REPUBLIC OF KENYA

PARLIAMENTARY SERVICE COMMISSION

Managing The Transition

Budget Options for 2012/13 and the Medium Term

Parliamentary Budget Office | March 2012

Disclaimer

The Parliamentary Budget Office (PBO) is a **Non-Partisan Professional Office** of the Kenya Parliament whose primary function is to provide timely and objective information and analysis concerning the national budget and economy.

Preamble

This is the third Budget Options Paper prepared by the Parliamentary Budget Office (PBO). Every financial year, the PBO prepares budget options to inform Parliamentarians and other stakeholders about the implications of various policy choices that the government is fronting. In doing so, this paper provides alternative policy options to trigger discussions on the budget proposals and to derive convergence towards a widely acceptable budget as well as economic proposals. This is also intended to assist policymakers in assessing the budget spending and taxation policies and their impact on the economy. The policy prescriptions are well anchored on the spirit of the constitution of Kenya and the Vision 2030 blueprint which seeks to transform Kenya into a newly industrialized middle-income country by the year 2030.

It has become a tradition that every year, just before Parliament interrogates the Budget Policy Statement and before the estimates of expenditure and revenue are finalized and submitted to Parliament, the Parliamentary Budget Office releases a paper titled *the Budget Options* for consideration by those involved in contributing to the policy choices and budget scenarios.

The 2012/13 budget sets forth an important turnaround as the country transits to a devolved system of Government and a new public finance architecture as provided in the new constitution. More specifically, key changes have been made in regard to the framework of Public Finance Management which includes; revenue raising powers, revenue allocation, budgets and spending, control of public money and financial offices.

There is no doubt that this reorientation comes with huge expected needs. The Government must take cognizance of the imminent expenditure pressures that unless checked, could lead to serious macroeconomic imbalances. The problem is further compounded by the uncertain global economic conditions as well as the internal shocks that that are likely to rock the Kenyan economy.

Based on these factors, PBO holds a pessimistic view of Kenya's economic growth. Growth is projected to reach 4.7% in 2011/12, 5.1% in 2012/13 and 5.5% in 2013/14. But this will only happen if we all recognize the need to ensure that there is a smooth transition from a centralized governance structure to a devolved structure.

Going forward, the 2012/13 budget must therefore be able to tackle the following trilemma situation, namely:-

(i) Maintaining macroeconomic stability amid internal and external shocks,
(ii) Identifying key sectors that support growth under the new governance structure, and
(iii) Tackling unemployment, which remains a major problem.

This paper attempts to shed light on the above mentioned issues. More specifically, it gives policy options that could be considered in the finalization of the 2012/13 budget and the medium term.

Acknowledgments

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List of Acronyms and Abbreviations

AICD	Africa Infrastructure Country Diagnostic
A.A	Appropriations in Aid
ARD	Agriculture and Rural Development
ASDS	Agriculture Sector Development Strategy
BROP	Budget Review and Outlook Paper
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CFS	Consolidated Fund Services
COMESA	Common Market for East and Southern Africa
CPI	Consumer Price Index
EAC	East African Community
ECF	Extended Credit Facility
EPAs	Economic Partnership Agreements
ESP	Economic Stimulus Programme
ETR	Electronic Tax Register
EU	European Union
FY	Financial Year
GDP	Gross Domestic Product
GIS	Geographic Information System
GNP	Gross National Product
GOK	Government of Kenya
GPRS	General Packet Radio Service
ICOR	Incremental Capital Output Ratio
ICT	Information Communication Technology
IMF	International Monetary Fund
KIE	Kenya Industrial Estates
KKV	Kazi Kwa Vijana
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
LATF	Local Authority Transfer Fund
MDGs	Millennium Development Goals
MENA	Middle East and Northern Africa
MTP	Medium Term Plan
ODA	Official Development Assistance
PAYE	Pay as You Earn
PBO	Parliamentary Budget Office
QEBR	Quarterly Economic and Budgetary Review
SAGAs	Semi Autonomous Government Agencies
SDR	Special Drawing Rights
SMEs	Small and Medium Enterprises
SSA	Sub Saharan Africa
TFGCF	Total Fixed Gross Capital Formation

ToT	Turnover Tax
US	United States of America
VAT	Value Added Tax
WTO	World Trade Organization

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EXECUTIVE SUMMARY

The year 2011 was tough for Kenya's economy on account of an unstable macroeconomic environment. Consequently, the provisional GDP growth rate for the year 2011 is expected to finally stand at about 4.4%. This is relatively lower compared to average growth rates of Sub Saharan Africa and East Africa Community which stand at 5.2% and 5.9% respectively.

Over the years, the country has experienced fluctuations in the GDP growth rate, reflecting the different economic situations and conditions facing the country at different periods. It is evident that consumption as opposed to investment, has contributed more to the country's GDP growth. Analysis of these two variables shows that while consumption has increased over the years, investment has been on the decline, recording negative trends from 1991-2002 before recording positive trends in 2004-2007. Consumption driven growth is an unreliable growth strategy as it is unpredictable and renders the economy vulnerable to external shocks*. **There is need therefore for a policy shift to ensure the economy moves from being consumption propelled to promoting investment.***

Kenya's physical capital has increased over the past years, with a significantly sharp rise between 2003 and 2007 but has stagnated since then. The decline in capital as a percentage of GDP reveals an interesting phenomenon concerning physical capital, that it is very sensitive to economic disturbances and therefore, ***policies to stimulate increase in capital stock should be formulated, adopted and well monitored.*** This is the case because physical capital contributes significantly to GDP growth.

In terms of human capital, the available workforce has grown steadily over the years. The growth of the workforce which stands at 3.4% annually is far above economic and output growths which stand at an average of 2.62% and 2.63% respectively. This implies that there is excess human capital which is not being optimally utilized. ***There is need therefore, to formulate policies which will ensure that the excess human capital is engaged in productive economic activity.***

Kenya has been experiencing inflationary pressure in recent times. Rising inflation contributors include ***shortage of food*** due to drought which led to importation of food at a time when global food prices were very high and a ***rise in world oil prices***. Kenya had also maintained a low interest rate regime for the past few years to stimulate economic growth, resulting in ***robust domestic demand which fuelled importation***. These factors among others witnessed inflation rising to a high of 19.7 percent in the month of November 2011. However, due to recent contractionary monetary policy, increased food production as a result of improved weather conditions and stability of oil prices, *inflation eased to 16.69% in February 2012 compared to 19.8% in November 2011*. Introduction of tight monetary stance has however had a negative impact on domestic demand and this is likely to slow down economic growth.

In 2011, the Kenyan currency continuously lost value against the world major currencies, most notably the US dollar, hitting a record low of Kshs.107 per US dollar in October 2011.This drastic depreciation was on account of a ***high import bill*** **(Current Account Deficit),** the ***Euro debt crisis*** and ***political instability in the Middle East and North Africa (MENA) region*** which resulted in high fuel prices. Delayed policy response worsened the situation.

The country's foreign reserves have been deteriorating and are currently below the statutory four months of import cover. As much as the government received an Extended Credit Facility from the IMF, the statutory four months of import cover has not been attained hence ***the need for urgent measures to boost foreign reserves and create certainty in the forex market.***

The world economic outlook for 2012 and 2013 remains uncertain with a possibility of another downturn. The debt crisis in the Euro zone and the persisting political instability in the Middle East and North Africa (MENA) region have had adverse effects on the Kenyan economy. If these trends persist, Kenya stands to lose out on the European export market and to incur a high import bill on account of rising oil prices. However the regional economic outlook shows an optimistic picture with a projected economic growth of 5.2 percent in 2011 and 5.8 percent in 2012 for SSA, 5.8 percent and 5.4 percent in 2011 and 2012 respectively for COMESA, and 5.9 percent in 2011 and 6.0 percent in 2012 for EAC. It is prudent that Kenya positions itself to take advantage of the stronger regional demand and to diversify its export portfolio so as to maximize its export earnings.

Macroeconomic projections underpinning the 2012/13 Financial Year and the medium term are premised on no change in policy. ***It is projected that this will result in economic growth rate of 4.9% in 2012, expanding to 5.2% in 2013***.The modest projection in 2012 is based on a number of factors, both internal and external, which are likely to weigh down on the 2012 economic outlook. Most notable is the ***impending general election***, ***unfavorable weather conditions***, the ***military operation in Somalia,*** the ***Euro zone debt Crisis*** and political ***instability in the MENA region.***

Medium term inflation outlook for Kenya is expected to improve due to a stable shilling, slower credit growth as well as growth in tourism and exports. However, notable challenges arise from unfavourable weather, inefficient food distribution mechanisms, investor pause due to the upcoming elections, security operations in Somalia among others that are likely to have an impact on price levels in the medium term. Based on this outlook, ***inflation is expected to revolve around 14.5% in 2012.***

Poverty remains a significant concern in the country as almost half of Kenya's population is considered to be poor. Economic growth has not trickled down to the poor, raising questions of inequitable wealth distribution. Measures should therefore be urgently put in place to reduce poverty and the 2012/13 budget should lead the way towards the attainment of this national goal. Proposed intervention measures include ***directing a relatively high percentage of government spending to acquisition of capital and setting the tone for decentralization of government spending by providing for ministerial budgets at both national and county level.***

There is need to create opportunities for idle capacity existing within the economy, both for the unemployed and for industries that operate below capacity to tackle poverty and unemployment. To sustain high economic growth, there is need to take into consideration ***the 4 I's of development (Investment, Infrastructure, Incentives & Institutions)*** and ***identify key sectors of the economy that have multiplier effect.***

I. **Investment** –It is important to invest in sectors which have a multiplier effect. There is need for radical policy in the agricultural and industrial sectors. Agro processing industry remains largely untapped, under resourced and hence almost contributing insignificantly in the broad agricultural sector. ***Investments efforts should be directed towards agribusiness, irrigation and information management to promote agro processing. Furthermore, selected dormant industries should be revitalized such as KICOMI in Kisumu.***

II. **Infrastructure**-The budget should focus on tackling the challenges of energy and transport which are severe. Kenya's power supply remains largely unreliable and costly considering that the country has traditionally relied on hydro electric power whose supply is largely dictated by weather conditions. Energy spending in 2012/13 should therefore focus on improving power supply. ***This calls for increased investment in renewable energy sources and geothermal development***. Of strategic importance to the country is ***revamping the railway transport network to*** enhance movement of freight across the East Africa region and enhance connectivity between Nairobi and its suburbs as well as major towns

III. ***Incentives-Reforms should be undertaken to make Kenya a preferred country of choice to foreign investors and also make domestic businesses more competitive.*** *The World Bank Doing Business Report 2012* shows that Kenya has dropped three positions within a year and currently ranks 109 out of 183 countries in terms of ease of doing business. Some of the reforms needed are: ***tax reforms, simplification of business registration procedures*** and ***reducing the backlog of judicial cases***. In order to boost trading patterns, there is need for a coordinated approach and revamping the country's commercial attaché abroad. This will help in building business linkages between large and small companies.

IV. **Institutions**-Credible institutions instill investor and public confidence, reduce red tape and give a sense of predictability. Functional administrative systems as well as clear cut policy directions will not only support economic development but also act as a catalyst for quick economic recovery and attainment of vision 2030 goals. Reforms in the Kenya's court system will give impetus for investor confidence and also reduce inertia with regard to tackling corruption. This implies continued support to the constitutional implementation process.

Consolidation of various government initiatives aimed at creating employment and reduction of poverty such as youth and women enterprise funds will make accessibility of funds easier and reduce administration costs. The funds should be disbursed based on ability to pay, capacity to borrow and linked to potential skills.

Kenya is a signatory to the Millennium Declaration and has focused its policies and development planning towards attainment of MDGs by 2015. Kenya's efforts have been spearheaded through a shift that focuses on policy setting for MDGs and MDG based planning. However, it is apparent that MDG 1 on poverty reduction, MDG 5 on improving maternal health and MDG 7 on ensuing environmental sustainability are unlikely to be met if current trends prevail.

The 2012/13 Budget will be under close scrutiny as **it facilitates a general election which transits the nation into a new structure of governance.** It is therefore expected to provide a delicate balance owing to the expected increase in expenditure. It is critical that the government strives to cut down on recurrent expenditure to avail resources for the anticipated extra costs.

Taxation remains the main source of government revenue accounting for 90% of state revenue. Revenue has exhibited an upward trend in the last decade, rising from a total of Kshs.192.3 billion in the FY 2000/01 to about Kshs.667.5 billion in the FY 2010/11 which translates to about 200% growth over the 10 year period. **PBO projects tax revenue to amount to Kshs.760.2 billion in 2011/12, lower than Treasury's projection of Kshs.787.6 billion as given in the Budget Review Outlook Paper (BROP)**. This will result in a shortfall of about Kshs.27.4 billion, a gap which can only be filled by **increased domestic borrowing or cutting down on non-priority expenditure.**

PBO further projects revenue yield in the coming fiscal year, 2012/13, to reach Kshs.872.4 billion. The drivers to revenue realization will include ***recovery in Value Added Tax*** and ***Excise duty from both local and import goods. Income taxes (PAYE and Corporate Taxes)*** are also expected to considerably edge upwards in line with the resilience of the Kenyan economy to maintain its GDP growth rate to average levels of between 5%- 6% into the medium term. Increased revenue performance in the medium term is crucial for the well being of the coming county governments. However, the ***operationalization of county governments is likely to enhance consumption propensity thus putting a lot of pressure on expenditure***.

The new constitution has resulted in an increase in expenditure which has resulted in a bulging budget. There is increasing pressure on the Government to increase tax collection. This translates to an increased burden on taxpayers. There is need therefore to unlock the country's revenue potential; which calls for broadening of the tax base driven by economic growth, increased employment and improved compliance. Best options include effective taxpayer education, efficient profiling of taxpayers and simplified tax laws.

The 2012/13 budget is indeed a transitional budget. It marks the end of the first phase of vision 2030, the final year of first medium term plan (2008-2012) and it will also be implemented over a period of shift from centralized to devolved government. In allocating revenue to the counties, it is important that the revenue allocation formula recognizes salient issues such as population, revenue raising capacity and level of development of the counties as well as equity.

Kenya is ***entering a defining time in its history in the next financial year*** and as such, the ***budget should be tailored with the idea of creating additional wealth through stimulating the existing capacity as well as managing the transition to avoid service delivery disruptions.***

Focus should be on priority sectors that have multiplier effect and more so taking into account the comparative advantage of different counties. The budget should be prepared in such a way that more resources are allocated to trade and industry, transport and agricultural sectors. The government should embark on a journey to reduce debt by enhancing revenue collection and rationalizing recurrent expenditure.

I. INTRODUCTION

1. **The 2012/13 Budget is being prepared in an exceptionally challenging environment, both internally and externally.** From the global front, the world economy is on the brink of another major downturn. Output growth slowed considerably in 2011 and anaemic growth is expected in 2012 and 2013. This has been driven by weak economic growth in many developed economies following the effects of the global financial crisis and the debt crisis in the US and the Euro zone. Growth in the US slowed down in 2011 and is expected to weaken further in 2012; a trend that is also expected in the Euro area. Given that the EU and the US form the two largest economies in the world, the risk of another global recession is very real.

2. Domestically, the implementation of the Constitution poses a great budgetary challenge. The operationalization of devolved governments and the many institutions set out in the constitution require a large outlay of resources. This, coupled with weak projected economic performance, calls for deliberate reorientation from 'business as usual' incremental budgeting to more innovative and efficiency oriented budgeting that includes reduction of non-core expenditure. This is indeed, a time to trim expenditures to the basic minimum.

3. **The 2012/13 budget must focus more on fiscal consolidation[1].** Recent studies have shown that the presence of fiscal rules – expenditure or budget balance rules – is associated with a greater probability of stabilizing debt. If fiscal rules are properly followed, they provide a useful yardstick to hold the Government accountable, thus creating the necessary fiscal space[2] in the event of a drastic fall in output.
4. **Processing the budget in the transition period is a major task ahead.** The Constitution has introduced changes in Kenya's public financial management architecture by providing for a shift from a highly centralized to a devolved framework of planning and budgeting. Under normal circumstances, the constitutional requirements imply that County Governments ought to implement their budgets as envisaged in Article 224 of the constitution. However, the following challenges lie ahead:
    a. Delays in determining administrative boundaries;
    b. Managing widespread public expectations with regard to specific allocation to counties;
    c. The challenge of county budget preparation given that county Governments are expected in place by mid financial year 2012 /13; and
    d. Legal impediments associated with enacting the requisite laws and regulations to make the county governments fully operational.

[1] Fiscal consolidation is a policy aimed at reducing government deficits and debt accumulation.
[2] Fiscal space can be defined as room in a government´s budget that allows it to provide resources for a desired purpose without jeopardizing the sustainability of its financial position or the stability of the economy.

