1. Key development issues and rationale for Bank involvement
The last adjustment credit to Kenya was approved by the Bank Board in 2000. Since then many significant political and economic changes have taken place in Kenya. A new government assumed office in December 2002 and prepared an Investment Program for Economic Recovery Strategy for Wealth and Employment Creation (ERS – Kenya’s PRSP) which was endorsed by the World Bank and IMF Boards in May 2004. The new government is implementing the ERS but faces serious resource constraints. Towards implementation of the ERS, there is some scope for creating fiscal space by restructuring expenditure but the challenge is much bigger than can be met through expenditure restructuring alone. Hence external concessional assistance is likely to be a significant source of resources for scaling up the implementation of the ERS.

The Kenya CAS completed in May 2004 noted the status of implementation of the ERS and included annual budget support operations (PRSCs) in future, pending improvements in budgeting and financial management and further development of sector development programs. The CAS supports the early phases of ERS implementation through an operation in FY06 that would also prepare the foundation for future annual budget support operations. This approach of doing preparatory work was in line with the guidance provided by Africa’s IDA strategy. In view of the disappointing track record of structural adjustment operations in Kenya, the CAS emphasizes implementation of actions prior to further support.

2. Proposed objective(s)
The broad development objective of the Credit is to support growth- and equity-enhancing government policies and actions. The Credit will do it by supporting the implementation of initial phase of the ERS. Accordingly, the following are seen as key development objectives of the ERSSC and the medium-term program:

- Expand fiscal space for public infrastructure and health. Towards that end, reform budgeting and execution to ensure that public expenditure is well-aligned with explicitly stated national priorities and is efficient;
- Further improve economic governance by strengthening financial management, procurement and audit institutions and ERS monitoring and evaluation
- Improve agricultural productivity and food security
- Lower the cost of private business and barriers to investment

1 The Economic and Public Sector Reform Credit (EPSRC) closed in April 2004, with one tranche undisbursed. The focus of EPSRC was budgetary and financial management reforms, privatization and civil service rightsizing.

2 The operation was planned as an adjustment credit and called Programmatic Structural Adjustment Credit in the CAS. It was renamed as ERSSC after the new OP 8.60 guidance became available in September 2004.
SWAs are being prepared separately in the health and education sectors. Hence the HD sectors are not included explicitly in the scope of this credit. However they will benefit from the focus of the Credit. In particular the budgetary and financial management component will help reinforce pro-poor spending trends in these sectors, not only when progress on a SWAp is smooth (education) but also in the midst of fundamental debates on the sector direction (health).

3. Preliminary description

**Component 1. Budgetary and financial management**

The Credit attempts to achieve the following outcomes related to budgetary and financial management.

1. *Improved reliability of budget as a public spending plan* by reducing deviation between budget and outturn. The government has initiated action on several recommendations made by the PEM-AAP and the PER. It has already strengthened guidance to accounting officers on virements. The 2004/05 budget execution will attempt to reduce deviation by taking actions on several other fronts such as minimizing mid-year policy changes.

   The impact of these actions will be continuously monitored and assessed at the end of the third quarter of the FY 2004/05 (end-March 2005). However the above administrative actions will need legal framework over a medium-term. The government will simultaneously initiate review of appropriation structure and regulations governing supplementary budget as part of discussions around an organic budget law.

2. *Restructured public expenditure that is better aligned with the ERS*. Analysis shows that there are various reasons for the gap between budget and explicitly stated priorities and policy: (i) The MTEF process is distinct from the annual budget process, largely because the MTEF is prepared separately from the budget; (ii) The MTEF/Budget process lacks political engagement in the development of budget strategy and ministerial ceilings; (iii) The ERS indicators are not directly linked with the budget process; (iv) There is weak capacity in the MoF for analysis of line ministries’ budget submissions.

   The government is taking action on most of the recommendations coming out of the MTEF Review.

