consolidate all entity quarterly reports to CA with copies to CRA, AG not later than 1month after each quarter.
	Accounting Officer to prepare annual financial statement of entity and submit to AG with copies to CRA, CoB and NT within 3 months of the end of the FY; Accounting Officer to prepare quarterly reports and submit to CS of the entity with copies to CECF and CoB within 15 days of the end of the FY.	Accounting Officer to prepare annual financial statement of entity and submit to AG with copies to CRA, CoB and CT within 3 months of the end of the FY; Accounting Officer to prepare quarterly reports and submit to CS of the entity with copies to CECF and CoB within 15 days of the end of the FY.
	Within 3 months of the end of the FY, receiver of revenue to submit annual report of all revenue received and collected to AG with copies to NT, CoB and CRA.	Within 3 months of the end of the FY, receiver of revenue to submit annual report of all revenue received and collected to AG with copies to NT, CT, CoB and CRA.
	Within 3 months after the end of the FY, NG to submit to AG a report of all waivers and variations in taxes, fees and charges.	Within 2 months after the end of the FY, NG to submit to AG a report of all waivers and variations in taxes, fees and charges.
	Within 3 months after the end of the FY an administrator of national public fund shall submit an annual financial statement to AG with copies to CS responsible for that fund; Administrator will also prepare a quarterly report of the fund.	Within 3 months after the end of the FY an administrator of county public fund shall submit an annual financial statement to AG with copies to CEC responsible for that fund; Administrator will also prepare a quarterly report of the fund within 15 days of the end of the quarter and submit to CT and CoB.
	Accounting Officer to prepare separate reports for State Corporations	Accounting Officer to prepare separate reports for State Corporations.
	NG to prepare pre and post-election reports within 4 months of the polling and election day respectively.	
Public Participation	Formulation of the BPS; budget estimates and strategic plans; preparation of the division of revenue Bills; IBEC; regulations to the Act to prescribe further guidelines; requirement of both publishing and publicizing reports.	Formulation of the CFSP; budget estimates and strategic plans; CBEC; regulations to the Act to prescribe further guidelines; requirement of both publishing and publicizing reports.

Thematic Areas	National	County
Enforcement	Article 225 of the Constitution provides that the Cabinet Secretary may stop the transfer of funds to a state organ or other public entity for a serious or persistent material breaches. Parliamentary approval for this must be within 7 days. The PFM Act assigns the responsibility of identifying and solving indigenous financial problems to the respective entity as well as notifying the CoB, CRA, CECF and IBEC; Once the CECF is aware: He/she may prescribe remedial measures or determine the breach as a material contrary to article 225; Material breach is defined as where an entity's financial problems have caused or cause the entity not to comply with this Act or Constitution or to meet its financial commitments; **Factors indicating material breach:** failed to make payments when due; defaulted on financial obligations; operating deficit in excess of a prescribed % of revenue; is more than sixty days later in submitting annual financial statements to Auditor General; failed to make payments amounting to 2% of the budget operating expenditure; the Controller of Budget has raised issues in quarterly report; the Auditor General has withheld or issued disclaimers on financial statements for withholding information; recurring or continuous failure by entity to meet financial obligations to the extent that it hinders ability to procure goods, services or credit. Procedure for stoppage of funds to national government entities; establishment of the joint intergovernmental technical committee.	Article 225 of the Constitution provides that the Cabinet Secretary may stop the transfer of funds to a state organ or other public entity for a serious or persistent material breaches. Parliamentary approval for this must be within 7 days. The PFM Act assigns the responsibility of identifying and solving indigenous financial problems to the respective entity as well as notifying the CoB, CRA, CEC and IBEC. Material breach is defined as where a county entity or county government does not operate financial management systems that comply with the Act; financial problems have caused or cause the entity not to comply with this Act or Constitution, is unable to meet financial commitments set out in the Constitution or PFM Act; **Factors indicating material breach:** failed to make payments when due; defaulted on financial obligations; operating deficit in excess of a prescribed % of revenue; is more than sixty days later in submitting annual financial statements to Auditor General; failed to make payments amounting to 2% of the budget operating expenditure; the Controller of Budget has raised issues in quarterly report; the Auditor General has withheld or issued disclaimers on financial statements for withholding information; recurring or continuous failure by entity to meet financial obligations to the extent that it hinders ability to procure goods, services or credit. Procedure for stoppage of funds to county governments; provision for a recovery plan; establishment of the joint intergovernmental technical committee.
	Accounting Officers who authorize bank accounts to be overdrawn shall be liable for the full cost of the overdrawn amount and other disciplinary measures.	Accounting Officers who authorize bank accounts to be overdrawn shall be liable for the full cost of the overdrawn amount and other disciplinary measures.
	Public officers and Accounting officers who engage in improper conduct (i.e. failing to comply with the Act, undermines financial management procedures, pay bills promptly and permits unlawful expenditure) shall be disciplined or referred to relevant office. If it is the accounting officer, CS can take disciplinary measures such as revoking the position of accounting officer or refer the accounting officer to the relevant body.	Public officers and Accounting officers who engage in improper conduct (i.e. failing to comply with the Act, undermines financial management procedures, pay bills promptly and permits unlawful expenditure) shall be disciplined or referred to relevant office. If it is the accounting officer, CEC can take disciplinary measures such as revoking the position of accounting officer or refer the accounting officer to the relevant body.