II. ECONOMIC OUTLOOK AND PROSPECTS

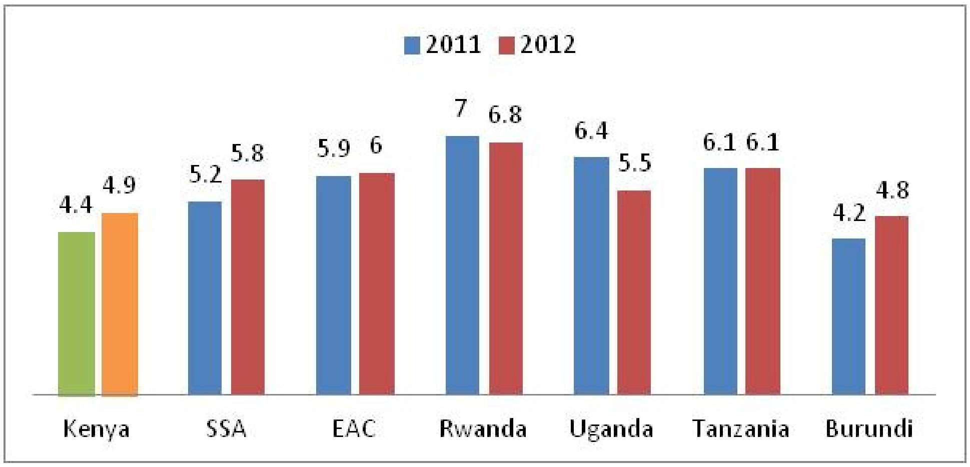
2.1.STATE OF THE KENYAN ECONOMY

i. Economic Growth

a) Demand Side

5. **The Kenyan economy experienced a tough year in 2011; characterized by severe internal and external shocks to the economy which upset the macroeconomic environment.** Consequently, the provisional economic growth for the year 2011 is a modest 4.4 percent. This growth is lower than the projected average growth rates[3] of 5.2 percent and 5.9 percent for Sub Saharan Africa and the East Africa Community respectively. Indeed, besides Burundi, the Kenyan economy is forecasted to grow at the slowest rate compared to other countries within the East African region (Figure 1).

Figure 1: Projected GDP Growth of EAC Countries in 2011 and 2012

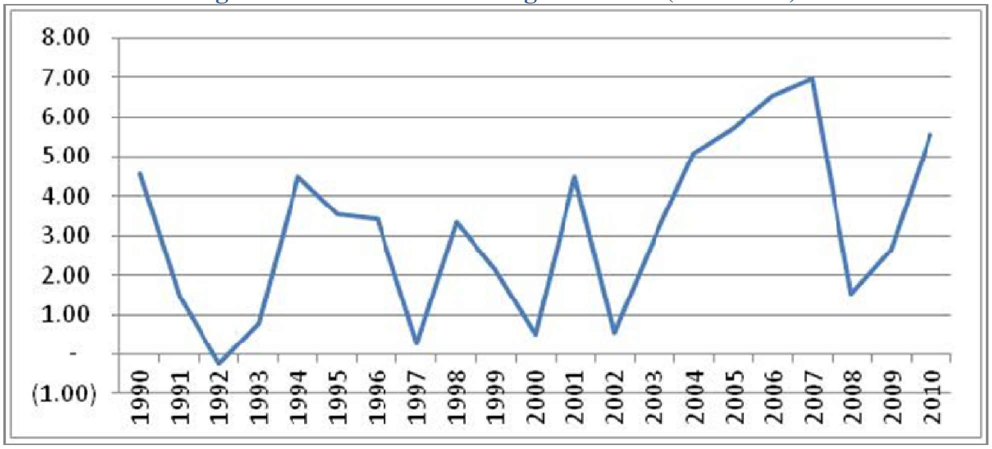


Source: Regional Economic Outlook, Sub-Saharan Africa, October 2011; and projections for Kenya

6. From a historical perspective, Kenya's real GDP growth has experienced fluctuations with various peaks and troughs typical of a business cycle. Figure 2 illustrates the trend in real GDP growth rate over time, from 1990 to 2010:

[3] IMF economic growth projections - Regional Economic Outlook, Sub-Saharan Africa, October 2011

Figure 2: Trend in real GDP growth rate (1990-2010)



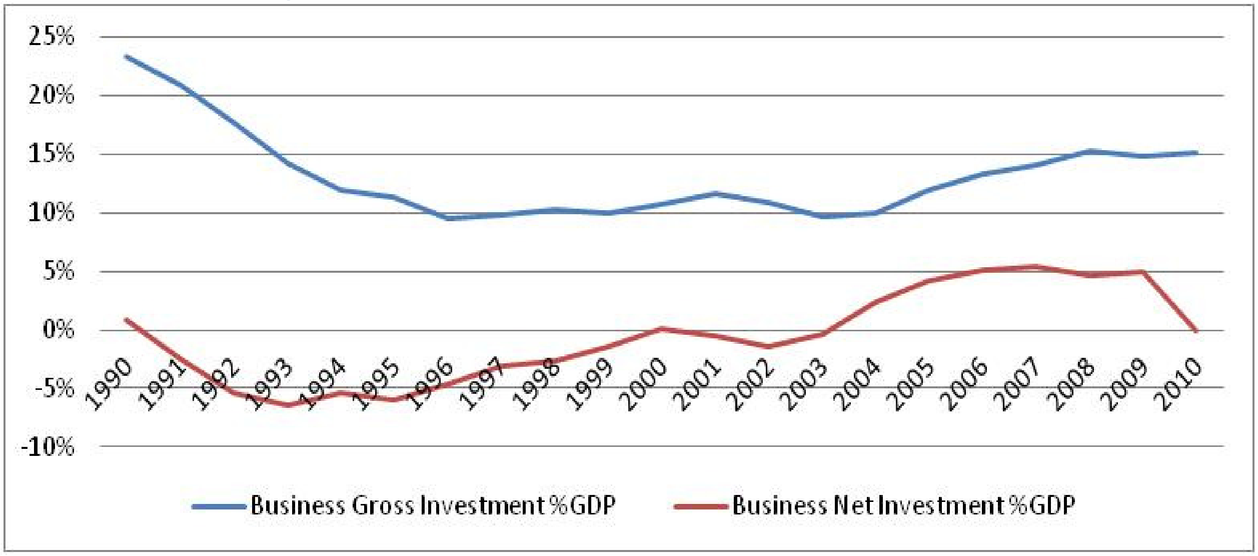
Data Source: Kenya Economic Survey (Various Issues)

7. **Kenya's economy is prone to negative political shocks during election periods as well as extreme weather conditions.** Results from figure 2 show that the slow growth periods comprise mostly the years during or immediately after a general election. Kenya's economy has also repeatedly suffered from the effects of severe drought in 1992 – 1994, 1999 – 2000 and 2008 - 2009 which probably explains the growth contraction during these years.

8. **The boom periods are mostly characterized by a macroeconomic environment conducive to economic growth, accompanied by improved weather conditions and political stability.** Growth acceleration in 1993 and 1994 is attributed to major economic reforms such as severe cutting of expenditure and liberalization of the exchange rate, favourable weather conditions and political stability. Tourism also performed exceptionally well during this period, accounting for 24 percent of export earnings in 1994. Growth in 1998 was boosted by good agricultural performance due to the El Nino rains in the first half of the year. Improved agricultural production also increased output in 2001. Performance of the economy between 2002 and 2007 is the best yet and can be attributed to a stable political and macroeconomic environment as well as policies conducive to growth.

9. **Private Consumption contributes significantly more to the country's GDP than investment.** A review of the shares of consumption and investment to GDP shows that as consumption increases, business investment has been on the decline, recording negative growth in 1991 – 2002 and positive growth as from 2004 to 2007 before declining slightly in 2008 and more significantly in 2010 (Figure 3). An uncertain business environment in the 1990s may have contributed to the decline in business investment. The gradual increase in business investment from 2003 to 2007 is perhaps due to the positive contribution of the Economic Recovery Strategy for Wealth and Employment Creation, a positive political environment with change in leadership as well as a positive change in the public's expectations, leading to increased investor confidence.

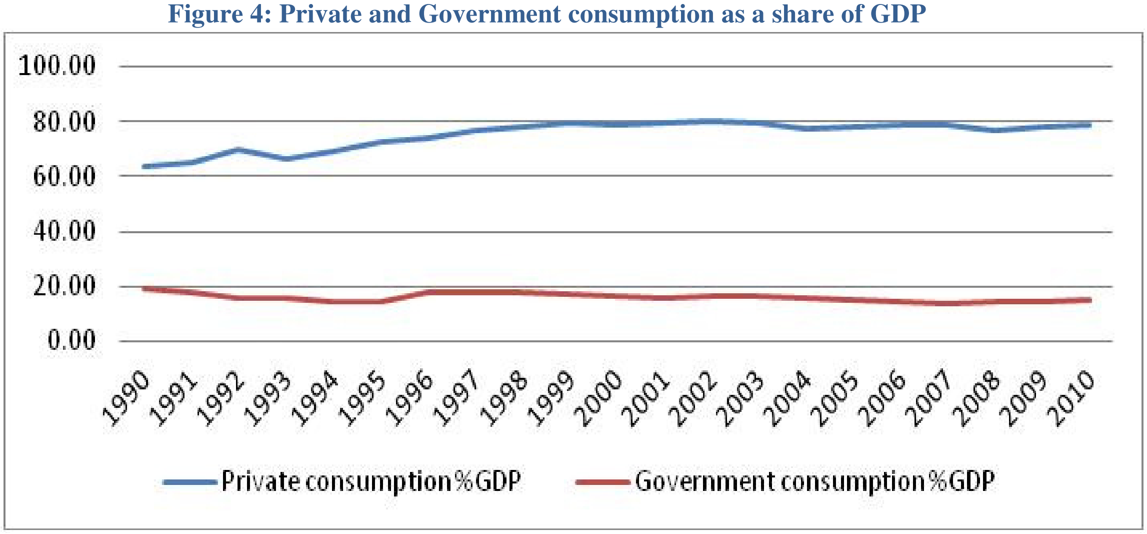
Figure 3: Business Gross and Net Investment as a share of GDP



Data Source: Kenya Economic Survey (Various Issues)

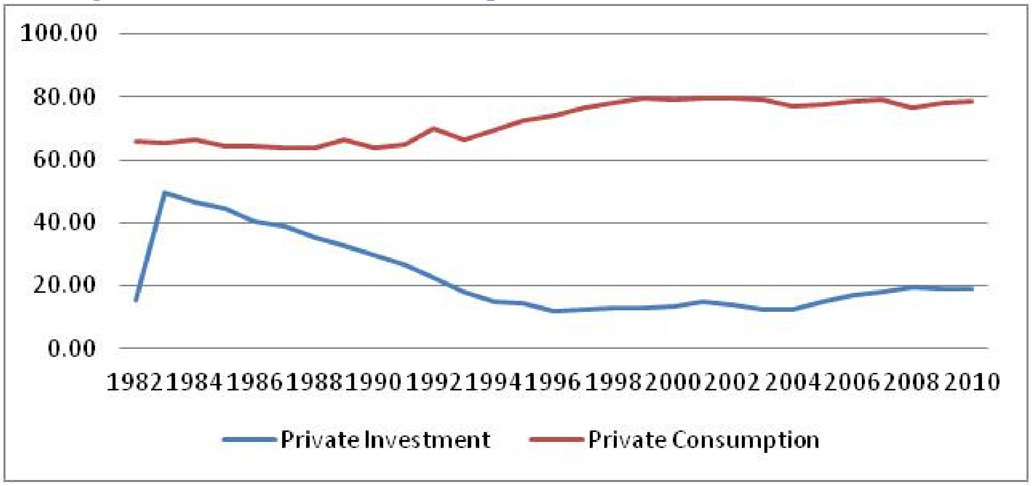
10. **Before the government tightened monetary policy in 2011, private sector credit growth, especially in personal loans was expanding rapidly. However, investment as a share of the GDP continued to perform dismally even as consumption increased.** Figure 4 and 5 illustrates the growth in private consumption, and private investment as a percentage of GDP.

Figure 4: Private and Government consumption as a share of GDP



Data Source: Kenya Economic Survey (Various Issues)

Figure 5: Growth in Private Consumption and Private Investment (% of GDP)



Data Source: Economic Survey (Various Issues)

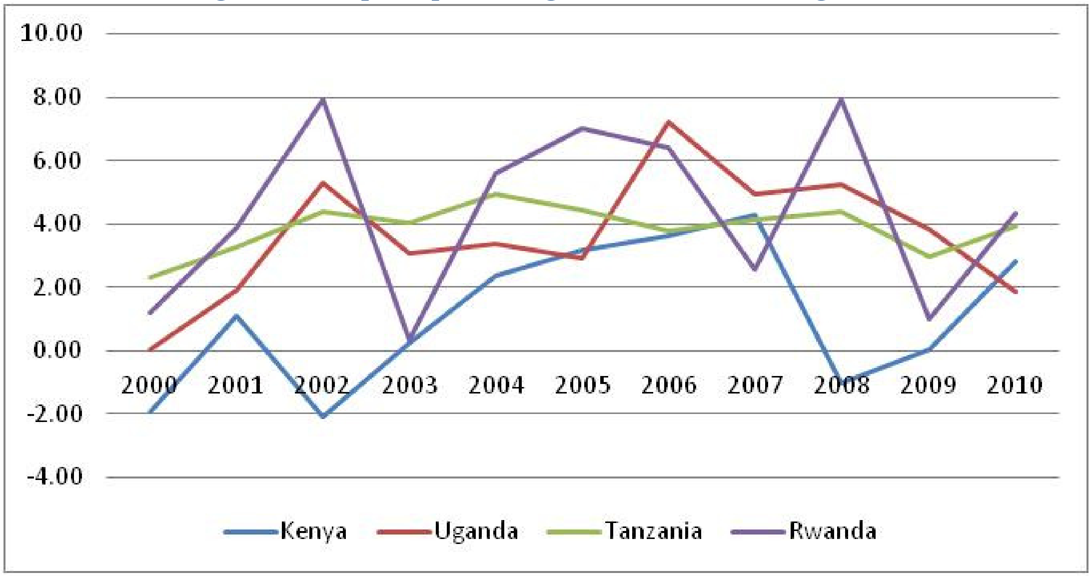
11. **Private investment as a share of GDP has been on a downward trend even as private consumption increases significantly.** This illustrates that economic growth in Kenya is consumption driven rather than investment driven and implies that the low interest rate regime did not promote investment and in fact, led to hyper consumerism in the country. This, to some extent, explains why the high growth rate is often unsustainable.

12. **The weakness of consumption driven growth is that it is not predictable and renders the economy vulnerable to external shocks.** Kenya relies heavily on a limited export portfolio which comprises mostly of horticultural produce. It also has a limited export market and therefore when there is a decrease in demand for its exports, the economy is adversely affected in terms of reduced foreign exchange inflows. However, given that Kenya is a net importer of commodities; increased consumption means that more funds are channelled outside as the country increases demand for imports. Thus the consumption driven growth has been a major cause of increased inflation, widening of the current account deficit and weakening of the shilling**. If economic growth is to be sustainable, there is need for the country to shift private and public spending from consumption to investment**. Thus policies that favour or create incentives for private investment should be encouraged.

13. **GDP per Capita**
    - **Kenya's GDP per capita depicts a low standard of living for the average Kenyan.** Figure 6 depicts that Kenya's GDP per capita has generally been lower compared to Uganda, Tanzania and Rwanda. Between 2000 and 2003, Kenya's per capita GDP was very low. From 2004 to 2007, per capita income increased with an increase in GDP growth. However, there was a sharp dip in 2008 followed by a gradual recovery in 2009 through 2010. Given the projected decline in GDP growth for 2011, per capita GDP is likely to decline at least in the medium term. This declining trend signifies that the economic growth experienced over the period is not able to meet the needs of the ever

increasing population. It is estimated that Kenya's population, currently estimated at 40 million, will continue to grow by more than one million people annually. If this population growth rate is not marched by a higher GDP growth rate, then the standards of living for the average Kenyan will continue to decline.