3. *Strengthened demand for governance and accountability*. In line with the CAS approach, ERSSC aims to support the demand for good governance by making government processes and decision more transparent and strengthening accountability institutions. Specifically, it focuses on making procurement more transparent and accountable. The Credit proposes to seek enactment of the pending Procurement Bill as a prior action; this will send a strong signal to all watchers that there is a broad ownership of procurement reform within Kenya, including that of legislature. More actions could be added based on the findings of the ongoing Country Procurement Assessment Report. On external audit, the Credit seeks progress on delayed audits of local authorities.

**Component 2. Rural Development**

In alignment with the SRA, the objective of the rural component is to support Government’s efforts to increase agricultural productivity and food security. In discussion with the Ministries of Agriculture, Livestock and Fisheries, Cooperatives, and Regional Development, the ERSSC team has focused on a few selected, but strategic areas. Additional actions are identified to be undertaken in the subsequent two years to develop a rolling three year program of policy and institutional reform.

**Identified program.** Based on the list of actions in the SRA and the Government’s stated priorities, broadly defined, and supported by the existing body of analytical work and by the team’s own preliminary analysis, the prior actions for the ERSSC include key reforms in the coffee and pyrethrum sectors, and the closely related cooperative sector. These are areas for which sufficient consensus exists, both within Government and outside.

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3 The PSM TA project is working in parallel on improving the capacity of parliament.
and for which sufficient progress is being made. They are also areas that are likely to have very high payoffs in terms of smallholder incomes and growth.

- **Coffee.** Coffee has traditionally been a key export crop, but Kenya has lost its prominence in the world market. Apart from contributing to foreign exchange earnings, coffee plays a significant role as a source of household income and hence poverty reduction. In 2003/04, coffee was ranked fourth after tourism, tea and horticulture, accounting for 5% of the total export earnings. This is a significant decline from the 15% share of total export earnings that coffee used to account for just a decade ago. While one-half of total production is currently accounted for by large estates, improving the returns to the smallholder sector (estimated at 600,000 households who depend on coffee) can potentially impact significantly on poverty. The Government is in the process of tabling a cabinet paper on coffee policy, which is a result of an inter-ministerial task force commissioned by the President. This paper builds on a large body of analytical work done over the last few years. The main issues which have been identified as key to improving the performance of the sector are the need to increase the competitiveness and efficiency in the marketing of coffee, providing farmers with better incentives and institutional arrangements to increase returns to coffee production.

- **Pyrethrum.** Pyrethrum is another area where Kenya has traditionally held a dominant export position that is now slipping. This sub-sector has significant potential, both for export earnings, domestic production, industrial processing and as an important income source for a large number of smallholders. The Government is well advanced in its thinking on the liberalization of the sector, and is committed to completing the reforms in this sector quickly.

**Agenda in the medium-term** Equally important to increasing productivity and commercialization of smallholder operations is the cost of production, involving key agricultural input sectors (seed, fertilizers and chemicals). The most often cited characteristic of the Kenyan agricultural economy is its high cost. But few comprehensive analyses have identified the main issues. Some specific reforms affecting the access and efficiency in the supply of some inputs have been identified, but additional analysis is needed to identify other key constraints. This analytical work will be carried out as part of project preparation for ERSSC and additional actions incorporated in due time. As the dialog proceeds, agreements will also be reached with Government on the future analytical agenda, which will facilitate progress on priority areas such as the sugar industry and maize marketing. The Bank is undertaking an analysis of key input markets, to be completed in the coming months. Broad areas are indicated:

- Strengthening the regulatory, quality control and inspection functions for the sector by merging the various regulatory bodies (e.g., KEPHIS, PCPB, etc.)
- Identifying the reasons and underlying policy and institutional issues behind farmers’ complaints that inputs are too costly or often adulterated, particularly seeds and fertilizers.
- Reviewing the regulatory framework for inputs with a view to identifying areas where costs may be reduced or market efficiency increased.
- Reviewing the role and functioning of NCPB in the input markets, especially fertilizers, as it has added to the uncertainty and disruption in the market place.

