Analysis of Fiscal Space and Policy Options for Targeted Intergovernmental Transfers, with Specific Focus on the Health Sector

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Executive Summary

Kenya’s growth experience reveals that economic growth has been quite episodic, with high sensitivity towards macroeconomic instability and higher political risks. Despite the improved economic growth, the country is unlikely to meet the Millennium Development Goals, especially poverty reduction and health related MDGs.

With the urgency of meeting goals such as the Millennium Development Goals, there is need to mobilize all available resources in order to fund public expenditure. Revenue collections have increased over time, from total tax revenue amounting to KShs. 408,445 million in 2007/08 to KShs. 866,347 million in 2012/13. Despite these increments, statistics indicate that total revenue collections have been below target. For instance, the deviation between actual and targeted revenue in 2008/09, 2009/10, 2010/11 and 2011/12 were KShs. 12,306 million, KShs. 10,825 million KShs. 6,309 million and KShs. 25,994 million respectively.

Expenditure trends reveal that there have been significant increases in government expenditure over time. For instance, total government expenditure increased from KShs. 432,591 million in 2005/06 to KShs. 789,360.62 million in 2009/10 and KShs. 1,539,513.30 million in 2012/13, which indicates that total expenditure almost doubled within only four years. In terms of composition of expenditure, the proportion of recurrent expenditure in total expenditure has declined over time. In addition, the central government has increasingly spent more on economic affairs, general public services and debt repayments while reducing the proportion of spending on social services.

The Health sector is one of the key sectors of Vision 2030 that are aimed at achieving equity and socio-economic goals as emphasized under the Social Pillar. The sector is financed by three main sources i.e. the government, private entities such as households and the donors. There are also considerable off budget resources, which mainly include user fees and financing from some development partners e.g.
funding from the US government for health are generally off budget. Statistics from the Kenya National Accounts 2009/10 estimate the total health spending at 5.1 percent, 4.8 percent and 5.4 percent of nominal GDP in 2001/02, 2005/06 and 2009/10 respectively.

The need for creation of fiscal space for health is largely due to the fact that health services are still not accessible to many Kenyans, with current level of access being estimated at 52 percent based on the 5km radius norm (Health sector report MTEF 2013/14 – 2015/16). The sector still experiences some challenges especially regarding to the high disease burden. Maternal Mortality Ratio also deteriorated from 414 in 2003 to 488 deaths per 100,000 live births in 2008-09.

Even though funding to the sector has been increasing in line with increases in total government expenditure, the health sector has very low public per capita spending, which undermines the sector’s ability to deliver services, especially purchase of critical inputs such as human resource, medical supplies and drugs, capital investments and support operations as well as maintenance. Recent estimates indicate that public per capita spending currently stands at $19.2 and per capita health spending still remains low at $42 compared to the WHO recommendation of $54 per capita.

Development and specific programme related expenditure in health has over time been substantially funded through donor support. In addition to unpredictability of donor funding, part of the donor funding is also disbursed directly to non-government entities such as non-governmental organizations. Given the sector’s limited control over the amount of resources and the timing of disbursements, the effective implementation of health programmes has been undermined.

With devolution, there has been costing of functions that have been assigned to the counties, especially health. Even though the county governments have been assigned the role of provision of health care, it is noted that the transfer of this function has not been adequately matched with the required resources. Further,
while costing of devolved functions followed the sectoral approach, this is not put into consideration while setting county budgetary priorities. There is a danger of the health sector being under-funded at the county level, given the already existing regional disparities in access to health.

It is acknowledged that the government has faced several challenges with regard to revenue shortfalls and mounting expenditure pressures (Budget Speech, 2013). From our analysis, we find that there are three key areas for creating additional fiscal space. First, **public expenditure can be rationalized through curtailing of less productive expenditures in a bid to create additional fiscal space for spending in priority areas.** Spending on goods and services is an area that contains scope for improving efficiency and thereby increasing fiscal space (Public Expenditure Review (PER), 2010). At sectoral level, reallocation of expenditure priorities within sectors can also result in additional fiscal space for financing unmet budgetary needs. This requires thorough efficiency studies of sectoral expenditure to identify more efficient expenditure priorities. **Additional revenue can also be generated by broadening the tax base.** This is largely through implementation of VAT reforms through the proposed VAT bill 2012, taxation of Small and Medium Sized Enterprises (SMEs), taxation of the real estate sector and re-introduction of capital gains tax. More revenue can also be generated by enhancing tax administration to enhance compliance. **Lastly, the government can increase fiscal space through borrowing.** Statistics indicate that the central government’s debt more than doubled between 2004 and 2012, increasing from KShs. 694.8 billion in 2004 to about KShs. 1,517.7 billion by June 2012. However, sustainability analysis indicates that the government’s debt position is still sustainable, even though increasing domestic debt much more might cause debt distress. Thus, external concessional borrowing and grants is the most likely instrument that should be pursued to achieve the government’s fiscal objectives. **With devolution, there is need to secure additional resources for counties through conditional/unconditional transfers from the central government and development partners and increased own revenue generation by counties to support under-funded essential social services such as health.** In addition, to ensure efficient service delivery of essential
services such as health, the national government could consider setting clear guidelines and benchmarks for sectoral allocations in county budgets, which will ensure that essential services are adequately budgeted for.
1. Introduction

Kenya’s growth experience reveals that economic growth has been quite episodic, with high sensitivity towards macroeconomic instability and higher political risks. Currently, the economy is on a recovery path following dismal performance in 2008, which was occasioned by the post-election violence. However, statistics indicate that growth performance has fallen below target over the 2008 – 2012 medium term i.e. the targeted growth rates for 2009, 2010 and 2011 were 6.2 percent, 8.3 percent and 9.1 percent respectively (Third Annual Progress Report (2010-2011) on the implementation of the First Medium Term Plan - GoK, 2012a).

Despite the improved economic growth, the economy still struggles with high levels of poverty, inequality and employment. The country is unlikely to meet the Millennium Development Goals, especially poverty reduction and health related MDGs. In terms of meeting the health related goals, statistics indicate that the Medium Term Plan (MTP) targets of reducing under five and maternal mortality were not met (GoK, 2012). For instance, while the MTP target for maternal mortality rate was 200 deaths per 100,000 live births, it was estimated that maternal mortality was still 414 per 100,000 births as reported in 2007.

With the urgency of meeting goals such as the Millennium Development Goals, there is need to mobilize all available resources in order to fund public expenditure. As stated in the High level Forum on the Health MDGs (2005), it is widely recognized that current levels of public expenditure, especially for health in low income countries are too low to achieve the MDGs. The central question, which relates to the issue of fiscal space, is whether it is possible, in the context of sustainable public finance stability, to mobilize additional resources in order to increase funding for core programmes, such as health, which are essential for meeting the Millennium Development Goals (Brun et al, 2006).
For the government to be able to provide more of essential services such as better health care, education, and infrastructure, there is need to create fiscal space. The Kenyan economy, faced with increasing government expenditure and a slower growth in revenues, has experienced budget deficits which have largely been financed through domestic borrowing. This increased domestic borrowing is contradictory to the government’s policy of maintaining sustainable external debt to GDP ratio while reducing the domestic debt burden (Parliamentary Budget Office, 2013). The stock of public debt has also more than doubled in the last decade, increasing from KShs. 749.5 billion in June 2005 to KShs. 1,793.2 billion as at December 2012.