Figure 6: Real per capita GDP growth (annual % change)



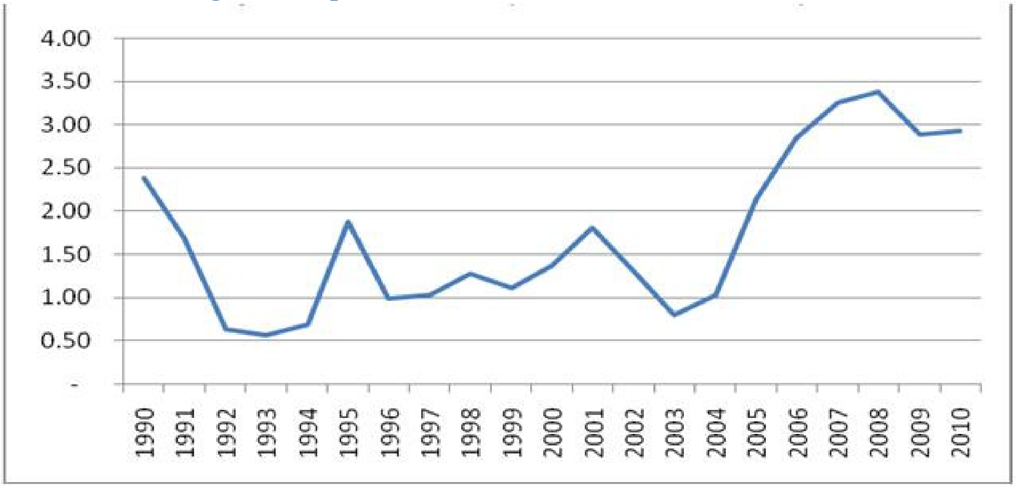
Data Source: World Bank

b) Supply side

14. The main aspects of economic growth from a supply side perspective are the capital available to the private sector (skilled workforce, plant and machinery), the workforce and the 'know how' present in terms of technology and regulatory framework within the country. Each of these aspects are highlighted below:

15. Physical capital (buildings machinery and equipment): Physical capital has been on the rise in Kenya in both absolute and real terms over the past 3 decades with a sharp rise between 2003 and 2007 but has largely stagnated since then.

Figure 7: Capital as a % of GDP (Contribution to GDP)

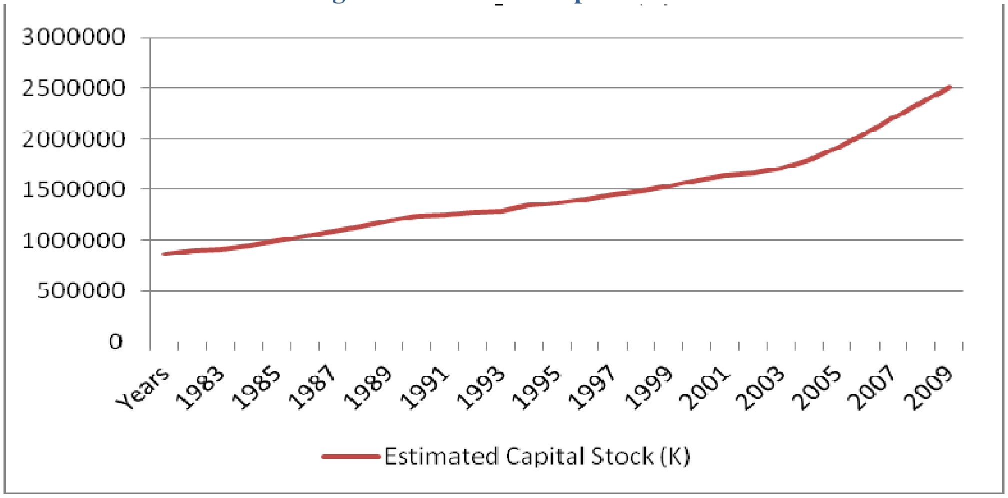


Source: Kenya Economic Survey (Various Issues)

16. This indicates that very low investment level in physical capital, which is critical to stimulating economic growth, contributed to suppressed economic growth that has been experienced since 2007. Periods of high economic growth, such as 1995, 1998, 2001 and 2003 – 2007 are denoted by an increase in capital as a percentage of GDP. The significant increase in capital from 2003 – 2007 is on account of expenditure reorientation towards fiscal and economic sectors. However, since 2008, physical capital has somehow dipped in terms of its contribution to GDP, from 3.4% to 2.9% of GDP. This decline indicates that physical capital in Kenya is very susceptible to economic shocks.

17. Policies to stimulate the increase in capital stock are imperative in Kenya and should be designed and embarked on as a priority. This is critical because physical capital is the highest contributor to GDP growth from a supply side perspective. Physical capital such as electricity transformers and solar electricity generators will enhance energy production. Construction of water storage facilities as well as a new port in Lamu will also go a long way in enhancing economic growth.

Figure 8: Estimated Capital Stock

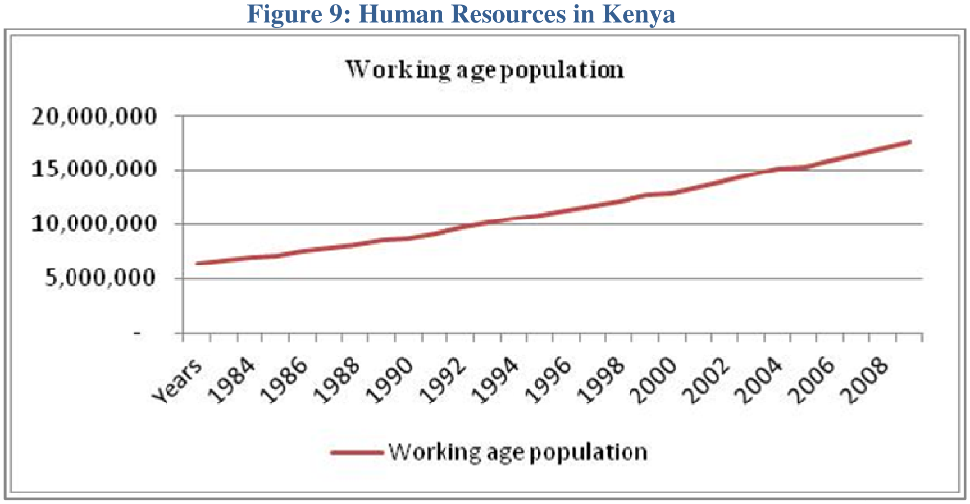


Source: Kenya Economic Survey (Various Issues)

18. Human Capital[4]

- Human capital can be assessed in two ways; first in terms of the available workforce (working age population) and secondly in terms of the actual part of the workforce that is engaged in gainful employment. The available workforce has grown steadily and systematically over the last three decades to approximately 18 million people in the year 2010. From the analysis, it is evident that the available workforce has grown by about 600,000 people per annum over the last 5 years and this translates to an annual percentage growth rate of around 3.4%. This is shown in figure 9:

Figure 9: Human Resources in Kenya



Source: Kenya Economic Survey (Various Issues)

[4] In this context, human capital refers to the labour force

- The growth in the workforce is well above both the economic and output growth[5] rates over the period which stood at an average of 2.62% and 2.63% respectively. This implies that the growth rate of the available labour exceeds the opportunities available to the country to utilize the available skills and there is therefore excess capacity of human capital that is not fully utilized. Policies to ensure full labour absorption are imperative in order to efficiently translate this stock of human capital into productivity and thereby ensure sustainable growth of the economy.

19. Total Factor Productivity

- Total factor productivity which incorporates technology and institutions has been volatile in the last three decades. Dips in total factor productivity are especially evident in 1992, 2002 and 2007 which were election years and this is symptomatic of what analysts and policy makers should anticipate in the future. This indicates high susceptibility of total factor productivity to exogenous shocks and it is more evident when compared with the contribution to GDP. GDP growth rate has been highly suppressed in the years in which total factor productivity experienced negative growth rates. This indicates that if policy makers are to ensure sustained and progressive growth in GDP, it is imperative that policies that support continuous growth of Total Factor Productivity are implemented.

Table 1: Contributions to Average GDP Growth in Kenya, 1982-2010 (Percentages)

	1982-2010	1982-1990	1991-2000	2001-2007	2008-2010
Average Growth	3.4	4.2	1.9	4.5	3.2
Total Factor Productivity	-0.1	-1.0	-0.2	1.7	-1.3
Capital	3.8	3.9	2.5	4.2	6.8
Employment	3.2	6.3	1.8	1.7	2.5
Working-age Population	3.7	3.8	3.9	3.4	3.1
Labour Force Participation	-0.5	1.7	-2.1	-1.7	-0.5
Employment Rate	0.9	1.5	1.1	0.8	2.2
Memo items:					
Gross Investment Rate	18.4	16.5	20.4	18.2	23.5

Source: Kenya Economic Survey (Various Issues)

20. Output gap[6]

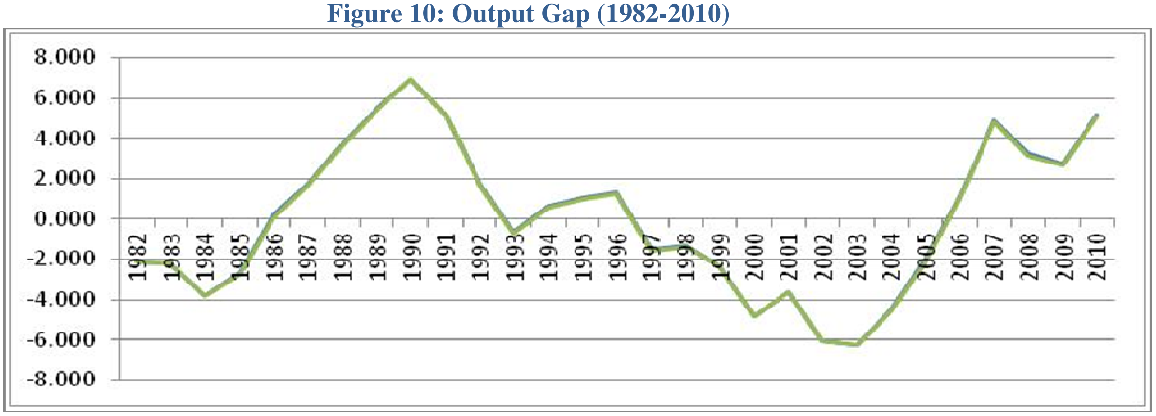
- The output gap measures the health of the economy by indicating whether the three indicators mentioned above, i.e. capital, employment and total factor productivity, are efficiently employed in the country. It is also important in measuring whether the

[5]Output growth refers to an increase in what the economy produces. The Output growth rate reflects the change in level of production on a year to year basis. It shows if the economy is growing or declining.
[6] Output gap is the difference between potential GDP and actual GDP or actual output

economy is actually operating at optimal level, below optimum which indicates excess capacity or above optimum which is an indicator of the economy 'overheating'[7].

- The positive output gap in 2010 is due to the 2009 Economic Stimulus Programme (ESP) that contributed to a significant increase in aggregate demand. Furthermore, funds under the *Kazi Kwa Vijana* programme were accompanied by manual, labour intensive jobs that were not economically productive. It is important for policy makers to be wary of a high positive output gap as the one experienced in recent years since it causes overheating of the economy. This is harmful because it means that the economy is growing at a rate that cannot be supported by the infrastructure and resources available in the economy. This normally results in high inflation which may take long in re-adjusting even when the output gap stabilizes.

Figure 10: Output Gap (1982-2010)



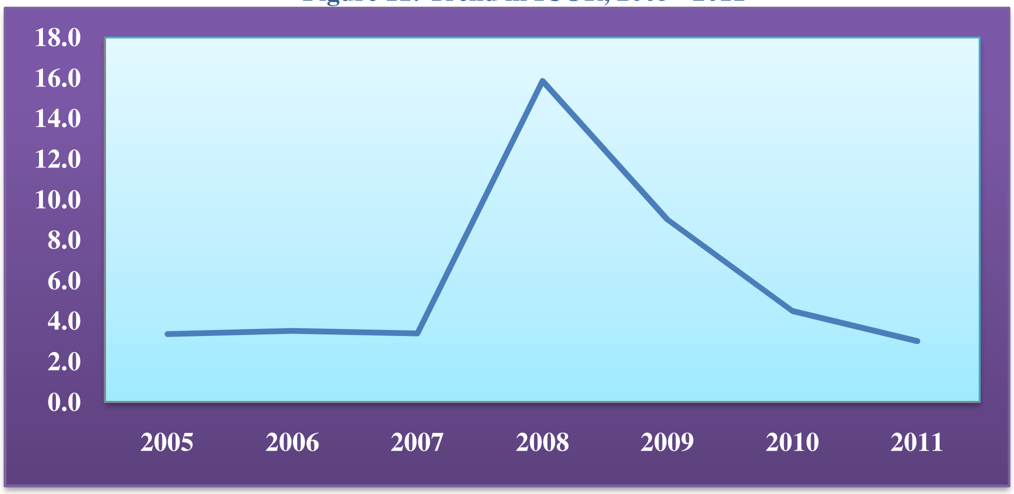
Source: Kenya Economic Survey (Various Issues)

21. Incremental Capital Output Ratio (ICOR)

- The Incremental Capital Output Ratio (ICOR) is a measure of the proportion of investment that contributes to the growth of the economy. It determines the amount of investment required to produce an additional unit of capital. The ICOR is an important measure as it determines the effectiveness of a country in utilizing the available capital. A low value of ICOR is indicative of effective use of capital whereas a rising ratio indicates declining efficiency.

[7] Overheating of the economy occurs when a country's economic growth exceeds its production capacity. The growth rate therefore becomes unsustainable, leading to inflation

Figure 11: Trend in ICOR, 2005 - 2011



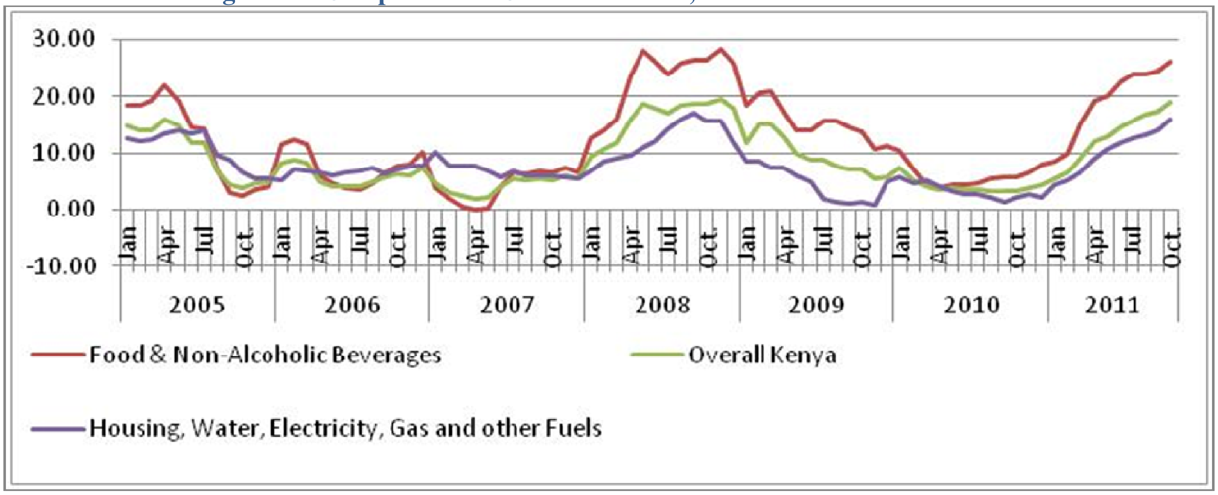
Source: Kenya Economic Survey (Various Issues)

- Kenya's ICOR oscillated between 3.3 and 3.5 between 2005 and 2007, before jumping to 15.8 in 2008, reflecting declining efficiency in utilization of capital during that year owing the spill over effects of post election violence. This has declined to an estimated 3.0 percent in 2011, denoting an improvement in the country's utilization of capital.

ii. Inflation

22. **Food shortage in the country has led to an escalation in food prices, and rising inflationary pressures.** Kenya has been facing periods of drought and unreliable rainfall for a number of years which affects food supply given that agriculture in Kenya is largely rain fed. The persistent drought which has ravaged the East African region since 2009 resulted in acute food shortages, necessitating the importation of food at a time when global food prices had soared. Food and non-alcoholic beverages contribute as high as 36.04% of the Kenyan CPI basket. As a result, food inflation has always had a substantial impact on overall inflation in Kenya over the years as depicted in figure 12 below.

Figure 12: Comparison of Overall inflation, food and fuel inflation



Data Source: Kenya Economic Survey (Various Sources)

23. **Other factors which contributed to the rising inflation include the rise in world crude oil prices. Crude oil prices have stayed above $100 per barrel since February 2011.** This has been attributed to the increase in demand for fuel by emerging economies like China and India, as well as political unrest in the MENA states which disrupted oil supply. Petroleum fuel accounts for 28.57% of the total final energy consumed in Kenya and is also a major input in the production and running of most of the sectors in the economy. Thus, the increase in international oil prices had a contagion effect on the Kenyan economy via imported inflation.

24. **The government's inflation target was 5 percent, but this has since been revised to 9 percent late last year to reflect the prevailing macroeconomic challenges.** Inflation targeting is typically carried out to ensure price stability in the economy. If inflation levels move significantly above the target, the government responds through tightening of monetary policy. Achievement of the targeted inflation level has however not been easy due to the Kenya Shilling's susceptibility to economic shocks; both internal and external.