Thematic Areas	National	County
	Offences by Public Officers are defined as :spending money, raising revenues or entering into obligations with financial implications other than authorized by the Constitution or an Act of Parliament; borrowing money or issuing a guarantee unless authorized by an Act (and within limits), directing another public officer to do an act contrary to law; and is found to be responsible for facilitating, contributing to an entity engaging in a prohibited act or failing to comply with an obligation prescribed by the Act. **Penalty:** A public officer if found guilty will be convicted for a sentence of 2 years and/or 2 million while an entity.	**Offences by Public Officers** are defined as: spending money, raising revenues or entering into obligations with financial implications other than authorized by the Constitution or county legislation; borrowing money or issuing a guarantee unless authorized by legislation (and within limits), directing another public officer to do an act contrary to law; and is found to be responsible for facilitating, contributing to an entity engaging in a prohibited act or failing to comply with an obligation prescribed by the Act. **Penalty:** A public officer if found guilty will be convicted for a sentence of 2 years and/or 2 million while an entity.
	Offences of Financial Misconduct - is defined as where a public officer without authority: issues government securities; opens a bank account in the name of the government; lends money on behalf of the government; issues guarantees; issues securities for loans; disposes property; fails to pay public funds due to the county or entity into a government bank account; incurs wasteful expenditure; fails to provide financial information required under the Act; fails to keep proper records; makes or utters false statements or declarations; fails to remit revenue received. **Penalty:** Fine not exceeding five years or to a fine not exceeding 10 years.	**Offences of Financial Misconduct** - is defined as where a public officer without authority: issues government securities; opens a bank account in the name of the government; lends money on behalf of the government; issues guarantees; issues securities for loans; disposes property; fails to pay public funds due to the county or entity into a government bank account; incurs wasteful expenditure; fails to provide financial information required under the Act; fails to keep proper records; makes or utters false statements or declarations; fails to remit revenue received. **Penalty:** Fine not exceeding five years or to a fine not exceeding 10 years.
	Other Offences: A public officer takes possession of public funds without authority; misappropriates funds or assets; conceals information on public finances to obtain financial benefit and engages in a corrupt act (including soliciting or receiving an inducement). **Penalty:** Fine not exceeding five years or to a fine not exceeding 10 million.	**Other Offences:** A public officer takes possession of public funds without authority; misappropriates funds or assets; conceals information on public finances to obtain financial benefit and engages in a corrupt act (including soliciting or receiving an inducement). **Penalty:** Fine not exceeding five years or to a fine not exceeding 10 million.
	Duty of Principal Secretary to report offences to relevant agency and failure to do this is a basis for disciplinary action	**Duty of a County Chief Officer** to report offences to relevant agency and failure to do this is a basis for disciplinary action.
	Public Officers shall be held personally liable for loss sustained by the government due to fraudulent or negligent conduct by the officer and committed an offence under the Act.	**Public Officers shall be held personally liable for loss sustained by the government** due to fraudulent or negligent conduct by the officer and committed an offence under the Act.
	Cabinet Secretary may impose institutional sanction on entities that: approve the contracting of debt beyond any debt limits; defaults on loans; provide inaccurate financial information; issuing guarantees without authorization creates liabilities in excess of its ability to finance those liabilities and fails to raise issues by the Auditor General. **Those sanctions include:** imposing additional reporting requirements; suspend the ability of the entity to reallocate funds; withhold funds; suspend the entity's authority to borrow and appoint administrators to administer the entity's financial affairs.	N/A