Given this background, it is important to examine the extent to which fiscal space is available to be able to advocate for increased targeted spending, especially spending on health, which is currently very low. The main objective of this study is to explore the scope for establishing additional targeted transfers by undertaking a comprehensive analysis of fiscal space. The study aims at analyzing the need, as well as the scope, for creating additional fiscal space to finance additional targeted expenditures, both in the health sector and more generally, by considering potential for:

- generating additional domestic revenues (through conducive macroeconomic conditions, improved collection efficiency, or expansion of the tax base);
- reprioritization of existing expenditures;
- improved efficiency (with a particular focus on the health sector);
- additional donor grants; or
- borrowing.

The focus of the study will be at the national level, but it should include specific consideration of the new intergovernmental revenue sharing arrangements to be implemented from 2013/14.
2. Trends in government revenue and expenditure

2.1 Revenue Performance
A look at revenue performance reveals that, revenue collections have increased over time, from total tax revenue amounting to KShs. 408,445 million in 2007/08 to KShs. 866,347 million in 2012/13 (Figure 1). We have also seen steady increases in tax effort, as measured by total tax revenue to Gross Domestic Product (GDP), from a low of 15.9 percent in 2002 to 22.8 percent in 2012 (Figure 2). The increase in total tax revenue can largely be attributed to significant increases in income tax revenue, which increased from KShs. 165,078 million in 2007/08 to KShs. 403,638 million in 2012/13 (Figure 3). This represents an increase of about 144 percent over the five year period.

Figure 1: Total Tax Revenue (KShs. Million) – 2007/08 – 2012/13


Value Added Tax revenue also significantly increased from KShs. 111,905 million in 2007/08 to KShs. 231,855 million in 2012/13, which represents an increase of about 107 percent over the five year period. Trade tax revenue also increased from KShs. 45,858 million in 2007/08 to KShs. 98,784 million in 2012/13, which represents an increase of about 115 percent over the five year period. Excise tax revenue recorded the slowest
growth of about 48 percent from KShs. 61,906 million in 2007/08 to KShs. 91,910 million in 2012/13. These increases in taxes were largely as a result of the tax amnesty that was offered by the Kenya Revenue Authority on waiver of interest on all tax arrears in 2004 and also after implementation of the principle of self-assessment.

Figure 2: Total Tax Revenue to GDP ratios (2000 – 2012)

Source: Own computation using data from Economic Survey (various issues)

Figure 3: Contribution of specific taxes to total tax revenue

Looking at the structure of taxes, we can see that income taxes have continued to play a dominant role in tax revenue, accounting for almost fifty percent of total tax revenue (Figure 4). The improved performance of income taxes can largely be attributed to higher tax compliance after the tax amnesty and the use of the personal identification number (PIN) for purposes of tax assessment.

Figure 4: Taxes as a percentage of total tax revenue


The VAT, despite being seen as a tax for the future⁴, has stagnated at 27 percent of total tax revenue over the five year period. Earlier analysis by Karingi et al (2005) revealed that VAT productivity had significantly declined since inception. It was argued that the low VAT productivity seemed to indicate existence of possible structural problems, which tax reforms may have failed to address. It was also an indication that VAT was yet to find its position in Kenya’s tax system as the tax of the future. In recent times, the poor performance of VAT can be attributed to lower tax compliance, especially in the use of the Electronic Tax Registers (ETR). After introduction of the ETR system, a compliance rate of 90 percent was targeted (KRA,

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⁴Which is in line with the Kenya’s objective of reducing reliance on direct taxes and also given the diminishing role of trade taxes.
2012). A survey done by KRA in 2009/10 found that whereas installation rates were high at 98 percent, the utilization (compliance) rate was in the range of 60 percent–65 percent. There are also many small and medium sized entities that do not file for VAT because they fall below the VAT threshold. Thus, attempts to impose a turnover tax on smaller entities will greatly complement VAT revenue collections.

The proportion of excise tax revenue has significantly declined from 15 percent to 11 percent over the five year period. This can largely be attributed to a shift from ad valorem\(^2\) to specific taxation regime in 2003/04, especially for beer and spirits which account for the largest share of excise tax revenue. This provides evidence on the superiority of ad valorem rates over specific rates in relation to their tax buoyancy. In order to maximize excise tax revenue collections, there is need to consider reverting back to the ad valorem taxation regime.

The share of trade tax revenue has stagnated at 11 percent over the five years, which is in line with the regional integration efforts which are aimed at reducing tax rates on imports. Looking at the overall structure of tax revenue, the over reliance on income taxes is against the government’s policy, since the advent of the Tax Modernization Programme in the 1980s, of relying more on indirect taxes as a major source of development finance so that savings and investment could be increased with less reliance on direct taxes (Karingi et al, 2005).

However, even though we have seen increments in total revenue collections over time, statistics indicate that total revenue collections have been below target. For instance, the deviation between actual and targeted revenue in 2008/09, 2009/10, 2010/11 and 2011/12 were KShs. 12,306 million, KShs. 10,825 million, KShs. 6,309 million and KShs. 25,994 million respectively (figure 5).

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\(^2\) Taxation of major excisable products in Kenya has mainly been shifting between an ad valorem regime (an optimal excise tax rate as a percentage of the price of the commodity) and a specific regime (specific value per unit of excisable commodity). Experience has shown that ad valorem taxes are more buoyant than specific taxes and would therefore lead to higher tax revenues. In addition, ad valorem rates adjust automatically to inflation, as compared to specific taxes which have to be adjusted periodically to keep up with inflation.
Figure 5: Deviations between Actual and Targeted Revenue (1996/97 – 2011/12)

Source: Kenya Revenue Authority

Figure 6: Deviations between actual and targeted revenue collections (Deviation = actual – target)

Source: Kenya Revenue Authority
Looking at the respective tax handles, statistics indicate that only Pay As You Earn (PAYE) taxes have exceeded the target between 2005/06 and 2011/12. The corporate, VAT and Excise tax collections have fallen below target, with the gap between actual and targeted revenue collection widening over time. One can attribute the impressive performance of PAYE on their administrative ease. In addition, income taxes have largely performed well because of use of the Personal Identification Number and also the self-assessment tax payment system.

2.2 Government Expenditure

A look at expenditure trends reveals that there have been significant increases in government expenditure over time. For instance, total government expenditure increased from KShs. 432,591 million in 2005/06 to KShs. 789,360.62 million in 2009/10 and KShs. 1,539,513.30 million in 2012/13, which indicates that total expenditure almost doubled within only four years (Figure 7).