25. Due to a tight monetary stance, increased food production and stability of fuel prices, Inflation which had risen to 19.8 percent in November 2011 eased downwards. The CPI decreased by 0.04 percentage points from 130.82 in January 2012 to 130.76 in February 2012 with the overall inflation rate standing at **16.69 per cent** in February 2012. Going forward, it is expected that inflation will ease downwards but then go up due to high food and electricity prices as the rains are predicted to be below normal this year.

iii. Developments in Other Macroeconomic Variables

a) The Exchange rate

26. **For the better part of 2011, the Kenyan shilling was on a free fall against major currencies especially the US dollar hitting record lows of Kshs.107 in October 2011, its worst performance ever in history.** The depreciation of the shilling was brought about by a number of factors; a huge import bill, the Euro Zone debt crisis, decreased investor confidence, political instability in the Middle East North Africa (MENA) region and skyrocketing fuel prices which put pressure on the country's Balance of Payments. Delayed monetary response also contributed to the exchange rate depreciation as the low interest rates may have encouraged financial arbitrage against the Shilling.

27. **The increased demand for foreign currency to fund the importation of food and fuel among other commodities at a time when international commodity prices were quite high weakened the shilling further against major currencies.** The persistent drought which has plagued Kenya since 2009 caused reduction in food reserves and forced the country to import food commodities. The increase in global oil prices brought about by instability in the MENA region worsened the situation further as the import bill increased significantly, thereby increasing the demand for foreign currency.

28. **The Euro zone's debt crisis also caused jitters in the financial market and led to uncertainty as some traders may have switched from the Euro to the dollar which was viewed as a more stable currency.** This increased the demand for dollars, weakening other currencies. The uncertainty in the financial market may have also caused some investors to play safe by selling their securities to buy dollars or evading risk by investing into the bonds market which is more secured. This contributed to the under performance of the securities market.

29. The Central Bank of Kenya increased the Central Bank Rate to the prevailing 18 percent. This has enabled the shilling to gain considerably against the dollar. The indicative mean exchange rates as at mid March 2012 stood at Kshs.82.26 against the dollar. The challenge is to maintain the current level of exchange rate amid uncertainty both internally and on the external front.

b) Interest rates

30. **Kenya has previously maintained a low interest rate regime to stimulate growth in the economy.** After the post election violence of 2008 and later following the global recession, the country's private domestic demand slowed down significantly, prompting the government to adopt an expansionary monetary and fiscal stance in order to stimulate growth to the economy. In this regard, the Central Bank Rate, which signals the government's monetary stance, was reduced significantly from an average of 8.85 percent in 2008 to 5.75

percent as at January 2011. As a result, private sector credit growth rose tremendously and domestic credit to private sector as a percentage of GDP increased from 29.9 percent in 2008 to 36 percent as at September 2011. The government also rolled out a massive Economic Stimulus Package in 2008/2009 which was extended up to 2010/2011 fiscal year; including the *Kazi Kwa Vijana* Programme which was aimed at engaging unemployed youth in manual work within their communities.

31. **The robust demand growth however, gave rise to inflationary pressures**, prompting the adjustment of the Central Bank Rate (CBR) upwards to 7.00 percent in September 2011, 11.00 percent in October 2011, 16.50 percent in November 2011 and 18.00 percent in December 2011.

32. **The tight monetary stance was geared towards taming inflation, however, the response of the lending rates to inflation which is slowly trending downwards, remains to be seen.** It is important to note the prices are sticky (the lag effect) and therefore, the lower interest regime may take time to be a reality. Obviously, this will have negative effect on domestic demand leading to dampened economic activity. To this end, there is need for deliberate measures (including moral persuasion) to ensure that financial institutions adjust the lending rates in line with the movement of inflation.

Table 2: prevailing interest rates

Rate	Percentage	Date
Central Bank Rate	18.00	01 Feb 2012
T-Bills (91)	17.98	12 Mar 2012
T-Bills (182)	18.11	19 Mar 2012
T-Bills (364)	17.04	12 Mar 2012
Interbank Rate	26.76	13 Mar 2012
CBK Discount Window	24.00	02 Dec 2011
REPO[8]	13.10	10 Feb 2012
Horizontal REPO	27.69	9 Mar 2012

Source: Central Bank of Kenya

c) External Position

33. To determine whether a country's economic position is sustainable or not requires an assessment of the country's net asset position, balance of payment flows, real exchange rate, and the expected evolution of these variables over the medium term under a set of policy parameters.

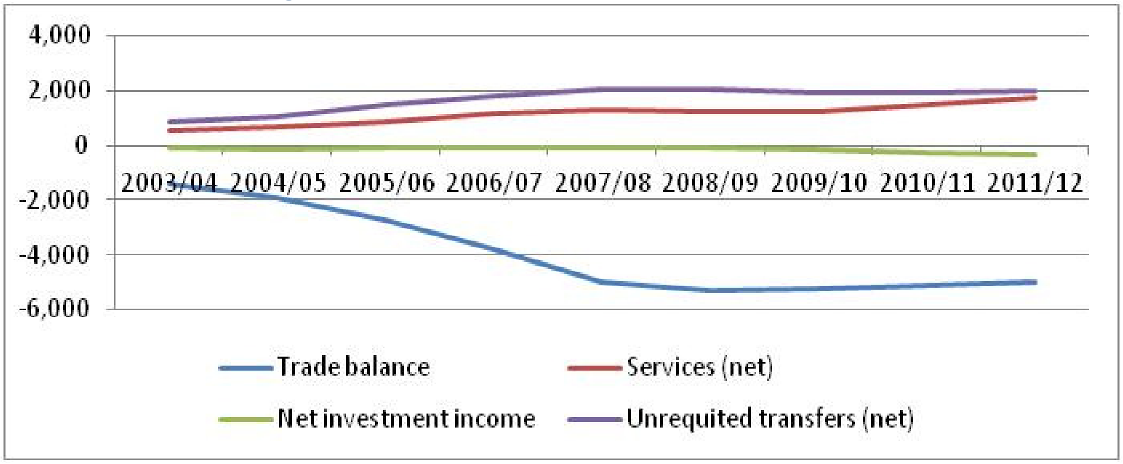
34. Key issues affecting external sustainability include balance sheets of government, firms and household, current account adjustments in respect to exchange rate changes and output

[8] REPO means Repurchase agreement which is a contract in which the seller of securities agrees to buy them back at a specified time and price

levels, sensitivity of capital flows to domestic and international developments; and adequacy of international reserves.

35. Figure 13 below shows the trend in the movement of Kenya's current account balance from 2003/04 to 2011/12.

Figure 13: Movement of the current account balance

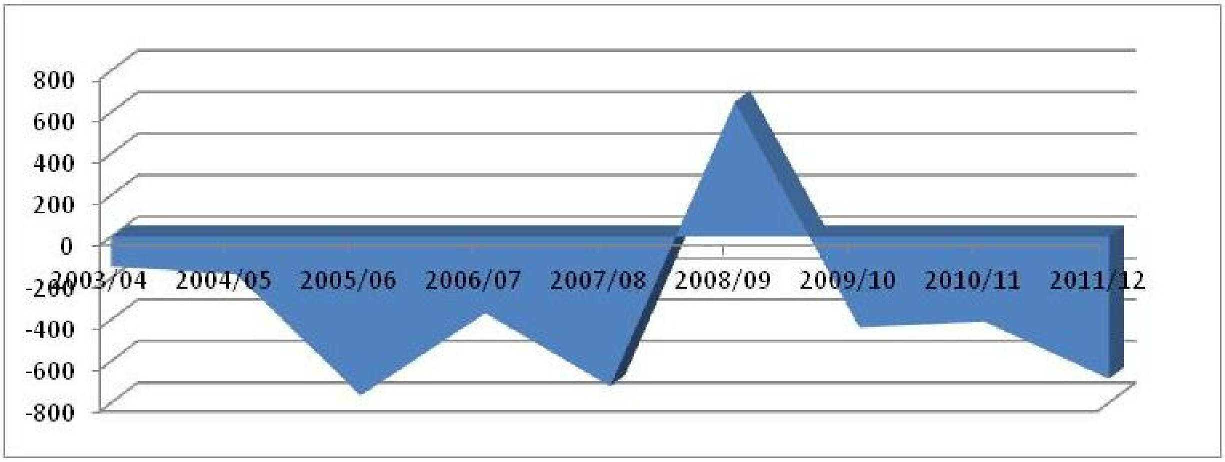


Source: Kenya Economic Survey (Various Issues)

36. The results show that the key driving factor for the widening of the current account is the trade balance, which measures the difference between exports and imports. In the recent past, the increase in fuel prices as well as the persistent drought which necessitated the importation of food at a time when import prices were high significantly increased the import bill. However, even as the import bill increased, there was no significant increase in export growth as Kenya's trading partners, notably the Euro Zone, were also experiencing economic turmoil. It is important to note that over the fourth quarter of 2011, the quantity of exports have been on the downward trend with products such as coffee registering a decrease in quantity from 3,317 Metric Tonnes in September 2011 to 1,989.9 Metric Tonnes in December 2011. Indeed, the value of total exports declined from 46.27 billion in August 2011 to 44.53 billion in December 2011 even as the value of imports stood at 123.32 billion as at December 2011.[9] As a result, the export earnings could not pay for the imports and the current account balance was largely financed by drawing down foreign exchange reserves; a situation that brought about the weakening of the shilling and a continued widening of the current account deficit. Figure 14 shows the trend in Kenya's foreign exchange reserve position.

[9] Leading Economic Indicators - December 2011, Kenya National Bureau of Statistics

Figure 14: Change in Reserve Position



Source: Kenya Economic Survey (Various Issues)

37. As it stands right now, the country's foreign exchange reserve is below the statutory 4 months of import cover. In the week ending March 8, 2012, the usable official foreign exchange reserves held by the Central Bank amounted to US Dollar 4,181 million (equivalent to 3.68 months of imports). Though the government has boosted the reserves by securing the Extended Credit Facility from the IMF, it is still barely able to meet the statutory requirement. Boosting the foreign exchange reserves is an urgent measure that the government should undertake as it will create certainty in the forex market, thereby reducing speculative tendencies among players. It is important therefore for the country to diversify its export portfolio as well as export markets and enhance quality of manufactured products so as to boost its export earnings. Aggressive promotion of Kenya on the global platform as a key tourism destination is likely to increase tourism inflows while a stable political and macroeconomic environment will encourage foreign direct investment.

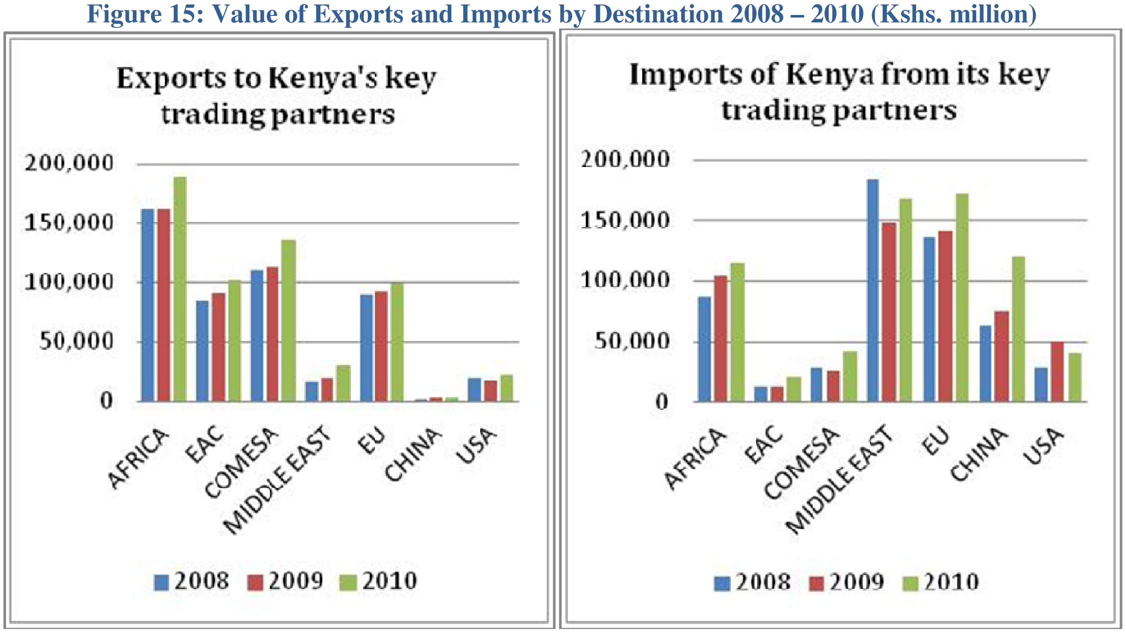
2.2.GLOBAL ECONOMIC PROSPECTS AND ITS IMPACT ON THE KENYAN ECONOMY

38. The world economic outlook for 2012 and 2013 remains bleak with the grim possibility of another economic downturn. The global economic recovery has been weaker than expected; a situation that has been attributed to a weak global aggregate demand due to high unemployment rates and stagnating incomes. More specifically, the sovereign debt crisis in the Euro Zone continues and has caused uncertainty in the financial markets. This crisis has had a negative effect of reduced foreign direct investment in Kenya by developed countries as their focus on strengthening their financial position. Political instability in the Middle East and North Africa (MENA) region has had adverse effects on Kenya's economy in terms of increased fuel prices.

39. The regional economic outlook paints an optimistic picture for the Sub-Saharan economy with a projected growth of 5.3 percent in 2011 and 5.8 percent in 2012. On the other hand, the economic growth in EAC is projected to average 5.9 percent in 2011 and 6.0 percent in 2012. The driving factor for the robust growth is the strong domestic demand as well as the high commodity prices. It is imperative that Kenya positions itself well to tap on the envisaged stronger regional demand through increased trade (Annex 1 provides details on the macroeconomic outlook of Kenya's key trading partners in Sub-Saharan Africa).

40. The bulk of Kenya's exports are consumed in Africa, especially within the COMESA region and the East Africa Community. Beyond Sub-Saharan Africa, Europe is Kenya's most important trading partner accounting for the largest share of Kenya's exports outside Africa. The Middle East and USA also consume a sizeable amount of Kenyan exports while very little is exported to China (Figure 15). The government through bilateral agreements should find ways of exploring new frontiers such as Far East and Latin America.

Figure 15: Value of Exports and Imports by Destination 2008 – 2010 (Kshs. million)



Source: Kenya Economic Survey 2011

41. Kenya's exports base is mainly dominated by agricultural products. This, as well as low growth of manufactured exports, explain Kenya's poor performance in world trade, which has resulted in the worsening current account balance. Thus, diversification in the composition of Kenya's export structure is essential if national development efforts in the long-run are to have a better chance of success. **Policy makers must put in place deliberate efforts to spur the processing and manufacturing sector by adopting a balanced strategy of import substitution and export promotion goals. There is also a need for policy focus on service sector since Kenya has a highly skilled man-power that can offer her a competitive advantage in services such as ICT (Business Process Outsourcing) and financial services (banking and insurance).**

2.3.ECONOMIC GROWTH PROJECTIONS AND RISKS TO GROWTH

42. This section gives the macroeconomic projections underpinning the 2012/13 financial year and the medium term with the assumption of **no change in policy**.

a) Economic Growth

43. **It is envisaged that the Kenyan economy will achieve a growth rate of 4.9 percent in 2012, before expanding to 5.2 percent in 2013 on account of the envisaged investment in the counties**. The modest growth projection in 2012 is on account of a number of factors which appear to weigh down on the 2012 economic outlook. The risks to growth are both internal and external. Internally, the country is likely to face significant headwinds from the upcoming general election, forecasted poor weather conditions and fiscal pressures arising from among others, the military incursion in Somalia. Externally, the risk of a worsening of the Euro Zone crisis will adversely impact Kenya in terms of reduced export earnings and decreased financial inflows into the country. More specifically, the pessimistic forecast for 2012 is underpinned by the following reasons:

i. **Kenya's vulnerability to political shocks during the election period:** A review of Kenya's real GDP growth trend shows that the slow growth periods comprise mostly the years during or immediately after a general election. Given that 2012 is an election year and looking at the historical trend, it is highly likely that growth will contract during this period. The misfortune of election years is that investors take a cautious approach to the economy, preferring to adopt a 'wait-and-see attitude' due to uncertainty surrounding the political environment.

ii. **Poor weather conditions:** The tea sector has suffered a significant setback due to severe frost that affected most key tea growing areas which has destroyed tea worth billions of shillings. The frost which has been termed as the worst ever to hit the country is forecast to persist at least in the near future. Given that tea is one of the country's key foreign exchange earners, this is likely to have an adverse impact on foreign exchange earnings. Furthermore, Kenya's economy has repeatedly suffered from the effects of severe drought as food prices escalate and millions face starvation. According to the Kenya meteorological department, depressed and poorly distributed rainfall is expected in 2012 over most parts of the country during the long rains season which covers the months of March, April and May. The western highlands, Lake Basin and central Rift Valley are expected to receive enhanced rainfall whereas the central highlands including Nairobi area, North-Eastern and South-Eastern are expected to receive depressed rainfall. This is likely to adversely affect the agricultural areas within the Central, South Eastern and Coastal Kenya, resulting in food shortages.

iii. **Kenya's military incursion in Somalia:** The cost of maintaining security operations in another country is very high. The military operation in Somalia is likely to consume a significant amount of resources and may bring about fiscal pressures, straining an already constrained budget.

iv. **Uncertainty in the Euro Zone:** The Euro Zone debt crisis has caused jitters in the global financial markets and the prolonged uncertainty has had a negative impact on Kenya's financial market. The European Union has a grim projected economic outlook for both 2011 and 2012. Traditionally, Kenya has relied mainly on the European market as the one of the favoured export destination. It follows therefore that any volatilities in this market significantly affect Kenya's trade in terms of reduced exports earnings. If the growth weakens further and curtails demand, the Kenyan economy will suffer due to weakened export and growth prospects.

v. **The Middle East Factor:** Instability in the MENA region has continued to have a negative impact on international oil prices. Though the oil prices appear to have stabilized, the situation remains fragile and a deterioration of the situation could affect oil supply and easily lead to skyrocketing oil prices. Furthermore, should the Iranian threat to close the Strait of Hormuz due to EU sanctions[10] materialize, it will adversely affect oil supply and increase oil prices. A surge in oil prices will also exert pressure on the country's external position.

b) Inflation Outlook

44. The overall rate of inflation stood at 16.69 percent in February 2012, down from 18.3 percent in January 2012. This drop is attributable to lower fuel prices, increased food production, a stronger shilling and tight monetary policy as well as the Extended Credit Facility from the IMF which buffered the country's forex reserves.