Annex 4: Adherence to budget calendar is compromised by tight timelines

	County	Budget Circular 30th August	Annual Development Plan 1st September	CBROPA 30th September	CFSP 28th February[4]	CDMS 28th February[5]	Budget Estimate 30th April
1.	Baringo	Submitted September	Approved 30th September	Not compiled	Approved 27th February	Not compiled	Submitted 30th April
2.	Bomet	Submitted 29th August	Not compiled	Submitted 27th September	Submitted 27th February	Submitted 27th February	Submitted 30th April
3.	Busia	Submitted 30th August	Submitted 28th February	Submitted 15th October	Submitted 28th February	Not compiled	Submitted 30th April
4.	Elgeyo Marakwet	Submitted 2nd September	Not compiled	30th September	28th February	Not compiled	Submitted 30th April
5.	Embu	Submitted 31st August	Submitted 30th September	Submitted 30th September	Submitted 28th February	Not compiled	Submitted 30th April
6.	Kericho	Submitted 29th September	Submitted 26th September	Submitted 24th February	Submitted 28th February	Submitted 29th April	Submitted 30th April
7.	Kiambu	Submitted 29th August	Not compiled	Submitted 30th September	Submitted 28th February	Not compiled	Submitted 30th April
8.	Kilifi	Not compiled	Submitted June	Not compiled	Submitted	Not compiled	Not submitted
9.	Kirinyaga	Submitted 30th August	Submitted in November	Not submitted	Submitted on 28th February	Not submitted	Submitted 30th April
10.	Kisumu	Submitted 20th September	Submitted 10th December	Submitted 18th December	Submitted 28th February	Not compiled	Submitted 30th April
11.	Kitui	Submitted August	Not compiled	Not compiled	Submitted in March	Submitted in March	Submitted April
12.	Marsabit	Submitted September	Not compiled	Not submitted	Submitted February	Not compiled	Submitted April
13.	Nyamira	Not compiled	Not compiled	Submitted 30th September	Submitted 28th February	Not compiled	Submitted 30th April
14.	Nyeri	Not compiled	Not compiled	Submitted 30th September	Submitted 28th February	Not compiled	Submitted 30th April
15.	Samburu	Submitted September	Not compiled	Not compiled	Submitted 28th February	Not compiled	Submitted 30th April
16.	Taita Taveta	Not compiled	Submitted June	Not compiled	Submitted	Not compiled	Not submitted
17.	Trans Nzoia	Submitted September	Submitted October 2013	Submitted September	Submitted March	Submitted March	Submitted 30th April
18.	Uasin Gishu	Submitted 30th October	Submitted 31st September	Not compiled	Submitted 28th February	Submitted 28th February	Submitted 30th April

4 *The CIC report "system of devolved government" from steps to strides" however provides that no county met the deadline for the CFSP*
5 *The CIC report "system of devolved government" from steps to strides" however provides that that no county met the deadline for the CDMS"*