Figure 7: Government Expenditure (KShs. Million)

<table>
<thead>
<tr>
<th>Government Expenditure (KShs. million)</th>
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<tbody>
<tr>
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</tr>
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</tr>
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<table>
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<tr>
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<td>0</td>
</tr>
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<tr>
<td>2012/13</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Economic Survey (various issues)

While there are significant increases in both recurrent and development expenditure, the proportion of recurrent expenditure in total expenditure
has declined over time. Recurrent expenditure increased from KShs. 370,209 million in 2005/06 to KShs. 603,831.5 million in 2009/10 and KShs. 1,079,546.5 million in 2012/13 while development expenditure increased from KShs. 62,381 million in 2005/06 to KShs. 185,529.1 million in 2009/10 and KShs. 459,966.9 million in 2012/13. As a result, the proportion of development expenditure in total expenditure has over time increased from only 8 percent in 2001/02 to an average of 30 percent in 2012/13 (Figure 8).

Figure 8: Proportion of Recurrent and Development Expenditure in Total Expenditure

Source: Own computation from data compiled from Economic Survey (various issues)

In terms of spending on government functions, the central government has increasingly spent more on economic affairs, general public services and debt repayments while reducing the proportion of spending on social services (Figure 9). The proportion of spending on economic affairs was 14 percent in 2007/08 as compared to 22 percent in 2012/13. Similarly, after a reduction in 2008/09, the proportion of spending on general public services also increased from 11 percent in 2008/09 to 17 percent in 2012/13. On the contrary, spending on education declined from 21 percent of total spending in 2008/09 to 16 percent in 2012/13, while health sector spending stagnated at 4-5 percent of total spending. The declining share of public spending on health is contrary to the commitments under the Abuja declaration which
required African member states to increase spending on health to at least 15 percent of total expenditure.

Figure 9: Classification of expenditures by functions of government

![Classification of expenditures by functions of government](image)

Source: Own computation from data compiled from Economic Survey (various issues)

### 3. Health sector performance and financing

The Health sector is one of the key sectors of Vision 2030 that are aimed at achieving equity and socio-economic goals as emphasized under the Social Pillar. The Vision of the health sector is mainly aimed at reversing the downward trends in health indicators. It is also aimed at restructuring the health delivery system to shift its emphasis from curative to promotive and preventive health care. The Government recognizes health as one of the priority sectors that contribute to the wellbeing of the nation and therefore remains committed to providing quality health services to all of its citizens. Further, the Bill of Rights in the Constitution of Kenya (2010) stipulates that access to equitable healthcare is a right for every Kenyan, irrespective of his or her income status.

The health sector is financed by three main sources i.e. the government, private entities such as households and the donors. There are also considerable
off budget resources, which mainly include user fees and financing from some development partners e.g. funding from the US government for health are generally off budget. Statistics from the Kenya National Accounts 2009/10 (NHA) indicate that Kenya spent approximately KShs. 122.9 billion on health in 2009/10, which represents an increase of about 20 percent over total health spending in 2005/06 (Table 1). In addition, per capita spending was estimated at KShs. 3,203 in 2009/10, which increased from KShs. 2,636 in 2001/02 and KShs. 2,681 in 2005/06. The total health spending was also approximated at 5.1 percent, 4.8 percent and 5.4 percent of nominal GDP in 2001/02, 2005/06 and 2009/10 respectively.

Table 1: Health Sector Financing

<table>
<thead>
<tr>
<th>Source</th>
<th>2001/02</th>
<th>2005/06</th>
<th>2009/10</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public</td>
<td>24,340,676,962</td>
<td>29,879,442,868</td>
<td>35,381,825,223</td>
</tr>
<tr>
<td>Private</td>
<td>44,405,289,053</td>
<td>40,077,204,939</td>
<td>45,087,256,448</td>
</tr>
<tr>
<td>Donors</td>
<td>13,486,050,749</td>
<td>31,613,062,420</td>
<td>42,384,478,132</td>
</tr>
<tr>
<td>Others</td>
<td>82,232,017</td>
<td>407,910,483</td>
<td>0</td>
</tr>
<tr>
<td>Total</td>
<td>82,314,248,781</td>
<td>101,977,620,710</td>
<td>122,853,559,803</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Percentage contributions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public</td>
</tr>
<tr>
<td>Private</td>
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<tr>
<td>Donors</td>
</tr>
<tr>
<td>Others</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>

Source: Kenya National Health Accounts

The household share of total health spending has declined over time while the share of expenditures from donors has increased over time. While households accounted for about 54 percent of total health expenditure in 2001/02, their share declined to 39.3 percent in 2005/06 and eventually to 36.7 percent in 2009/10. On the contrary, the share of expenditures from donors increased from 16.4 percent in 2001/02 to 31 percent in 2005/06 and eventually to 34.5 percent in 2009/10. It is further estimated that off budget expenditures from donors accounted for about 56 percent of all public sector health spending in 2009/10.
3.1 Why do we need additional fiscal space for health?
First, statistics indicate that the health sector has achieved considerable outcomes including but not limited to: a reduction of Under Five Mortality from 115 per 1,000 live births in 2003 to 74 per 1,000 live births in 2008/9 and Infant Mortality from 77 per 1000 live births to 52 per 1000 live births in the same period (GoK. 2012c. Health Sector Working Group Report: MTEF 2013/14 – 2015/16). The sector has also seen increased immunization coverage for under 1 year olds from 71% in 2008 to 77% in 2011. The 2008/09 Kenya Demographic and Health Survey (KDHS) estimates the HIV prevalence rate at 6.3 percent, slightly lower than the previous estimate of 6.7 percent (KDHS 2003).

However, despite these improvements, the sector still experiences some challenges especially regarding to the high disease burden. According to the Health Sector report, 70 percent of outpatient morbidity is caused by Malaria, Diseases of the Respiratory System, Skin Diseases, diarrhea, and accidents. Malaria contributes about a third of total outpatient morbidity. Mortality on the other hand has been increasingly due to Infectious and parasitic diseases (42 percent of total mortality in 2008) followed by Diseases of Respiratory System (11 percent), and Diseases of Circulatory System (7 percent). The incidence of non-communicable diseases especially cancer has also been increasing, with over 82,000 new cases and 18,000 deaths (third among the causes of death in Kenya) reported annually.

Maternal Mortality Ratio also deteriorated from 414 in 2003 to 488 deaths per 100,000 live births in 2008-09. Births attended by skilled health personnel declined from 51 percent in 2007 to 43 percent in 2010/11. The 2008/09 KDHS also indicates that the nutritional status of children has also not shown significant improvement over the years. An estimated 16 percent of children under-five years are underweight, 7 percent are wasted, and 35 percent are stunted compared to 2002/03 KDHS where an estimated 20 percent of children under-five years are underweight, 5 percent are wasted, and 30 percent are stunted.
Health services are still not accessible to many Kenyans, with current level of access being estimated at 52 percent based on the 5km radius norm (Health sector report MTEF 2013/14 – 2015/16). In addition, there are wide variations in access to health care across the country, with the worst areas being in the Northern part of Kenya. Although the Government has put a lot of efforts in rehabilitating and upgrading health facilities in the country, there is still need to invest more in infrastructure particularly in equipment and technology.