45. The medium term outlook for Kenya is favourable on account of:

- A stable shilling due to the Extended Credit Facility from the IMF and slower credit growth due to high interest rates, which will aid in lowering inflation;
- Good economic performance in the regional economy providing support to agricultural, manufacturing (exports) and tourism sectors; and
- Investor confidence as a result of implementation of the new constitution.

46. However, there are considerable headwinds from:

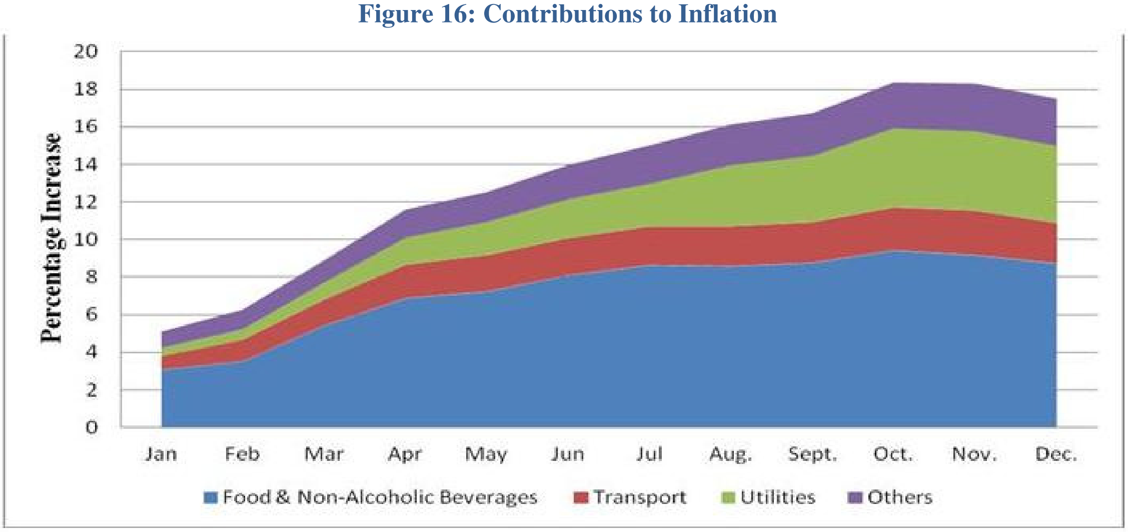
- Unfavourable weather conditions that could put stronger pressures on the external position (due to increased food imports);

[10] The EU imposed an oil embargo on Iran as part of its sanctions regarding Iran's alleged nuclear weapons program, prompting Iran to threaten to close the Strait of Hormuz. This is a vital link between the Persian Gulf and the Gulf of Oman through which a significant amount of the world's oil passes. Closing it will result in high energy costs globally

- Inefficient food distribution mechanisms which will push up cost of food in some regions of the country;
- Slower growth in the developed economies, especially Euro zone which could affect demand for our exports, tourism and remittances;
- High interest rates hindering private sector growth;
- Cautious expectations in the run-up to the upcoming elections as well as investor pause;
- Spending pressures due to the implementation of devolved government as well as the general election;
- Protracted military intervention in Somalia, translating into additional budgetary costs;
- Progressive widening of the current account deficit with adverse consequences on the long term stability of the Shilling; and
- Increase in international oil prices as a result of possible crisis in the MENA region.

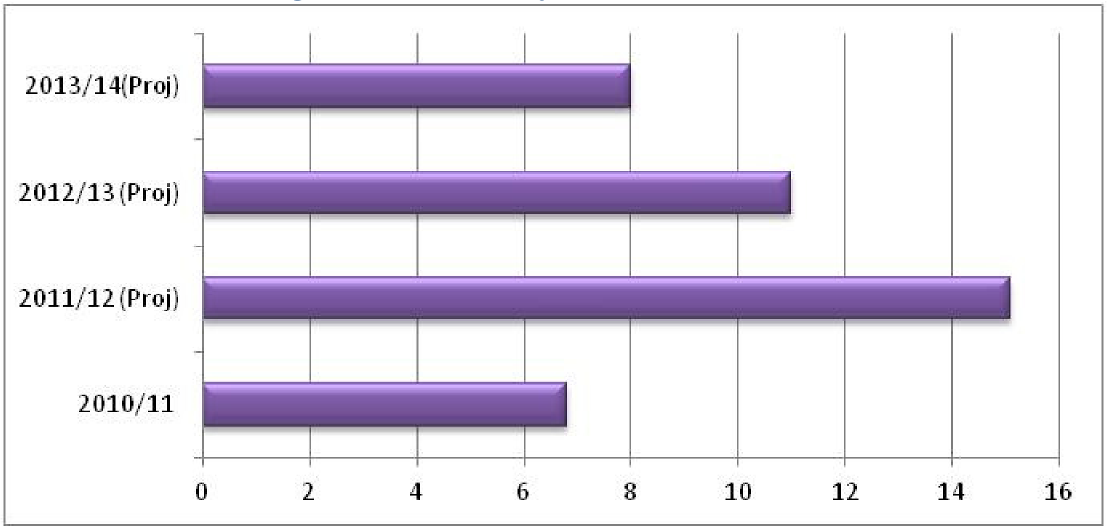
47. Given the scenarios above, **overall inflation is forecasted to average about 14.5 percent in 2012.** There is high risk of increased food inflation (which contributes 36.04%) considering that the country relies on rain-fed agriculture. Though improvement in food production is expected, the country being a net food importer even during periods of good rains, the expected reintroduction of the import duty on grain imports is likely to temper the fall in food prices. Moreover, the restoration of the import duty on fuel by the end of fiscal year 2011/2012 may counter the effect of easing oil pump prices.

Figure 16: Contributions to Inflation



Source: Parliamentary Budget Office

Figure 17: Inflation Projections 2011/12 – 2013/14

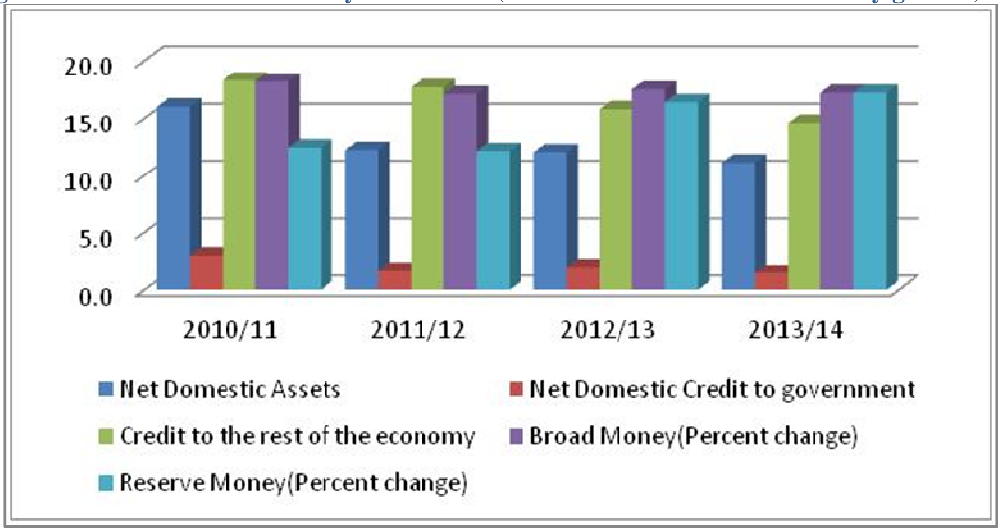


Source: Parliamentary Budget Office projections

c) Developments in Money and Credit

48. Growth of broad money (M3) is projected to decrease from 18.2 percent in 2010/11 to 17.1 percent in 2011/12 denoting a decrease in money supply probably as a result of the rise in interest rates. It is projected to increase slightly to 17.5 percent in 2012/13. The decrease in growth of broad money is supported by a projected decrease in Net Domestic Assets from 16.0 percent in 2010/11 to 12.2 percent in 2011/12 and 12.0 percent in 2012/13. This is on account of a decrease in private sector credit. Reflecting this position, credit to the rest of the economy is projected to decrease from an estimated 18.3 percent in 2010/11 to 17.7 percent in 2011/12 and 15.8 percent in 2012/13. On the other hand, Net Domestic credit to the government is expected to decrease from 3.0 percent in 2010/11 to 1.7 percent in 2011/12 before increasing to 2.0 percent in 2012/13. Reserve money is projected to grow at 12.4 percent in 2010/11, 12.1 percent in 2011/12 and 16.4 percent in 2012/13.

Figure 18: Performance of Money and Credit (Percent contribution to monetary growth)

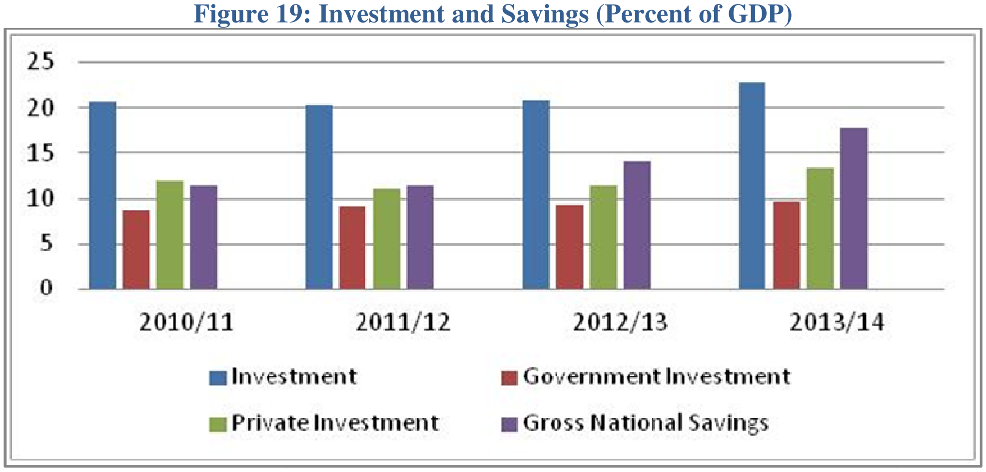


Source: Parliamentary Budget Office

d) Investment and Savings

49. It is expected that investment as a percentage of GDP will decrease from an estimated 20.6 percent in 2010/11 to 20.3 percent in 2011/12, improving slightly to 20.8 percent in 2012/13. Generally, investment is low in the country and more so private investment which is projected to decrease from an estimated 11.9 percent in 2010/11 to 11.1 percent in 2011/12 before increasing to 11.3 percent in 2012/13. On the other hand, Central government investment is projected to increase from an estimated 8.7 percent in 2010/11 to 9.2 percent in 2011/12 and 9.4 percent in 2012/13. The level of Gross National Savings is estimated at 11.3 percent of GDP for 2010/11 and 2011/12, increasing to 14.1 percent in 2012/13.

Figure 19: Investment and Savings (Percent of GDP)



Source: Parliamentary Budget Office

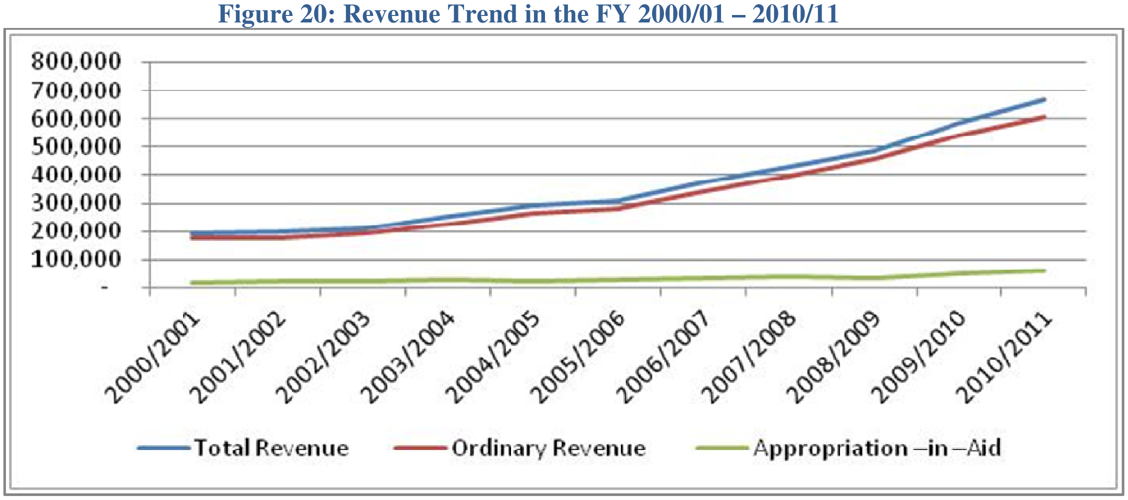
e) External balance outlook

50. The current external balance including official transfers is in deficit and is estimated at 9.7 percent of GDP in 2010/11, 9.0 percent of GDP in 2011/12 and 6.6 percent of GDP in 2012/13. The gross international reserve coverage in terms of next month's import cover is estimated to amount to 3.6 months in 2010/11, increasing to 4.0 months in 2011/12 and 4.6 months in 2012/13. The import value as a percentage of GDP is projected to decrease from 39.4 percent in 2010/11 to 38.0 percent in 2011/12 and 33.6 percent in 2012/13. The value of exports as a percentage of GDP is not as significant as that of exports and is estimated at 16.8 percent in 2010/11, decreasing to 16.3 percent in 2011/12 and 15.3 percent in 2012/13.

f) Trends in revenue performance

51. Revenue has exhibited an upward trend in the last decade, rising from a total of Kshs.192.3 billion in the FY 2000/01 to about Kshs.667.5 billion in the FY 2010/11, which translates to about 200% growth. In the same period, ordinary revenue rose from Kshs.175.5 billion to Kshs.609.2 billion, about 247% rise, whereas Appropriation in Aid grew from Kshs.16.8 billion to Kshs.58.3 billion representing a 24.6% growth[11] over the 10 years period.

Figure 20: Revenue Trend in the FY 2000/01 – 2010/11



Source: Treasury

52. Figure 20 indicates that even though both ordinary revenue and A-in-A contribute to total revenue, the contribution of the two is not directly proportional. It is noted that total growth corresponds proportionately with that of ordinary revenue only. The A-in-A has portrayed a sluggish and near stagnant growth making it an unreliable source of government revenue.