The Bank is carrying out poverty and social impact analysis (PSIA) in two areas to better understand the implications of medium-term elements of the program. (i) A maize sector PSIA is looking at the impact of policy interventions in the maize market on welfare of the poor. (ii) A PSIA is planned to understand the welfare implications of sugar sector reform. The Bank team is committed to carrying put further PSIAs as the need becomes evident during the course of further elaboration of development program.

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*4 The EPSRC had a third tranche condition relating to coffee sector. It required cabinet approval of a sessional paper separating the regulatory functions of the Kenya Coffee Board from its marketing role. While the paper was published, reforms were not undertaken. As mentioned earlier, the third tranche of EPSRC was not disbursed.*
Component 3. Private sector competitiveness

Disinvestment and private sector participation in utilities. The Bank recognizes the new government’s approach to privatization of utilities. The CAS, therefore, took a more differentiated approach to the issue of privatization of utilities. It proposed supporting parastatal reform and privatization process ‘through its budget support, technical assistance projects and sector operations under an overarching strategy for private sector development’ rather than through ‘a single credit’. For example, the Energy Sector Recovery Credit (FY05) is expected to facilitate the privatization of Kenya Power and Lighting Company and the Financial and Legal Sector TA Credit will facilitate divestiture of the state’s remaining ownership stakes in banks. The ERSSC is expected to prepare the ground for the privatization of telecommunications and railway concessioning.

Privatization bill and privatization strategy. The privatization strategy will be the new government’s first comprehensive public statement on parastatal reform and will be shared with parliament. The privatization strategy will include a time table against which future credits will follow-up on implementation of the strategy. While a change in the legal setup (with the Privatization Bill) would accelerate reforms, there is significant progress that can be made until further consensus is reached on legislative action.

Investment climate etc. The analytical work on private sector has generated a rich agenda for reform covering legal framework for investment, licensing procedures and inspections, access to land for investment, customs and trade administration, tax administration, labor market, and barriers to growth in garments, coffee, pyrethrum and cotton sectors. The agenda is wide-ranging making the PSD reforms less amenable to capturing in a couple of key action points

- Much of the reforms are legal and institutional in nature and are likely to be implemented in medium to long-term.
- Reforms are likely to involve a wide-range of ministries and public bodies in the government, in particular, the MoTI, the Ministry of Justice, the Attorney General’s Office, Kenya Law Reform Commission, the Ministry of Agriculture, Ministry of Labor, Ministry of Health and Ministry of Education.

Work is already underway. Under the Governance Justice Law and Order Sector Program (GJLOS), there’s a program to reform Kenya’s key commercial laws (including the Companies Act and insolvency law), and to identify and reform other priority laws that are not conducive to private sector development. The work is being led by the Kenya Law Reform Commission (KLRC), in close consultation with private sector stakeholders. A Bank project for micro, small and medium size enterprises is focused on business entry issues.

The approach of the ERSSC on PSD is to arrive at a sequencing of reform program that is widely accepted and owned within the government, generate a strong momentum towards reform through early wins that could have a demonstration effect, and initiate actions on legal and institutional reform that will be carried forward in the following PRSC.

4. Environment Aspects
The only components with possible environmental implications are coffee and pyrethrum reforms. In the team’s view coffee and pyrethrum sector reforms are not expected to lead to expansion in the area under these crops. However the team is working closely with the ENV group to better assess and understand the environmental risks from agricultural reforms and the country capacity to manage them.

5. Tentative financing
Source: ($m.)
BORROWER/RECIPIENT 0

5 The last credit (Economic and Public Sector Reform Credit – EPSRC) had explicitly sought privatization of Telkom Kenya Limited (TKL). The revised Letter of Development Policy prepared by the new government in 2003 had also made new commitments on divestiture in energy sector, converting Mombasa port into a landlord port, and privatization of urban water and sanitation utilities.
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