Annex 5: The tight budget calendar could undermine the credibility of the budget

Target Date (Annually)	Activity
30th August	**Budget Circular Issued** ! Budget Circular must also outline procedures for inviting the public to participate in the process.
1st September	**County Integrated Development Plan Submitted** Within 7 days of submission to the County Assembly, the County Executive Committee member responsible for planning must publish and publicize the plan.
30th September	**BROP/CBROP submitted** • Treasuries prepare and submits the BROP to the Cabinet/County Executive. • Cabinet/County Executive must review and approve within 14 days of submission. ! Within 7 days of approval by the cabinet or county executive committee, the respective treasury must arrange for the paper to be laid before the national or county assembly. Thereafter the papers are published and publicized the paper.
31st December	**Audit Reports Submitted** Audit reports submitted to Parliament and County Assemblies.
31st December	CRA makes recommendations on revenue sharing (vertical and horizontal).
15th February	**BPS Submitted** • The BPS is submitted to Parliament on 15th February. • Parliament and must review and adopt it within 14 days of submission. ! Within 7 days of submission to the Parliament, the National Treasury must publish and publicise it.
28th February	**C-FSP Submitted** • The C-FSP is submitted to County Assembly for approval by 28 February. • County Assembly must review and adopt within 14 days of submission. ! Within 7 days of submission to the County Assembly, the County Treasury publishes and publicizes the C-FSP.
28th February	**County Debt Management Strategy Submitted** • Medium Term Debt Management Strategy submitted to the County Assembly. ! As soon as practicable after the statement has been submitted to the county assembly, the CEC-MF publishes and publicizes the statement and submits a copy to the CRA and IBEC.
28th February	**DoRB and CAoRB Submitted** • Cabinet Secretary submits Division of Revenue Bills to Parliament. • Parliament to Consider and Approve Bills with or without amendments within 30 days. ! Once the Bills are submitted the Cabinet Secretary shall notify the CRA and IBEC.
30th April	**Budget Estimates Submitted** • CECF submit the budget Estimates to the County Executive for approval, and thereafter to the County Assemblies by 30th April. • Budget Estimates must be submitted with all supporting documents and draft bills. ! As soon as practicable after the budget estimates and other document have been submitted to the County Assembly publish and publicize the documents.
15th June	• County Governments to prepare and submit annual cash flow projections for the county to the CoB with copies to IBEC and NT.
30th June	**Budget Estimates Approval** • County Assemblies consider budget estimates and approve them with or without amendments, in time for relevant appropriation law or laws required to implement the budget—to be passed by 30th June.
By 30th September	• The CECF with approval from the County Executive submits the County Finance Bill to the County Assembly, which sets out the revenue raising measures for the national or county government, together with a policy statement expounding on those measures.

Decision Time: Spend More or Spend Smart?

Kenya is currently in an expansionary phase of its fiscal policy reflected in a widening primary deficit. The envisaged exit from fiscal stimulus program of 2009/10 did not materialize. Instead, there is discernable built up in fiscal pressure emanating from multiple sources which are expected to prevail in the medium term. These include the buildup of administrative expenses associated with the roll out of devolution, rising security expenditure, increase in infrastructure spending, funding new flagship projects in fulfillment of the government's pre-election pledges, and the rising wage bill at both levels of government.

This policy note observes that Kenya is moving in the right direction in terms of investing in infrastructure to enhance its growth potential. However, weak budget execution and declining provision for Operation and Maintenance (O&M) undermine the efficiency of ongoing investments. With regard to devolution, the note observes that county governments have budgeted to spend about 5 percent of GDP in the medium term. However, three key challenges undermine national service delivery targets as well as the potential benefits of devolution. Notably, the quick built up of administrative spending crowds out much needed investments and in this regard only ten counties allocated at least 30 percent of their budget to development spending. At the same time, weak budget execution locks unutilized development funds. Moreover, ambitious revenue forecasts coupled with limited revenue mobilization undermines budget credibility.

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