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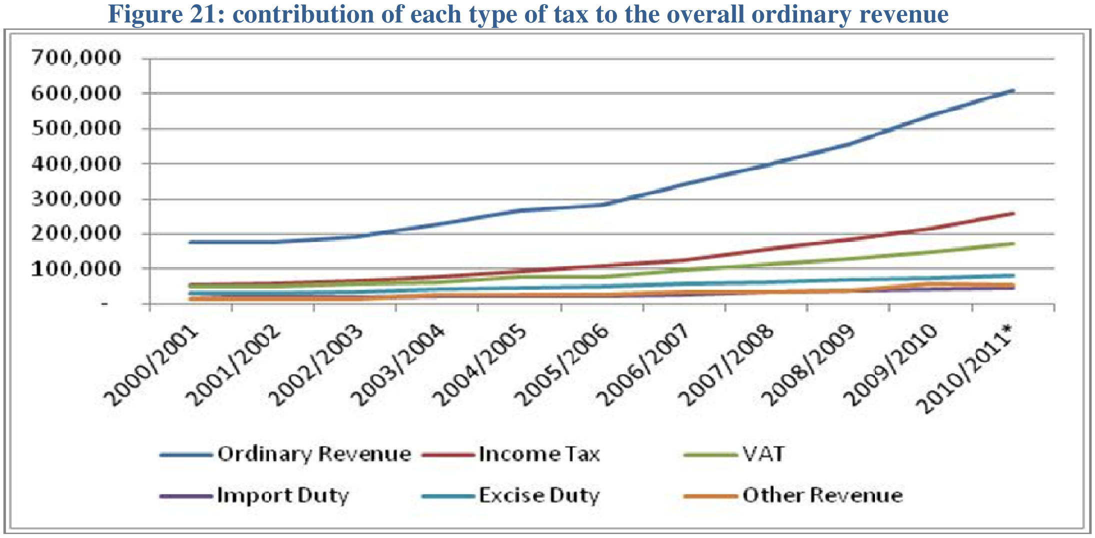
[11] This growth in Appropriations-in-aid was occasioned by a better capture of estimates in appropriations in aid in the budget books, in particular the universities.

53. Indeed, growth in A-in-A would have been expected to be higher than it is anticipated to exhibit this kind of a trend given that every aspect that leads to its contribution seems to have grown over this 10 year period. For instance, the population in the country, according to 2009 Census, is said to have added about 10 million people in that period; budgetary allocations have also increased and so the government services which mostly contribute to collection of revenue in the form of A-in-A. This could be explained by the fact that most service fees remain at the same rate for a long time. A breakdown of ordinary revenue performance is shown in figure 21.

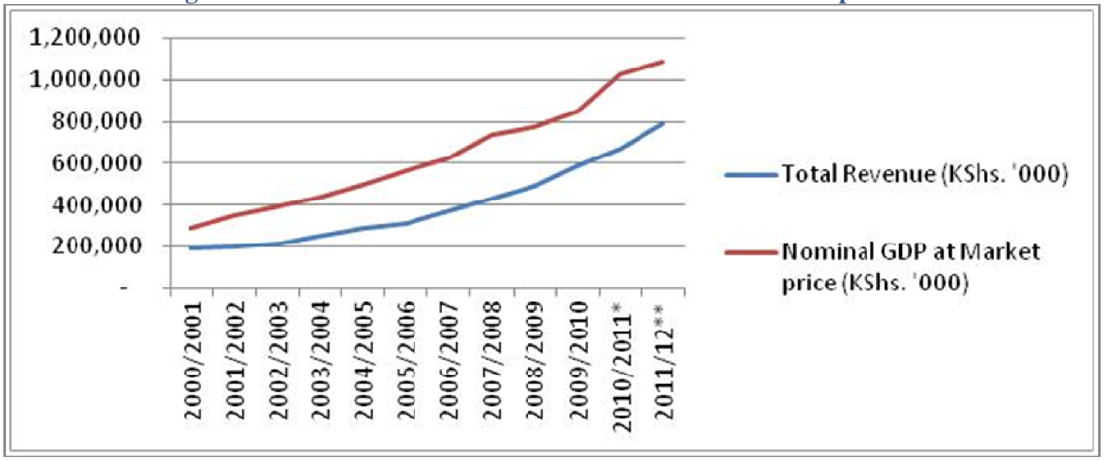
Figure 21: contribution of each type of tax to the overall ordinary revenue



Source: Treasury

54. From the graph above, it can be inferred that only income tax and VAT show a corresponding growth to that of overall ordinary revenue. Import duty, excise duty and other revenues (property rates, trade licenses, fines and forfeitures, etc) display slow growth. New revenue raising strategies should therefore be considered along these tax types to boost their growth trends and enhance overall revenue growth trend. Figure 22 compares total revenue performance and nominal GDP at market prices for the last decade:

Figure 22: Trend on Revenue and Nominal GDP at market price



Source: Treasury

55. From figure 22, there exists a positive correlation between the total revenue collected over the review period and the nominal Gross Domestic Product (GDP). The country should therefore prioritize growth in line with the Vision 2030 blueprint to achieve enhanced revenue performance for development.

g) Debt Management

56. It is envisaged that the overall balance on cash basis (including grants) could amount to 6.3 percent of GDP in 2012/13. Under such circumstances, it is estimated that the government could undertake net foreign financing amounting to 3.3 percent of GDP, and net domestic borrowing amounting to 2.0 percent of GDP, leaving a financing gap amounting to 0.9 percent of GDP.

57. The assumptions on external and domestic loans as outlined in the government's 2011 Medium Term Debt Strategy are as follows:

i) External debt: the pricing assumptions of external sources of financing are that:

- The government intends to continue prioritizing external financing on concessional terms and the concessional external loans are priced at a fixed rate of 0.75 percent, with a 40-year tenor and a 10-year grace period and are denominated in Special Drawing Rights (SDR).
- In the absence of concessional financing, the government will maintain non-concessional financing;
- Accessing the international capital market is priced off the assumed effective yield curve, which is based on the underlying forward US Treasury curves plus an assumed credit spread;

- The **net external borrowing** for financial year 2011/12 is **1.9 percent of GDP** and expected to rise to 2.5 percent of GDP in the financial year 2013/14.

ii) Domestic Debt:

- Domestic borrowing will be undertaken through issuance of Treasury Bills and Treasury Bonds at the ratio of 30:70 to ensure that the maturity structure of the existing portfolio is lengthened to minimize refinancing risk;
- In addition, Treasury Bonds will be issued around Benchmark Bonds of 2, 5, 10, 15 and 20 year tenors to build liquidity; and
- **Net domestic borrowing** for financial year 2011/12 is **3.5 percent of GDP** and is expected to fall to 1.2 percent of GDP in the financial year 2013/14.

58. The Treasury estimates that public debt will amount to 44.3 percent of GDP in 2012/13, gradually decreasing to 43.6 percent in 2013/14 (Budget Review and Outlook Paper, 2011). However, given the widening fiscal deficit due to the likelihood of a slowdown in economic growth, underperformance of revenue as has happened in the last two financial years, fiscal pressures with the upcoming general election, implementation of the devolved government and the military incursion in Somalia, the actual outcome may differ considerably. **These risks point to a likelihood of increasing the borrowing level and pushing the government into increased deficit financing thereby crowding out the private sector.**

59. Kenya's debt burden has been slowly ballooning and stood at 45.1 percent of GDP as at end December 2011 (Quarterly Economic Budgetary Review, Second Quarter 2011/2012). The structure of Kenya's debt burden is as follows:

Table 3: Kenya's Public Debt, end December 2011 (Kshs. billion)

	Kshs. billion ***(Prov)***	
External* **		
Bilateral	236.8	34.5 % of External Debt
Multilateral	426.8	62.2 % of External Debt
Suppliers Credit	22.0	3.2 % of External Debt
Sub-total	**685.6**	
Domestic Debt		
Banks	431.2	53.9 % of Domestic Debt
Central Bank	68.5	
Commercial Banks	362.7	
Non - banks	369.5	46.1 % of Domestic Debt
Sub-total	**800.7**	
Grand Total	**1486.3**	**45.1 % of GDP**

***includes IMF loans

Source: Quarterly Economic and Budgetary Review, Second Quarter 2011/2012

60. A major risk to debt sustainability arises from contingent liabilities. These are obligations that the government may have to assume in the event that some uncertain future event which is beyond the control of government occurs. Recognized contingent liabilities for the Kenyan government include losses in the state corporations, assumption of debt servicing costs in the event of a default on a publicly guaranteed loan, an underfunded NSSF and the Pay-as-you-go pension scheme. As Kenya enters in Public Private Partnerships, it is imperative that the government takes cognizance of the possibility of PPPs turning into liabilities should the private partner(s) fail to deliver on a project. It is important for the government to compile and publish accurate data on all contingent liabilities, assessing the likelihood of defaults. Ideally, contingent liabilities should be part of the analysis of the national debt strategy as well as the budget process and should have a policy for management. This is essential given that the national government may be guaranteeing loans incurred by counties in the near future. Currently, contingent liabilities are not included in Kenya's domestic debt stock despite their risk to the government due to lack of information.

61. The Government should move deliberately to reduce public debt to sustainable levels (below 42 percent of GDP) over the medium term. In order to reduce the country's borrowing requirement, there is need to enhance revenue collection and rationalize recurrent expenditure. In the long run, fiscal policy should rebuild fiscal space to enhance government's capacity to provide for additional spending should the need arise, without risk to debt sustainability.

III. THEMATIC ISSUES FOR CONSIDERATION IN THE 2012/13 BUDGET

3.1.Poverty Reduction

62. In spite of recent shocks, the Kenyan economy has experienced some positive developments in the last decade. During this period, poverty levels have fallen from 51 percent to 46 percent (KNBS). However, poverty is still a significant concern in the country as almost half of the Kenyan population remains poor. The high economic growth was initially touted as beneficial to everyone in the country since wealth created would ordinarily trickle-down to even the poorest in the society. Several policy measures are imperative in ensuring that equity is provided for. This naturally leads to the question of how uniformly this growth has been distributed and whether redistribution along with growth is achievable in the first place.

63. In this regard, there is need for a delicate balance between achieving sustainable economic growth while ensuring distribution of wealth by reducing poverty and creating employment opportunities. This is critical in meeting the principles of equity and fiscal responsibility that will ensure that the country continues on the path towards becoming a fully cohesive and inclusive society.

Policy measures

64. Kenya's economic growth is mostly generated from consumption rather than investment as shown in other sections of this paper. This implies that the poor are unable to contribute to growth and it is this lack of participation that results in the poor not benefitting from the expansion of the economy. This therefore implies that urgent and comprehensive measures are necessary to significantly reduce poverty and bring about inclusive development in the country. Budget 2012/13 should lead the way in showing commitment of the National government in attaining this goal. Specifically, the urgent intervention measures needed are that;

a. Directing a proportionately higher portion of government expenditure to acquisition of capital (investment) as opposed to present consumption. This would create employment while setting the tone for even higher economic growth for the country.

b. Setting the tone for the decentralization of government expenditures by providing for ministerial budgets at the county level in the 2012/13 budget. Decentralization of expenditure is expected to entrench distribution of services across the country.

Current basis of allocation to poverty alleviation programmes

65. The recent direct poverty alleviation measure of providing free funds to the poor has not worked and is not financially sustainable in the long term. This is because Kenya has not reached the economic levels of the developed world where social protection is comprehensive with unemployment benefits provided universally. Instead, efforts should be geared towards providing employment opportunities in order that poverty alleviation may be sustainable while reducing the direct cost implication on the government.

66. Availing microcredit facilities through private-for-profit financial institutions is not the most effective way to ensure access to the target groups, i.e. the poor. This is because the credit is availed at a further premium to the end user by the middle man, which is the financial institution thus making it more expensive due to additional charges such as processing fees. In addition to this, the people who are in a position to access the credit are the individuals who can best fill in the paper work and those who understand and are at ease with banking processes. It is important to note that these individuals are not necessarily the most adept farmers or those with the most viable projects but rather those who are most adept at filling in the credit request forms.

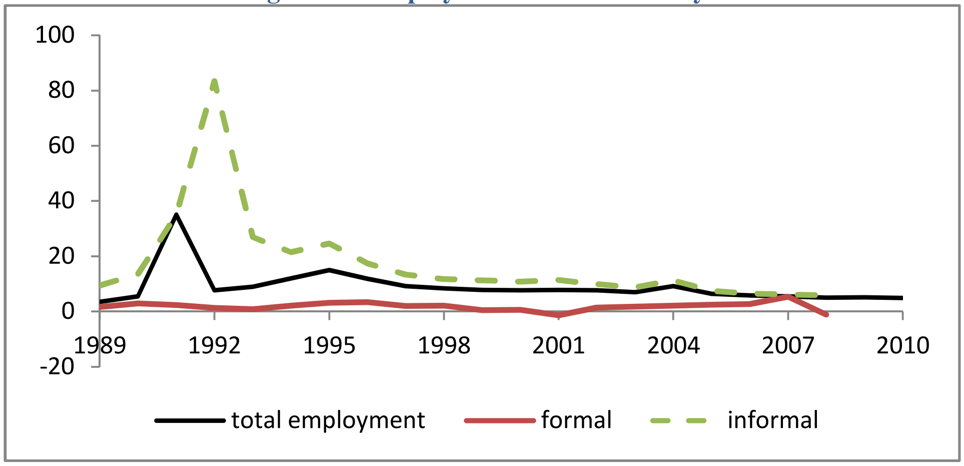
67. It would therefore be more effective to provide direct credit facilities through established government owned development finance institutions as opposed to private sector institutions. This is the most effective way to provide cheap, accessible and hassle free credit to the needy end-users. However, it would be advisable to analyze the performance of government owned finance institutions with regard to channelling credit before making this proposal. The performance of institutions such as Agricultural Finance Corporations has been wanting.

3.2.Addressing Unemployment

a) Unemployment trends

68. Unemployment was not a serious problem in the first decade after independence, but since 1970s the country has not been able to create enough job opportunities for rising labour force. As a result the rate of unemployment in Kenya has remained high and is currently estimated at about 12.7 percent. This rate of unemployment is too high compared to the Sub-Saharan average rate of 8.2 percent or 6.2 percent rate of unemployment in South-East Asia. The fact that Kenya still faces grim unemployment conditions is a reflection of ineffectiveness of past economic policies. To address these to levels of about 8 percent requires change and perhaps reorientation of resources to programmes that will produce mass employment for Kenyans.

Figure 23: Employment Growth in Kenya



Data Source: KNBS

69. The spike in employment in 1990-1993 may hold a clue as to what the country could do to create mass jobs for its citizens (Figure 23). The rise in total employment in the period 1990 to 1993 is attributed to a sharp acceleration in growth of the informal sector employment. In early 1990s the government removed trade restrictions and licenses on small enterprises that triggered the unprecedented rise in the jua kali sector enterprises and consequent explosion in informal sector jobs. As a result the informal sector became the main driver of total employment growth in Kenya's economy.

70. Nevertheless, the rise of informal employment during this period was counterbalanced by the contraction of the formal sector either due to substitution of informal sector jobs for formal sector jobs or due to the decline of the formal sector enterprises due to tough economic conditions before and after the 1992 elections. In particular, interest rates and inflation rose to unprecedented levels due to loose monetary policies associated with the 1992 elections. At the same time, structural adjustment programs, which entailed removal of price controls and liberalization of the exchange rate, triggered a collapse of industries which especially thrived under the controlled regime.

71. Through the mid-1990s, growth in informal sector jobs remained volatile with noticeable protracted decline analogous to the growth of total employment. Indeed, from a peak growth of 24 percent in 1995, the sectors' employment expanded by just less than 6 percent through 2008.

72. Formal sector employment, conversely, grew at less than 2 percent since 1990 with zero growth in some years between 1990 and 2002. Accelerated civil service retrenchment added to the tightening of formal employment conditions in 2001. But, the rise in formal sector employment after the 2002 elections, from 1.8 percent in 2003 to 6.2 percent in 2007 is connected with the implementation of the Economic Recovery Strategy and the likely impact of new hiring of civil servants by the new government.

73. The sharp decline in formal sector employment after 2007 is associated with reversal of these economic conditions due to electoral related disturbances in 2008, drought and the global financial crisis. The election related political disturbances were partly seen to have been fuelled by hordes of unemployed youth in Kenya. The apparent association between youth unemployment and post election violence gave way to targeted labour intensive programmes such as the *Kazi kwa Vijana*. As part of fiscal stimulus programme, the program would employ youths in Kenya to work in public works such as building of roads, irrigation among others. Even in absence of supporting data, the outcome of the programme is mixed.

74. Growth in total employment was for the most part depressed since 1995 until a temporary rise to about 9.2 percent in 2004. This was followed by an extended slowdown to 4.5 percent in 2010. The general trends of the formal and informal sectors since 1990 reveal a direct relationship between growth of formal sector jobs and economic growth, and an inverse relationship between growth of formal sector jobs and growth of informal sector jobs. For example, high growth rates of the informal sector between 1990 and 2002 are associated with a slump in employment in the formal sectors, but the rise in formal sector jobs associated with economic recovery (2003-2007) relates with probably non-ambiguous slowdown in growth of informal sector jobs. In other words, economic growth can help create new quality jobs in the public and private sector that to a great extent replace some low quality informal sector jobs.