Second, even though funding to the sector has been increasing in line with increases in total government expenditure, the health sector has very low public per capita spending. Recent estimates indicate that public per capita spending currently stands at $19.2 and per capita health spending still remains low at $42 compared to the WHO recommendation of $54 per capita. As highlighted in the health sector report MTEF 2013/14 – 2015/16), the low public per capita financing and overall sector underfunding undermines the sector’s ability to deliver services, especially purchase of critical inputs such as human resource, medical supplies and drugs, capital investments and support operations as well as maintenance. Inefficiencies in the use of available resources have also constrained achievement of the sector’s policy objectives.

Development and specific programme related expenditure in health has over time been substantially funded through donor support. For instance, over 90 percent of funding for ARVs is by donors, which cannot be sustained in case of declining donor support. In addition, donor support has been unpredictable both in terms of amounts and disbursement patterns (Health sector report MTEF 2013/14 – 2015/16). This has been attributed to poor public financial management systems, where funds are not properly budgeted and accounted for (GoK, 2010, Public Expenditure Review). However, this is expected to improve following the implementation of the Integrated Financial Management Information System (IFMIS). In addition to unpredictability of donor funding, part of the donor funding is also disbursed directly to non-governmental entities such as non-governmental organizations. Given the sector’s limited control over the amount of resources and the timing of disbursements, the effective implementation of health programmes has been undermined. These calls for
efforts to make donor financing more predictable to support proper planning of activities through increased accountability.

**There is empirical evidence that shows that higher levels of health expenditure are associated with better performance on the health-related MDG indicators.** Using cross country data for 2009, Freire and Kajiura(2011) demonstrate that higher levels of expenditure (both public and private) are associated with lower rates of under-five mortality.

**Using cross country data for 2010 for 178 countries, we also find a negative correlation between the proportion of public spending on health\(^3\) and maternal mortality (rate per 100,000 live births) – figure 10.** Kenya’s position is shown by the arrow, with an average of about 40 percent public spending on health and maternal mortality of a minimum of 360 per 100,000. Some of the countries with low proportions of public spending and high maternal mortality rates include: Chad, with public spending on health of 25 percent and maternal mortality rate of 1100; Sierra Leone, with public spending on health of 15.3 percent and maternal mortality rate of 890; Guinea Bissau, with public spending on health of 33.1 percent and maternal mortality rate of 790; Liberia, with public spending on health of 19 percent and maternal mortality rate of 770 and; Sudan, with public spending on health of 27.6 percent and maternal mortality rate of 730. However, there are also countries that are exceptions, with high proportions of public spending on health and high mortality rates. For example, Lesotho’s proportion of public spending is 70.3 percent, with maternal mortality rate of 620. Also Malawi has a proportion of public spending of 74.2 percent, with maternal mortality rate of 460.

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\(^3\) We find similar results of negative correlation when also using health spending per capita. The results show that countries with high spending on health per capita have considerably lower levels of maternal mortality. However, there are fewer exceptions (i.e. with high per capita spending on health and high maternal mortality or vice versa) when using per capita spending as compared to the proportion of public spending.
Figure 10: Correlation between public spending on health and maternal mortality

Source: Own compilation using data from World Bank (http://data.worldbank.org/indicator)

Thus, for Kenya to improve its outcomes on health related MDG indicators, there is need to increase the proportion of public financing in total health sector expenditure. For instance, it is expected that the government’s recent move of providing free maternal care will reduce maternal mortality. The plan is to pay hospitals KShs. 5,000 for every birth conducted. However concerns have already been raised by health sector players that the allocated financing in the 2013/14 budget of KShs. 3.8 billion is not adequate to provide free maternal health care⁴. It is estimated that about 1.5 million children are born annually in Kenya, which implies that about a minimum of KShs. 7.5 billion would be require to offer free maternal care to all. Furthermore, the cost of delivery would surpass the allocated KShs. 5,000 for any additional services beyond normal hospital delivery.

Third, in line with the Constitution of Kenya (2010), some of the health sectors functions have been transferred to county governments. Under this provision, the national government is expected to focus on health policy, national

⁴Article by Secretary General of the Doctor’s Union (KMPDU), Business Daily, ⁷th June 2013. Free Maternal health care plan needs more cash.
referral hospitals, capacity building and technical assistance to counties. The county
governments on the other hand are expected to focus on county health facilities and
pharmacies, ambulance services, promotion of primary Health Care; licensing and
control selling of food in public places; veterinary services, cemeteries, funeral parlous
and crematorium; referral removal; refuse dumps and solid waste. As indicated in the
health sector report, delivery of these functions will need concerted effort in
restructuring organizational arrangement in relation to human resource management,
infrastructure development and maintenance and increased health financing. Given the
existing regional disparities in access to health services, inadequate planning and
financing of health service delivery might result in worsening of health indicators in
some regions.

4. Understanding of Fiscal Space and Method of Analysis

Fiscal space can be defined as the availability of budgetary room that allows
a government to provide resources for a desired purpose without any
prejudice to the sustainability of a government’s financial position (Heller,
2005). By creating fiscal space, further resources can be made available to increase
government spending or reduce taxation on an activity deemed important.

Heller (2005) further identifies potential sources of raising additional revenues as:

- Through tax measures or by strengthening tax administration. An effort can be
  made to raise the tax to GDP ratio, even though, experience from African
countries shows that it has taken several years for some countries to raise their
  revenue to GDP ratio by a few percentage points.

- Reduction in lower priority expenditures in order to make room for more
desirable ones. This entails a reduction in unproductive expenditures, especially
recurrent expenditure. Measures can include: revision of subsidy programs,
reduction in foreign travel expenses, rationalization of civil service to ensure
leaner manpower with higher productivity, streamlining expenditure on wages
and salaries etc. In most low income countries, it has been argued that overall
wages and salaries of governments are unsustainable and efforts are needed to reduce the public wage bill and allow expansion of spending on key policy programs.

- Resources can be borrowed, either from domestic or external sources. However, there is need for assessment of the overall sustainability of a government’s borrowing program, given the size of the government’s existing obligations for debt service and principal repayments.

- Additional resources can be derived through borrowing from the central bank by printing money. This is not very desirable given its likely inflationary pressures. A government’s borrowing from the central bank should be driven by monetary policy objectives, especially the creation of sufficient liquidity to support an economy’s real growth. Given the money multipliers in most developing countries, the scope for additional expenditure that can be financed in principle by money creation is rarely above one percent of GDP, unless a clear and relatively quick supply-side impact can be obtained from the higher level of expenditure (Heller, 2005).