75. But, the problem of employment creation in Kenya is more intricate than merely pursuing high economic growth. The fact that the formal sector has underperformed over the years and given that the largest stock of jobs and most new jobs are in the informal sector implies the need to design a mix of policies to create mass jobs for Kenyans in both sectors. The options to achieve employment creation goals include specific policies to create jobs for the youth, reviving the manufacturing sector, and wage reforms.

b) Addressing the unemployment problem

76. The fact that the formal employment sector has underperformed over the years and given that the largest stock of jobs and most new jobs are in the informal sector implies that we cannot walk away from the informal sector. Thus, a plausible solution to unemployment integrates a blend of policies to create mass jobs for Kenyans in both sectors. The solution to unemployment should also include policies to sustainably improve the size and capacity of manufacturing sector and well designed interventions to reduce youth unemployment, To help deal with unemployment, the following policies need to be implemented during the next budget and in the medium term.

77. **Option1: Create job opportunities for Kenyan Youth**; youth constitute about 79 percent of total Kenyan population. Thus, youth employment and training is critical for Kenya's development and also for stability. To achieve the dual goal of increased employment and training for youth, the following measures are suggested:
    i. More resources should be allocated to develop science and industrial polytechnics. At least Kshs.10 million should be allocated to each of the 520 registered youth polytechnics in Kenya to purchase equipments and infrastructure.
    ii. Increase tuition support for students enrolled in youth polytechnics to Kshs.2 billion (Kshs.890 million was allocated in 2010/11).
    iii. Provide aid and fiscal incentives to major companies that offer student industrial internships;
    iv. Expedite completion of flagship projects which may benefit the youth such as the Info city at Konza, and the planned resort cities.

78. **Option 2: Implement wage reforms:** High wages and wage disparities place upward pressure on minimum wages, perpetuate income inequities, contribute to unemployment, and also raise the cost of labour sometimes with limited rise in work effort or productivity. Even though politically unpopular, wage reforms should entail:
    i. Wage rationalization through the Salaries and Remuneration Commission which may include standardization of wages across the public sector and introduction of bi-weekly pay to most workers; and,
    ii. Introduction of a system of contractual work which is likely to increase job mobility and probably bring down the costs of labour. This will also help improve Kenya's cost of production and international competitiveness.

79. **Option 3: Expand traditional manufacturing and modernize agriculture:** The country can seek to expand the size of traditional sectors such as manufacturing and agriculture, whose collapse in 1990s has led to the decline of manufacturing and importation of substandard products and second hand products. This will require reinvesting in these sectors to reverse their growth stagnation. Specifically, the country should: one, increase investments to boost the contribution of manufacturing sector to about 20 percent of GDP; two, reengineer dormant vehicle assembly plants and attract vehicle manufacturing franchises; three, revitalize dormant manufacturing and textile industries and four, modernize agriculture as an incentive to encourage young people to engage in the same on commercial basis. In this regard, the government should provide 10 year tax holiday to the following industries:

i. Large textile industries that use 100 percent local raw materials and labour to produce products for local market and export;
ii. New or revitalized paper milling companies that sustainably use 100 percent of local raw materials;
iii. Fully fledged vehicle manufacturing industry with strong domestic supply linkages; and,
iv. Vehicle manufacturing companies that enter into franchise arrangements with either Numerical Machining Complex or local vehicle assembly industries to fully manufacture vehicles in Kenya.

80. Option 4: Support SMEs through innovative policies: The government should also promote SMEs through creating local markets for SME produce and food. For example, various city authorities should be encouraged to use open streets for small scale trading at given times of the day or week. This will increase trading and economic activities and also generate employment to young people.

3.3. *Key priorities for the 2012/13 Budget*

81. Kenya has been touted as a "kadogo/sachet" economy; heavily reliant on small scale production which acts as a deterrent to growth and is dependency[12] driven. In order to reduce dependency, there is need to scale up production as well as consumption and achieve our full growth potential. It is therefore important to concentrate on the sectors that have multiplier effects. There is need to utilize idle capacity both for the unemployed as well as for industries that operate below capacity in order to address the twin problem of poverty reduction as well as creating growth that injects new investment and employment opportunities. To sustain the economic pulse at a high level it is important to address the 4 Is of development:

i. **Investment,**
ii. **Infrastructure,**
iii. **Incentives, and**
iv. **Institutions.**

i. Investment

82. Kenya has not been able to attract new investments and sustain multinational enterprises that are sources of job creation opportunities and income generation. Addressing unemployment and poverty reduction will require substantial investment in sectors more likely to generate employment and income; notably, agriculture and industry sectors.

[12] A culture of handouts that has been manifested from harambees for the needy to harambees to afford dowries during cultural activities such as weddings

a) Opportunities for Agro-industry Development

83. **Agricultural spending in the 2012/13 budget should focus on projects that enhance smallholder agricultural productivity, competitiveness and rural growth by strengthening rural non-farm sector growth and facilitating the growth of smallholder agricultural enterprises and irrigation.** Accelerated development of agro-industries and agri-business enterprises is a key strategy and therefore more effort and investment should be devoted to the development of all post-production segments of agriculture value chains. Agro-processing and value addition provides linkages and multiplier effects with respect to creation of non-farm employment and income generation opportunities, reduction of post-harvest losses and improvement of food quality and safety as well as increased access to international markets. This is likely to be the driver to ensuring Kenya's Balance of Trade is sustainable amidst the current unsustainable global prices of oil and other economic uncertainties that have pushed imports north.

84. Other specific Policy recommendations include improving access to credit to farmers in addition to offering incentives (financial guarantees, tax incentives/measures) and directives on formation of cooperatives on proposed value chains; investment in key infrastructure (e.g. roads, electricity, ports and markets) likely to promote agro-enterprises and make it accessible to farmers; Investment in Research and Development which is a key driver to innovation in addition to building capacity; and investment in skill training through vocational training deliberately focusing on agro-industries thereby filling the skills gap.

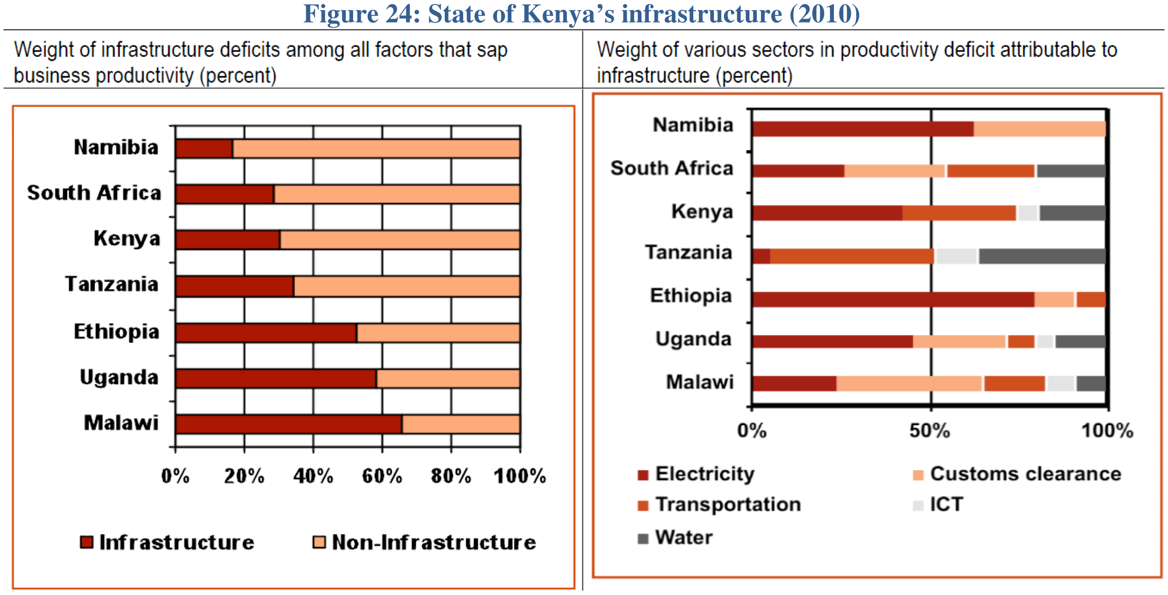
b) Generation of employment through revamping viable key industries

85. **Government selected dormant industries, with particular focus on revamping the existing infrastructure before venturing into new industries.** This includes reviving the collapsed cotton ginneries and textile industries such as Kisumu Cotton Mills (KICOMI) and Rivatex in Eldoret whose collapse left a vacuum for the importation of cheap, second hand clothes. The revival of Rivatex by Moi University has created some new life and interest in cotton farming. Reviving of KICOMI, the dormant cotton ginnery, while regulating the importation of second hand clothing will not only generate employment but also reduce importation and promote economic growth. Furthermore, substantial funding to credit facility institutions such as the Kenya Industrial Estates (KIE) Limited has potential to drive industrial growth and generate employment opportunities. Also, substantial funding to the Numerical Machining Complex is instrumental in providing engineering solutions to the manufacturing sector and promoting industrialization in the country as well as manufacture and assembly of farm implements.

ii. Infrastructure

86. According to the Africa Infrastructure Country Diagnostic (AICD) report on Kenya's Infrastructure (2010), over the last decade, infrastructure contributed 0.5 percent to Kenya's annual per capita GDP growth. The report indicates that approximately 30 percent of productivity constraints in Kenyan firms' are as a result of infrastructure deficits. Power is cited as the biggest infrastructure constraint, followed closely by transport. This is illustrated in figure 24:

Figure 24: State of Kenya's infrastructure (2010)



Source: Escribano and others 2009, as cited in- Kenya's Infrastructure: A continental Perspective, AICD report, 2010

87. For the country to achieve robust and sustainable economic growth therefore, the infrastructure budget must focus on addressing these two challenges which are power and energy. ***Energy spending in the 2012/13 budget should therefore go towards projects that will improve electric power supply***. These include increased investment in renewable sources of energy such as geothermal power, solar, wind and coal energy. These projects have high initial (capital) costs but the cost of running them is low. In the long run, they will reduce the cost of electricity. On the other hand, infrastructure spending should concentrate more on substantial investment in the Mombasa-Nairobi-Kampala Railway network, to boost the construction of the proposed standard gauge railway as well as the proposed mass transit light rail system to enhance connectivity between Nairobi and it suburbs as well as major towns such as Mombasa and Kisumu. In essence, the government should ban the transportation of cargo through roads, restricting movement of freight to the railway. A properly developed railway network will ease congestion on Kenyan roads without having to expand the existing road network.

iii. Incentives

88. Kenya's investment climate is characterized by low-end technology users being technological imitators instead of attracting high-end technology investments. In the recent years there has been high turnover of companies relocating to other countries, citing Kenya as economically unattractive to invest in due to the high cost of doing business. This is occasioned by the high energy tariffs, inefficiency in the port of Mombasa which is gateway for most business activities within the country as well as across the border. Indeed, the World Bank Doing Business report 2012 indicates that Kenya has dropped three positions from 2011 and currently ranks at 109 out of 183 economies in terms of ease of doing business.

89. Generally, Kenya's business environment appears to be hostile. Most indicators lie in the second half of the global ranking. Regionally, despite being the largest and most vibrant economy within the EAC, Kenya lies behind most of its regional competitors in most indicators. This calls for urgent reforms to make Kenya the preferred destination of choice for foreign investors and also make our domestic businesses globally competitive. Some of the reforms required are tax reforms, simplification of business registration procedures and speeding up of judicial cases. Concerted efforts must be directed towards encouraging high-end technologies such as Franchise and Export-oriented investment ventures, improving the services sector such as the hospitality and tourism sector and diversity of service industry to encompass Joint-ventures such as Kenya Industrial Estates and the public private partnerships.

iv. Institutions

90. Credible institutions of governance instil investor and public confidence, reduce the red tape and give a sense of predictability as well as reducing the cost of doing business. Functional administrative systems as well as clear cut policy directions will not only support and spur economic development but also act as a catalyst for quick economic recovery and achievement of the Vision 2030 goals. These Institutions will ensure peaceful coexistence and political stability which are prerequisites for economic well being. It will also boost economic activity which in turn will result in gainful entrepreneurial activities thereby reducing poverty. Efficiently functioning governance institutions will ensure the rule of law and respect of social cultural and human rights are upheld. All these are essential ingredients for robust economic activity which will result in investment and wealth creation as well as implicitly address issues of unemployment and poverty reduction. Indeed, reforms in the socio-judicial and economic system will catapult the impetus for investor confidence in Kenya as a preferred investment destination, reduce the feelings of inertia with regard to corruption and rent seeking motives and above all create an enabling business environment.

This implies continued support to constitutional implementation and leveraging reforms in social fiber and the economy.

3.4. TAKING STOCK OF THE ACHIEVEMENT OF MILLENNIUM DEVELOPMENT GOALS

91. The signing and endorsement of the Millennium Development Goals (MDGs) by World leaders epitomizes the importance of the time-bound global vision for development. Kenya was among the first signatories of the Millennium Declaration and has since then focused her policy and development planning towards achievement of the development goals by the year 2015.

92. Developing countries are guided towards the attainment of the 8 goals by the 21 targets and 60 quantifiable indicators which ensure that a country can maintain focus and measure progress. However, the road towards achievement of the MDGs has not been smooth and various challenges have come in the way of many developing countries. The prominent of the challenges encountered is the inadequacy of resources which has been exacerbated by failure by development partners to honour their commitment that they dedicate 0.7 per cent of their Gross national product (GNP) to Official Development Assistance (ODA). In the face of recurrent global economic crisis, ODA is indeed declining. However, Finland has over the years set pace and met this target.

93. Kenya's efforts in the achievement of the MDGs have been spearheaded through a paradigm shift that focuses on policy setting for the MDGs and MDGs based planning. Available information for Kenya indicates the following (GoK, 2010):

Table 4: Achievability of Millennium Development Goals

Goals likely to be achieved by 2015	
MDG 2	Achieve universal primary education
MDG 3	Promote gender equality and empowerment of women (gender parity in primary and secondary schools to be achieved by 2015, constitutional provisions also likely to contribute to its achievement).
MDG 4	Reduce child mortality (Targets can be met with increased efforts)
MDG 6	Combat HIV and Aids, malaria and other diseases (Targets likely to be met with increased efforts).
MDG 8	Develop a global partnership for development (ICT-related targets on track).
Goals unlikely to be achieved by 2015	
MDG 1	Reduce extreme poverty (any achievements eroded by recurrent domestic and external setbacks/shocks)
MDG 5	Improve maternal health (target unlikely to be met if current trends prevail)
MDG 7	Ensure environmental sustainability (targets unlikely to be met if current trends prevail).

3.4.1. Emerging from the Challenges - Budgeting and the MDGs, the Medium Term Plan and Vision 2030

94. The budget process stands out as the key entry point in entrenching government efforts in the achievement of the MDGs and the Medium Term Plan goals of Vision 2030. An effective budget process that takes into account an all-inclusive participation and also the country's development agenda is a critical political statement of a government's commitment to the MDGs achievement. Sustained allocation of national resources to targeted components of the development programmes must take priority within the purview of a country's development plans.

95. The process of mainstreaming cannot be left to the executive whose political interests can derail the entire process. Parliament therefore has a critical role to play through some of its constitutional mandates and established entities. For instance, it is incumbent that parliament holds the executive accountable for its commitment and progress in achieving the Medium Term Plan goals of Vision 2030. This can only be achieved through anchoring the vision in a parliamentary legislation. Currently, Vision 2030 is not anchored in law and there exists no macro framework for its operationalization. It is critical that Parliamentary Departmental Committees whose mandates are aligned to specific line ministries in whose mandates the Vision fall should be at the forefront of ensuring that ministerial programmes and budget estimates incorporate the Medium Term Plan components.

96. Besides mainstreaming Vision 2030 into among others the ministerial budget, spending of the devolved funds needs to include the Vision into the community projects being undertaken. Such actions will hasten Kenya's attainment of the lagging MDGs, as well as complement government efforts towards realization of the Kenya Vision 2030.