- Governments may also benefit from any fiscal space arising from the receipt of grants from external sources. However, the grants need to be sustained and predictable to create potential for scaling up of expenditure that can be maintained in future. The question on whether there is a limit on the amount of grants that a country can absorb largely depends on the impact of the external flows on the real exchange rate and the size of the tradable sector. Capital inflows have been associated with a marked appreciation of the real exchange rate in most countries (Lartey, 2007; Guillermo et al 1993). The larger transfer from abroad has to be accompanied by an increase in domestic absorption. If part of the increase in spending falls on non-traded goods, their relative price will increase and the real exchange rate appreciates.

**Fiscal space is closely linked to the issue of fiscal sustainability – which concerns the capacity of government to finance government spending, meet**
its debt service obligations and ensure its overall solvency (Powell-Jackson et al., 2012). According to Heller (2005), some of the important considerations include:

- Whether the higher expenditure in the short term, and any associated future expenditures, can be financed from current and future revenues. If debt financed, the expenditure should be assessed in terms of its impact on the underlying growth rate or by its impact on a country’s capacity to generate the revenue needed to service that debt.

- Whether the expenditures for which fiscal space is created are likely to be concentrated in the immediate term or whether they are likely to require future expenditures, in which case some fiscal space will be needed in the future as well. For instance, budgetary room could be made available in a given budget year to finance a health clinic, where the initial spending has clear implications for subsequent spending on operations and maintenance that would require the availability of future budgetary resources. In practice, the idea is for higher expenditures to be sustained for a long period of time for programs which require additional fiscal space.

- It is necessary that any consideration of fiscal space must be made in the context of at least a medium-term expenditure framework that has a comprehensive perspective on the government’s expenditure priorities. If future funding is not guaranteed, then some initiatives could end up being under-funded or there could be need to cut back on other expenditure items. Thus, fiscal space should not be seen as a sector-specific issue, but it should be evaluated within a comprehensive and forward looking fiscal and budgetary framework. When applied to the health sector, the intention is to increase financial resources for health over the short to medium term in a way that is consistent with a country’s macroeconomic fundamentals such that the long-term solvency of the government and its economic potential is not jeopardized. It is also presumed that any increase in health spending does not crowd-out other priority sectors.
4.1 Method of Analysis

To assess whether there exit fiscal space for increasing expenditure, we analyze three key aspects.

a) **Whether it is possible to re-allocate resources across sectors.** This entails assessment of current spending patterns across sectors as well as a better understanding of the priorities, programmes and costs at the sector level, for which a detailed public expenditure review would be necessary. The idea here is to reallocate spending from sectors with lesser priorities to higher priority sectors and also from less effective to more productive programmes. This mechanism also allows for an opportunity to increase both operational and allocative efficiency. Operational efficiency could be improved by funding more effective programmes, whereas allocative efficiency could be strengthened by supporting the strategic prioritization of expenditure across policies, programmes and projects in line with government priorities.

b) **Whether there is room for increasing tax revenue in Kenya.** We look at two channels. First, tax revenue can be increased through the creation of new taxes, higher tax rates and/or improved administration or the broadening of the tax base. For Kenya, analysis of compliance levels can reveal whether there is room to increase tax revenue through improving tax administration. In addition, tax bases can be broadened by recruiting new taxpayers (especially the informal sector), incorporating additional taxable commodities (for instance, as suggested under the Value Added Tax Bill 2012) etc. Also, by relating the tax revenue to their tax bases, we can be able to decipher whether increases in the tax base have necessarily led to increases in tax revenue. Secondly, tax revenue can also be enhanced by increasing economic activity. We will assess the responsiveness of the tax revenue to the growth of the economy through estimation of tax buoyancy and tax elasticity.

We define tax elasticity as the responsiveness of revenue yields to movements in the tax base. Generally, the elasticity concept assumes the following functional relationship:
\[ T = \alpha B^\beta \varepsilon \]

Where \( T \) = tax revenue, \( B \) = Tax base, \( \alpha \) and \( \beta \) represent parameters to be estimated, and \( \varepsilon \) is the multiplicative error term. Taking logs, we obtain a log-linear specification of the form:

\[ \log T = \log \alpha + \beta \log B + \log \varepsilon \]

This equation can be presented in the following standard form:

\[ \log T_t = \alpha + \beta \log B_t + \mu_t \]

When using unadjusted revenue data, the coefficient \( \beta \) represents the tax buoyancy of the tax revenue to its base. To derive tax elasticities, there is need to adjust revenues by netting out the effects of discretionary measures that are aimed at changing the tax rate or tax base.

c) **Whether there is room for increased borrowing.** We will assess whether the country’s debt position is sustainable. Consider the government’s budget constraint:

\[ G_t - R_t + r_t B_{t-1} = \Delta B_t \]

Where:
- \( G_t \)is government expenditure (both recurrent and development)
- \( R_t \)is total revenue (includes tax revenue, non tax revenue and grants)
- \( B_t \) is public debt (domestic and foreign)
- \( r_t \) is real interest rate

Recent literature for testing sustainability of debt entails two approaches (Taye, 2011; Mahmood and Rauf, 2012). The first approach focuses on the flow of debt by examining how revenue and expenditure flows move together over time and the extent to which the movements exhibit some correlation. The idea is to assess whether revenue and expenditure are co-integrated i.e. whether revenue and
expenditure show close co-movements as a trend. If co-integrated, then their co-movements have a linear combination and converge to zero even though each variable behaves randomly. The co-integrating regression takes the following form:

\[ R_t = \alpha + \beta G_t + \varepsilon_t \]

The null hypothesis to be tested is whether \( \beta = 1 \) and \( \varepsilon_t \) is stationary. If the null hypothesis is not rejected, then public debt is said to be sustainable. Thus, the necessary and sufficient condition for debt sustainability is for government revenue and expenditures to be co-integrated. The second approach focuses on the stock of debt and hypothesizes that for debt to be sustainable, the discounted stock of debt should converge to zero.

5. Analysis of potential sources of fiscal space

5.1 Re-allocation of resources

It is acknowledged that the government has faced several challenges with regard to revenue shortfalls and mounting expenditure pressures (Budget Speech, 2013). Making a choice between competing objectives under tight fiscal position is necessary to ensure that scarce resources are directed towards priority areas and also to ensure more efficient service delivery. This has necessitated rationalization of expenditure through curtailing of less productive expenditures in a bid to create additional fiscal space. Some of the targeted expenditures for scrutiny to create fiscal space include: telephone & related expenses; domestic and foreign travel; contracted professional and technical services; purchase of vehicles; refurbishment of buildings; hospitality supplies and; training expenses, among others (Budget Policy Statement, 2013).

Spending on goods and services is one of the areas that contain scope for improving efficiency and thereby increasing fiscal space (Public Expenditure Review (PER), 2010). Attempts were made in the 2013/14 budget to reallocate expenditures from unjustified expenditures to more productive expenditures.
For instance, the Budget and Appropriations Committee report on the estimates of revenue and expenditure for the year 2013/14 suggested measures of reallocating expenditures that were not justified (such as some budgetary items for the National Treasury, transfers to Semi-Autonomous Agencies – SAGAs and the expenditure items listed in the paragraph above) to priority areas, including provision of housing for health centers. This highlights the importance of budget reforms initiated under the Public Financial Management Act (2012) and the Constitution (2010) which have strengthened the role of parliament and other stakeholders in the budget making process. This public scrutiny of the budgetary allocations ensures a more efficient allocation of resources.

While the non-discretionary expenditures account for an average of 27.5 percent of total government spending, it is important to allocate the remaining 75-80 percent of expenditure more effectively (PER, 2010). It is further noted that compensation of employees as a proportion of GDP in Kenya is higher (estimated at an average of 9 percent of GDP) than in the comparator countries (Egypt 7 percent; Mauritius 6 percent; Malaysia 5 percent). Efforts to lower further the average expenditure on compensation of employees would result in efficiency gains.

There have also been significant increases in the wage bill over time which was mainly due to an increase in absolute number of employees and also as a result of an increase in the average wage of civil servants. The PER (2010) further notes that about one third of employee compensation is paid in allowances, which are considerably high as compared to neighboring countries i.e. twice as much as allowance in Tanzania. The use of allowances can be a way of increasing civil service wages or compensation for working in unpopular areas.

Fiscal space can also be created by aligning available resources to the key sector priorities. As shown in figure 9, the central government has increasingly spent more on economic affairs, general public services and debt repayments while reducing the proportion of spending on social services. The government however acknowledges that infrastructure and social services are key priority areas of consideration for additional resources.
At sector level, reallocation of expenditure priorities within sectors can also result in additional fiscal space for financing unmet budgetary needs. This requires thorough efficiency studies of sectoral expenditure to identify more efficient expenditure priorities. Earlier findings on efficiency of spending in the health sector (PER, 2010) indicate that the comprehensive public resource envelope for health is predominantly allocated to preventative care which is likely to be more efficient than curative care. However, the budgeted central government expenditure on health is more skewed towards hospitals rather than primary health care and public health programmes. It is argued that it is more efficient to provide health care through primary care facilities rather than hospitals given that the cost of health care provision in hospitals is much higher than in primary health care facilities. Further, it was noted that the hiring freeze that has been aimed at limiting the public sector wage bill has been a major disadvantage to the health sector which is a labour intensive sector. To guide more efficient re-allocation of resources within the health sector, there is need for in-depth analysis of efficiency of expenditure.

5.2 Increased Tax Revenue Generation

As discussed in section 2.1, revenue collection has been below target over time, especially for Value Added Tax and Excise tax revenue. For VAT, the below target performance has mainly been attributed to lower tax compliance, especially in the use of the Electronic Tax Registers. In addition to lower tax compliance, there are also many small and medium sized entities, which are also largely informal, that do not file for VAT because they fall below the VAT threshold. Thus, attempts to impose a turnover tax on smaller entities will greatly complement VAT revenue collections.

In addition to imposing a turnover tax on small scale business and the large informal sector, proposals have been made to broaden the VAT base by imposing a standard tax rate on goods that were previously zero-rated or exempt. Table 2 provides a comparison between the VAT Act Cap 476 that has been in force and the proposed VAT Bill 2012.
## Table 2: Comparison between VAT Act Cap 476 and VAT Bill 2012

<table>
<thead>
<tr>
<th>Exempt Goods and services</th>
<th><strong>VAT Act Cap 476</strong></th>
<th><strong>VAT Bill 2012</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Goods</strong>:</td>
<td>Poultry, livestock (unprocessed meat and dairy), Fresh fish &amp; other sea foods, Fresh (unprocessed) agricultural foods, Petroleum products, currency, charcoal, military weapons, sanitary towels, raw skin and hides, cinematographic film, cereals and cereal flours.</td>
<td>Agricultural inputs; petroleum products; laboratory products; live animals; unprocessed milk; eggs; meat; fruits and nuts; machinery; cereals except corn, wheat, barley and rye; petroleum products.</td>
</tr>
<tr>
<td><strong>Services</strong>:</td>
<td>Exempt supplies include financial services, insurance, public education and training services, health (including veterinary) services, sanitary services, agricultural services, transport, burial and cremation, renting and leasing of land and housing, postal services, and social welfare services.</td>
<td>Exempt supplies include financial services, insurance, public education and training services, health (including veterinary) services, sanitary services, agricultural services, transport, burial and cremation, renting and leasing of land and housing, postal services, and social welfare services.</td>
</tr>
<tr>
<td>Zero rated goods and services</td>
<td><strong>Goods</strong>: Milk, rice, maize flour, agricultural inputs; Medicines and medical equipment; Kerosene and gas; Insecticides; Newspapers and journals; agricultural machinery and parts; generators, textile machinery and equipment, including parts; Ambulances;</td>
<td><strong>Goods</strong>: Medicines and medical supplies</td>
</tr>
</tbody>
</table>
Educational materials; Purchase of public transport vehicles.

**Services:** Exports; services in transit; supply of coffee and tea for export; supply of domestic electricity consumption (<200KW); airport services to transit aircraft; water drilling.

**Services:** Exports; international air transport; export processing zone supplies; treatment and supply of water; supply of coffee and tea for auction

Source: Compiled from VAT Act Cap 476 and VAT Bill 2012

**It is expected that more revenue will be collected as envisaged given that the VAT Bill proposes measures that considerably increase the VAT base.** Currently, the base is narrow because of exempting and zero-rating some goods and services. To gauge how much potential there is under VAT, we assess the relationship between VAT revenue collections and the VAT base, which in this case is the private final consumption. VAT has grown at a slower pace than the tax base (private final consumption) except between 2003 and 2005 and also in 2011. This is mainly because of two reasons. First, as discussed above, not all goods and services that are consumed attract VAT given that some goods and services are exempt or zero rated. Thus improving VAT performance would require a review of what proportion of private consumption of goods and services is taxable.

Figure 11: Nominal growth in VAT and private consumption
Secondly, VAT compliance has been low. From the graph, we can see that the gap between VAT and its tax base significantly narrowed between 2004 and 2005, which can be attributed to increased compliance resulting from the tax amnesty granted to taxpayers in 2004. Thus, measures to improve tax compliance would lead to higher VAT collections.

Figure 12: VAT revenue collections vis-à-vis the VAT revenue potential

Source: Own compilation

There is a big potential for increasing VAT revenue collections in Kenya. Figure 12 below shows a comparison between the VAT collections and the VAT potential. The VAT potential is derived by assuming that all goods and services are taxable at the standard rate of 16 percent, which implies that there are no goods and services that are exempt or zero rated. The VAT potential is then derived as the tax rate (in this case the standard tax rate of 16 percent) multiplied by the tax base (which is private final consumption). Thus, the VAT potential is the maximum amount of VAT that can be collected given the current level of private final consumption. We see a clear disparity between the VAT collections and the VAT potential, which has widened between 2005 and 2011, a clear indication of either reduced tax compliance or a reduction in the tax base following changes in tax policy.
This gap is expected to narrow down through an increase in VAT collections when the VAT tax base is expanded, mainly through reducing the number of goods and services that are exempt and zero rated as proposed in the VAT Bill 2012. However, it should be noted that attempts to increase VAT base should take into consideration the principle of equity as it is expected that implementation of the VAT Bill 2012 will make the VAT more regressive given that it introduces a standard rate of taxation on basic necessities that are largely consumed by the poor.

Figure 13: Growth in Cigarette Consumption and Excise Tax Revenue

Figure 14: Growth in Beer Consumption and Excise Tax Revenue

Excise tax revenues have also not grown in line with growth in consumption of excisable commodities. Figure 13 and 14 show the relationship between the growth in consumption of beer and cigarettes and their respective tax revenues. We see considerable increases in consumption of beer and cigarettes in 2003/04 which was not matched with an increase in excise tax revenue. This gap can largely be explained by the shift in taxation of excisable commodities from ad valorem to specific taxes in 2003/04. As earlier discussed, efforts to maximize excise tax revenue should consider shifting the excise taxation regime back to ad valorem taxes, which have largely been found to be more buoyant.
In addition to taxation of the informal and the small, micro and medium sectors mainly by revamping the turnover tax and review of the VAT law, the tax base is also expected to be increased through taxation of properties, especially the real estate sector. Property owners are to be identified through Geographical Information System (GIS) maps and also using information from utility companies and tenants.

There are considerable revenue generation gains that can be derived through re-introduction of the capital gains tax. The capital gains tax was abolished in mid 1980s to encourage investments in property and securities market. However, there has been tremendous growth in the property market and securities held at the Nairobi Stock Exchange. To broaden the tax base, the government should consider re-introducing the capital gains tax on capital gains from sale of properties and other marketable assets. This tax is applied in Uganda at 30 percent and in Tanzania at 20 percent (Parliamentary Budget Office, 2013).

There are also moves to enhance compliance through adoption of the personal identification number (PIN) as a common identifier, harmonization of KRA taxpayer information databases and imposition of stiff penalties for the non-registered taxpayers. KRA has sought to increase the range of transactions for which the PIN will be required as a means of increasing the potential for detection. The audit department is also expected to be strengthened to enhance compliance. Electronic Cargo Tracking System and cargo scanners will be used to increase compliance of excise and customs excise taxes.

In general, how well tax revenues perform also depends on the buoyancy of the tax system in relation to the growth of the economy. Our estimates of overall tax buoyancy indicate that tax revenue is not buoyant in the short run (with an estimate of 0.11) but it is buoyant in the long run (with an estimate of 1.26)\(^5\). Thus, we can deduce that revenue collections will not automatically increase in the short run.

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\(^5\) See Appendix for econometric results
following, for instance, growth of the economy. Therefore, efforts, especially those aimed at increasing compliance, should be targeted if revenue collections are to be increased in the short run. This can partly explain why we have seen impressive performance by PAYE due to its administrative ease. In addition, if taxes are not buoyant in the short run, then setting of revenue targets in the medium term should not necessarily be pegged on overall performance of the economy. Currently, the government estimates that a one percent growth in GDP would yield an increase in revenue of KShs. 8.6 billion per year, implying that a projected GDP growth rate of 5.9 percent in 2013/14 would yield an increase of about 50 billion in additional revenue (Budget Policy Statements, 2012 and 2013).

5.3 Increased Borrowing
The government can increase fiscal space through increased borrowing. The viability of this option depends on whether government debt is sustainable. As noted in the Budget Policy statement (2013), the government of Kenya acknowledges that pursuance of a sustainable debt level is important given the effect of key macroeconomic variables (stability of inflation, interest rates and exchange rates) on private sector participation in the economy through increased investment and employment creation.

Figure 15: Central Government Outstanding Debt (2004 – 2012)

Source: Economic survey (various issues)
A look at the central government’s debt trends shows that total debt more than doubled between 2004 and 2012, increasing from KShs. 694.8 billion in 2004 to about KShs. 1,517.7 billion by June 2012 (Figure 15). While the proportion of external debt declined from 64 percent in 2004 to 49 percent in 2012, the proportion of domestic debt increased from 36 percent to 51 percent over the same period.

Despite the increase in public debt, the Medium Term Fiscal Framework (2011/12 – 2015/16) as highlighted in the Budget Policy Statement (2013) indicates that the overall proportion of public debt to GDP is expected to reduce from 44.3 percent in June 2012 to about 41.7 percent in 2015/16. This is largely due to an anticipated increase in government revenue following enhanced tax administration and tax reform and also rationalization of expenditure.

Figure 16: Growth in government revenue and expenditure

As discussed in the study approach, an analysis of the relationship between revenue and expenditure would shed light on the sustainability of government debt. The analysis of growth in revenue and expenditure shows that the growth in expenditure has over time mirrored the growth in revenue, except for increased expenditure during election years (Figure 16).
Further analysis of the relationship between revenue and expenditure reveals that there exist a long run relationship between revenue and expenditure, which implies that public debt is sustainable. This implies that the government is in a position to increase borrowing as a means of creating additional fiscal space. This is in line with the findings by the International Monetary Fund (IMF, 2012) that showed that Kenya faces a low risk of external debt distress as all external public debt indicators were found to be below the relevant country-specific debt burden thresholds (for Kenya, a threshold of 40 percent of GDP and 150 percent of exports). The Net Present Value (NPV) of external debt as a percentage of GDP was found to largely remain stable at 17-19 percent range from 2011 to 2016 when using the baseline, but increased slightly to between 17 and 26 percent of GDP when considering shocks. In addition, the Net Present Value (NPV) of external debt as a percentage of exports was found to be in the 57 - 83 percent range from 2011 to 2016 for the baseline and 57 -90 percent range when considering shocks.

However, sustainability analysis of domestic public debt on the other hand showed that total public debt shows greater risk of unfavorable debt developments, especially under a shock to GDP growth, unchanged fiscal policy, or materialization of some contingent liabilities (IMF, 2012). Thus, sustainability of the public debt largely depends on macroeconomic performance and a prudent borrowing strategy. It is also argued that extension of the average maturity of debt to an average of 5.6 percent has significantly lowered the rollover risks of the domestic debt despite the relatively large size of the debt. Given these constraints, external concessional borrowing and grants is the most likely instrument that should be pursued to achieve the government’s fiscal objectives.

6. Implication of additional fiscal space for health sector financing under devolution

Following the implementation of the Constitution (2010) and the implementation of a devolved system of government, counties have been assigned roles, key of which are health sector functions. There have been
attempts to cost the functions that have been assigned to county governments as discussed in the Budget Policy Statement (2013) – Table 3. These costs include spending by ministries at county level, current transfers to local authorities such as the Local Authority Transfer Fund (LATF) and current transfers to constituencies such as the Constituency Development Fund (CDF).

Table 3: Cost of devolved functions by sector (KShs. Billion)

<table>
<thead>
<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>Agriculture &amp; Rural development</td>
<td>10.5</td>
<td>11.2</td>
<td>9.8</td>
<td>14.9</td>
<td>15.7</td>
<td>16.5</td>
</tr>
<tr>
<td>Education</td>
<td>0.4</td>
<td>0.4</td>
<td>1.6</td>
<td>1</td>
<td>1.1</td>
<td>1.1</td>
</tr>
<tr>
<td>Energy, Infrastructure and ICT</td>
<td>45.7</td>
<td>53.5</td>
<td>67.6</td>
<td>77</td>
<td>80.9</td>
<td>84.8</td>
</tr>
<tr>
<td>Environment, Water &amp; Sanitation</td>
<td>8</td>
<td>8.8</td>
<td>5.8</td>
<td>10.9</td>
<td>11.4</td>
<td>12</td>
</tr>
<tr>
<td>General Economic, Commercial, Labour Affairs</td>
<td>8.7</td>
<td>6</td>
<td>4.9</td>
<td>9.7</td>
<td>10.2</td>
<td>10.7</td>
</tr>
<tr>
<td>Governance, Justice, Law &amp; Order</td>
<td>0.3</td>
<td>0.3</td>
<td>0.5</td>
<td>0.5</td>
<td>0.6</td>
<td>0.6</td>
</tr>
<tr>
<td><strong>Health</strong></td>
<td><strong>21.8</strong></td>
<td><strong>31.4</strong></td>
<td><strong>53.9</strong></td>
<td><strong>47.7</strong></td>
<td><strong>50.2</strong></td>
<td><strong>52.5</strong></td>
</tr>
<tr>
<td>Public Administration &amp; International relations</td>
<td>14.9</td>
<td>17.6</td>
<td>22.3</td>
<td>25.3</td>
<td>26.6</td>
<td>27.8</td>
</tr>
<tr>
<td>Social Protection, Culture &amp; Recreation</td>
<td>6.2</td>
<td>10.1</td>
<td>7.7</td>
<td>11.2</td>
<td>11.8</td>
<td>12.4</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>116.5</strong></td>
<td><strong>139.3</strong></td>
<td><strong>174.1</strong></td>
<td><strong>198.2</strong></td>
<td><strong>208.5</strong></td>
<td><strong>218.4</strong></td>
</tr>
</tbody>
</table>

Source: Budget Policy Statement, 2013

In 2013, there are additional costs related to new administrative structures such as wages and salaries for county executive and county assembly and setting up of necessary infrastructure totaling to an addition KShs. 10 billion. This implies that the total cost of devolution is estimated to be KShs. 183.2 billion, representing 30 percent of audited revenue in 2012/13.

An assessment of the 2012/13 and 2013/14 budget shows that about 62 percent of the health sector resources were allocated to counties in 2012/13, as compared to 51 percent in 2013/14 (Table 4). This is projected to stabilize at
about 52 percent of total health sector central government spending. However, looking at the magnitude of the functions that the county governments have been allocated and the existing regional disparities in health, the 52 percent allocation seems inadequate.

Table 4: Projected budget for the Health sector (KShs. Billion)

<table>
<thead>
<tr>
<th></th>
<th>2012/13</th>
<th>2013/14</th>
<th>2014/15</th>
<th>2015/16</th>
<th>2013 MTEF</th>
</tr>
</thead>
<tbody>
<tr>
<td>National</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Of which transfer to public entities</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Counties</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Budget Policy Statement, 2013

As stated Budget and Appropriations Committee report on the estimates of revenue and expenditure for the year 2013/14, even though the county governments have been assigned the role of provision of health care, the transfer of this function has not been adequately matched with the required resources. The report also highlights several key priority areas that were not funded in the budget, key among them, provision of Anti Retro Viral drugs and vaccines, which was estimated to require KShs. 6 billion.

Further, while county governments have been mandated with the budgeting role, county sectoral priorities will largely be set by the respective county governments. It is therefore not guaranteed that the essential social services such as health would receive adequate funding to ensure efficient health service delivery at county level. It is noted that while costing of devolved functions followed the sectoral approach, this is not put into consideration while setting county budgetary priorities. For instance, while the cost of devolved health sector functions is estimated to be about 31 percent of the total cost of devolved functions in 2012/13 (Table 3), it is clear that most county governments have allocated smaller proportions of their budgetary spending towards the health sector. The question is whether there is need for the
national government to set clear guidelines and benchmarks for sectoral allocations in county budgets, which will ensure that essential services are delivered.

**In addition to the equitable budgetary transfers to counties, conditional and unconditional transfers to specific sectors can be developed to support the under-funded essential services sectors, which can be financed by the national government or development partners.** However, given that most of financing by development partners in the health sector has been off-budget, there is need to try and incorporate such funding into the budgetary system to ensure more efficient allocation of resources.

**Counties also have the potential to either raise their own revenue or borrow funds.** Counties can impose property taxes, entertainment taxes in addition to other taxes and user fees as stipulated by law. There is need to examine the potential of revenue collection in counties and examine mechanisms of increasing compliance, which was a major challenge in previous local authorities. Counties also have the right to borrow money but only with approval of the county government’s assembly and guarantee by the national government. To avoid county governments facing the same challenges of large accrued debts like the previous local authorities, there is need to ensure that relevant provisions that provide for financial credibility are adhered to. Of particular importance is the PFM Act (Article 142), which puts a limit on short term borrowing for cash management that is pegged at 5 percent of the most recent audited revenues, with a condition that it is repaid within a year.

**7. Conclusion**

Given the government’s rising expenditures and consistent revenue shortfalls, this study sought to assess whether there is an opportunity for increasing fiscal space to generate additional funding for unmet expenditure priorities. The study found that additional fiscal space can be generated through three key areas. First, additional revenue can be generated by broadening the tax base (through VAT reforms, taxation of SMEs, taxation of real estate sector, re-introduction of capital gains tax etc) and through enhancing tax
administration to enhance compliance. On the expenditure side, fiscal space can be created at the national level through reallocation of resources across sectors depending on sectoral priorities. This requires rationalization of expenditure through curtailing of less productive expenditures in a bid to create additional fiscal space. At sector specific level, efficiency studies should guide reallocation of resources towards more efficient sectoral priorities.

The report also notes that despite the health sector being a key priority sector for funding, the central government only accounts for about 30 percent of total sector spending. In addition, a large proportion of spending by development partners to the sector is off-budget, which poses challenges in creation of more efficient planning and budgeting systems at the sector level especially due to the unpredictability of the funds. With devolution, there has been costing of functions that have been assigned to the counties, especially health. Even though the county governments have been assigned the role of provision of health care, it is noted that the transfer of this function has not been adequately matched with the required resources. Further, while costing of devolved functions followed the sectoral approach, this is not put into consideration while setting county budgetary priorities. There is a danger of the health sector being under-funded at the county level, given the already existing regional disparities in access to health. This calls for sourcing of additional resources for counties through conditional/unconditional transfers from the central government and development partners and increased own revenue generation by counties to support under-funded essential social services such as health. In addition, to ensure efficient service delivery of essential services such as health, the national government could consider setting clear guidelines and benchmarks for sectoral allocations in county budgets, which will ensure that essential services are adequately budgeted for.
References