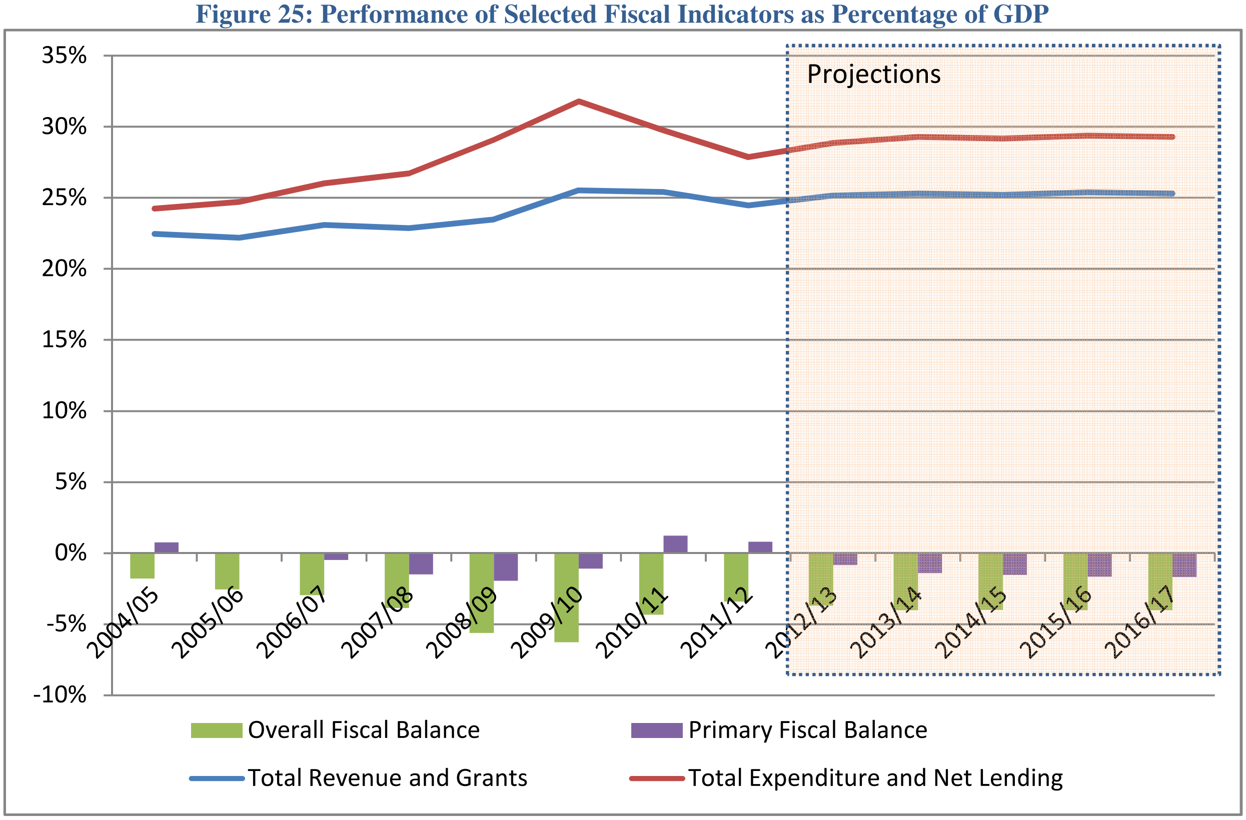
IV. FISCAL TRENDS, SUSTAINABILITY AND OUTLOOK

4.1. Fiscal Policy and Implications on the Economy

97. Fiscal policy, just like the monetary policy is important not only because of its macroeconomic implications, but also **because it influences the scope for state economic intervention, level and direction of the economic transfers** (which, in turn, influence distribution of income and wealth), employment level and the amount of economic activity.

98. The Government of Kenya has in the last few years, used fiscal policy to stimulate the economy. A number of programs such as *Kazi kwa Vijana* and Economic Stimulus Package were undertaken in the FY 2009/10 as a way to sustain the growth momentum in the face of global recession. However, these prevailing expansionary fiscal policies accentuated internal and external macroeconomic imbalances.

Figure 25: Performance of Selected Fiscal Indicators as Percentage of GDP



Source: Parliamentary Budget Office Projections

99. Figure 24 above indicates that the **overall fiscal balance**[13] **has consistently been in deficit** dropping to -6.27% of the GDP in FY 2009/10. This deficit is projected to persist within a range of -4% in the medium term.

4.1.1. Expenditure Performance for 2011/12

100. As discussed elsewhere in this report, **the economy of Kenya is expected to continue facing turbulence in the medium term.** The performance of the economy has implications on the revenue collection which in turn, affects government programs. The table below shows recurrent and development expenditure trends for FY 2009/10 - FY 2011/12. The projections for FY 2011/12 are deduced using the current trends based on the 2011/12 second quarter QEBR data as well as economic performance.

Table 5: Trends in Expenditure (in billions of Kshs.)

			2009/10 Provisional	2010/11 Provisional	2011/12		
					Budget	As at Dec 2011	Projected
Expenditure & Net Lending			**743.8**	**832.3**	**1,000.10**	**411.1**	**1,037.00**
Recurrent			**529.1**	**612.9**	**677.7**	**305.4**	**698.3**
	CFS		*111.2*	*122.4*	*146.5*	*57.4*	*153*
		Interest	63.5	76.2	84.1	42.5	91.8
		Domestic	57.4	69.2	76.6	37.8	84.9
		Foreign	6.1	7	7.5	4.7	7.5
		Pensions	29	25.7	34.8	14.9	34.8
		Repayments	18.7	20.5	27.6	-	25.8
	Wages & Benefits		*172.6*	*198.5*	*222.6*	*108*	*222.6*
	Other		*245.3*	*292*	*308.6*	*140*	*322.7*
	Other		188.4	232	243.4	140.1	257.5
	Defense & NSIS		56.9	60	65.2		65.2
Development			**214.7**	**219.4**	**322.4**	**105.7**	**338.7**
	Domestic		*151.9*	*150.1*	*202*		*192.2*
	Foreign		*60.5*	*67*	*117.8*		*146.5*

Source: Treasury Publications & Parliamentary Budget Office Projections

101. **Tightening of monetary policy has negatively affected interest rates.** The 91-day T-Bill rate has risen from 3.3% in April, 2011 to 18.75 percent in March. The cost of domestic borrowing on the budget is expected to go up by about Kshs.8.3 billion if the government uses T-Bills to fund the domestic financing gap of Kshs.57 billion. This has made domestic borrowing expensive and as a result, the government may incur unplanned expenses.

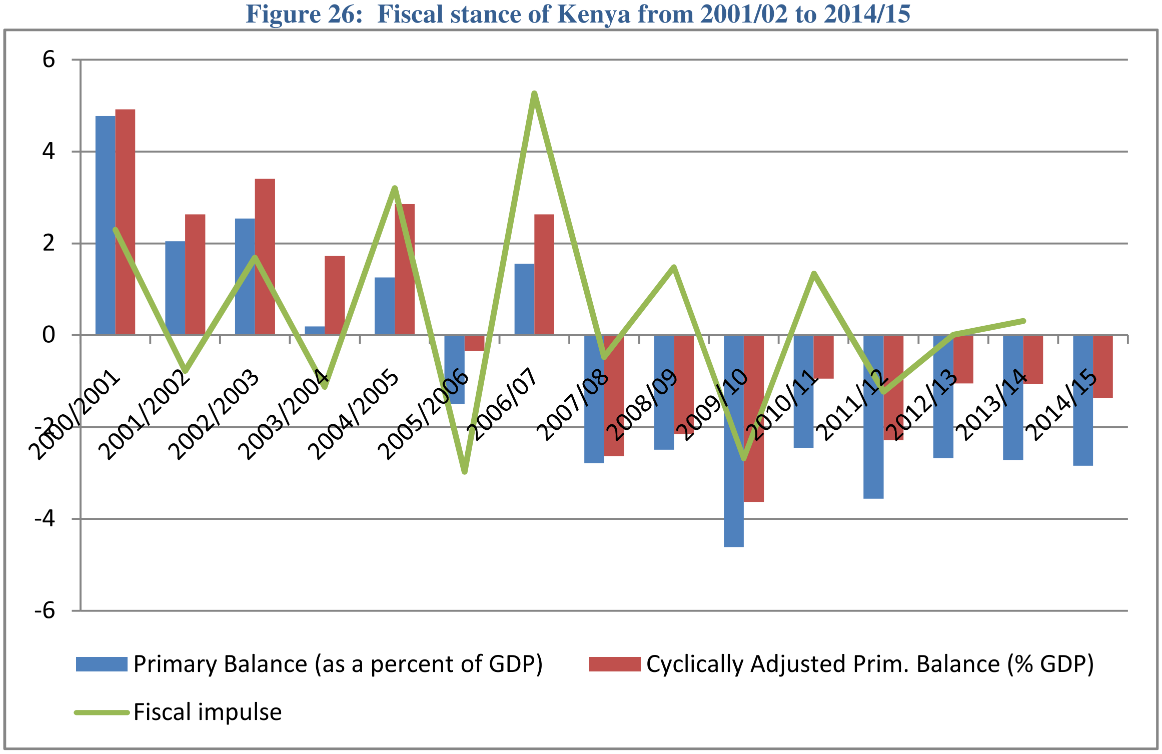
[13] Fiscal balance is the balance of a government's revenues (tax revenues, asset sales), minus government spending. If the balance is positive the government has a fiscal surplus, if negative a fiscal deficit.

4.2.Fiscal Sustainability

102. Whereas the fiscal framework underpinning the Vision 2030 calls for increased spending on "flagship" projects, while at the same time ensuring that the overall fiscal deficit is maintained at 5% of GDP and government wage bill at 6% of GDP**, these targets would not be met under the current circumstances.** Furthermore, the target of reducing net domestic debt from 17.8 % of GDP to 14.3 % by 2012/13 is unlikely.

103. An analysis of Kenya's fiscal policies indicates that both the primary balance and the cyclically adjusted primary balance are projected to remain in deficit in the medium term. Persistent fiscal deficit could have a number of negative consequences to the Kenyan economy. Deficits reduce national savings, push up interest rates and 'crowd out' both public and private investment. This would lead to lower levels of output in the long run and a fall in the living standards. Higher levels of debt can also restrict government's ability to respond to future economic difficulties. Still, the fiscal balance is projected to remain in deficit in the medium term (Figure 26)

Figure 26: Fiscal stance of Kenya from 2001/02 to 2014/15



Source: Parliamentary Budget Office Projections

4.3.The 2012/13 Budget and Medium Term

104. The 2012/13 Budget will be under close scrutiny as it facilitates a general election which ushers in a new structure of governance. **The budget is expected to provide a delicate**

balance given the expected upsurge in recurrent expenditure in the coming financial year. This upsurge is on account of the following:

i. **Operationalisation of the Devolved Governments:** Putting in place new structures set by the Constitution is expected to push up the government budget, especially the recurrent vote. As discussed elsewhere in this report, the doubling in the size of Parliament is expected to see an increment of recurrent cost from Kshs.6.6 billion to Kshs.11 billion[14] in FY 2012/13 and Kshs.14.3 billion in subsequent Financial Year. The cost of the 47 new county legislatures is estimated at Kshs.22 billion or in excess of that should the members of county assemblies demand similar terms as those of the National Legislature. In addition, the cost of set up of the County Executive is similarly likely to need more than the 15% envisaged in the constitution.

ii. **General Elections**: The forthcoming general elections which are expected to cost the country about Kshs.15 billion - a 300% increase from what was spent in 2007 general elections and during the 2010 constitution referendum.

iii. **Public Sector Wage bill:** With the establishment of new institutions in the country, wage bill is expected to go up from 6.8% to about 7.2% of GDP. This will be further driven up by the current ongoing demands by public officers for better wages as well as staff rationalization, if any. The Salaries and Remuneration Commission should therefore move with pace and address the alleged disparities in remuneration while at the same time setting indicative wages for the posts that are yet to be filled especially in devolved level. Moreover, there is need to address the rationalization of public servants amid devolution function from national to county Governments.

iv. **Pensions:** Public servants who benefited from the extension of their retirement age five years ago are expected to retire in the course of the next financial year. The payment of pensions therefore is expected to surge in the next budget from current Kshs.34.8 billion to about Kshs.40 billion.

v. **Public Debt Payment:** With the forecasted revenue shortfalls, government debt is expected to widen. Servicing of domestic debt is expected to increase relative to GDP from 2.4% in 2011/12 to about 3.1% in 2012/13 on account of relatively high interest payments. Interest on foreign debt will be largely influenced by the strength of the Kenya shilling to foreign currencies.

105. In this regard, the government needs to ensure that available resources are efficiently utilized. Government should also ensure that unnecessary expenditures are avoided. To curtail an upsurge in public wage bill, setting of wage standards in public sector should be prioritized to address the increasing demands for higher wages in the public service.

[14] Assuming the current remuneration and logistical support remain at the same level, that is, no policy change

106. In order to retain the budget within the balance, the government should focus on rationalizing public entities. A review of all SAGAs should be undertaken with a view of abolishing those whose mandates are not relevant as well as merging institutions with overlapping mandates. An evaluation of all existing Fund Accounts should also be undertaken to restore synergy, transparency and eliminate duplications and overlaps. Impact of the Funds on communities should be established before enhancement. Further, as recommended in the Budget Options for 2011/12, there is need to weed out poorly performing programs and low priority activities. As Parliament recommended in the FY 2011/12 budget, allocations for travel, hospitality, furniture, vehicles and communication should be maintained at low levels. Government should continue reducing wastages in public service by leveraging on ICT whose cost has been on a downward trend. Furthermore, it is high time the government considered outsourcing goods and services that are considered low in priority.

107. Auditing allocations to ministries should more than ever, focus on value for money rather than focus on approvals. A review of audit process in government should be undertaken to ensure that controls that have been rendered unnecessary or ineffective by changes in the nature of operations are replaced. It is essential to ensure that systems of management control remain effective, and eliminate or alter controls that are no longer needed or have become unnecessarily burdensome.

108. Public debt is projected to reach 47.9% of GDP in 2012/13 against a target of within 45% of GDP. The current high level of public borrowing risks undermining fairness, growth and economic stability. Tackling the deficit is essential as it will reduce the country's vulnerability to external shocks or a loss of market confidence, which could force a much sharper correction. It will also underpin private sector confidence, supporting growth and job creation over the medium term; help keep long-term interest rates down which will thus trigger growth by availing affordable credit for investment to the private sector.

4.4.Revenue outlook

4.4.1. Projected revenue performance for fiscal year 2011/12

109. As much as the Government projected the 2011/12 revenue to reach Kshs.787.57 billion, this is highly unlikely to be realised owing to a number of reasons. Firstly, the half year revenue performance has remained subdued due to unfavourable macroeconomic environment including the runaway depreciation of the Kenya shilling in the second half of 2011. The results were depressed trade and other economic activities which reduced opportunities for expansion of revenue collection. In addition, the twin shocks of spiralling oil prices and steady hike in food prices fuelled inflation for the whole of 2011 thus clouding growth prospects which is a major determinant in revenue performance.

110. The underperformance trend is highly likely to continue to the end of the fiscal year in June 2012. Indeed, the revenue projections (see 4.4.2) show that only about Kshs.760.2 billion is likely to be realised in fiscal year 2011/12. The expected performance to June 2012 will therefore result in a shortfall of about Kshs.27.4 billion which may only be plugged by increased domestic borrowing. The underperformance has persisted despite the fact that KRA has reportedly improved tax administrative reforms and employed various means including increased focus on tax audits, investigations and tightening the tax laws in a bid to maximise collections.

4.4.2. Revenue projections for 2012/13 and the Medium Term

111. Based on the projected performance of 2011/12 the projection for fiscal year 2012/13 is that the Government will only realise Kshs.872.4 billion. It is projected that revenue for fiscal year 2011/12 will reach Kshs.760.2 billion contrary to Treasury projection of Kshs.787.6 billion (*Quarterly Economic and Budgetary Review-2011/12)*. Furthermore, revenue in the coming fiscal year, 2012/13, is projected to reach Kshs.872.4 billion. The drivers to revenue realization will include recovery in Value Added Tax and Excise duty from both local and import goods. Income taxes (PAYE and Corporate Taxes) are also expected to considerably edge upwards in line with the resilience of the Kenyan economy to maintain its GDP growth to average levels of between 5 percent and 6 percent in the medium term. Increased revenue performance in the medium term is crucial for the well being of the coming county governments. However, the operationalization of county governments is likely to enhance consumption propensity thus putting pressure on expenditure. Projections for individual tax heads are as shown in the table below.

Table 6: Revenue Estimates for FY 2011/12 – 2014-15 (Kshs. Millions)

PERIOD IN F/Ys	2011/12	2012/13	2013/14	2014/15
Total revenue	**760,167**	**872,377**	**968,195**	**1,068,057**
Ordinary revenue	**686,210**	**785,220**	**871,038**	**960,900**
Income tax (exc. LATF)	***305,728***	***347,000***	***392,962***	***440,635***
Import duty	***51,934***	***55,627***	***59,982***	***64,355***
Excise Duty	***74,715***	***95,302***	***102,154***	***109,443***
VAT	***177,984***	***205,336***	***228,397***	***252,666***
Investment income (BROP)	***11,700***	***13,700***	***15,400***	***17,300***
Other Revenue	***64,149***	***68,256***	***72,143***	***76,500***
LATF	**16,091**	**18,263**	**20,682**	**23,191**
Ministerial and Departmental Fees	**57,866**	**68,894**	**76,475**	**83,966**

Source: PBO Estimates

4.5. Unlocking the revenue potential

112. There is genuine concern that despite the remarkable revenue collection growth in the last decade, Kenya's revenue performance is still below the country's optimum level. In the short term, the Government must step up its administrative strategies to enhance domestic tax collections as well as facilitating international trade to spur economic growth. This should be accompanied with continued tax policy reviews to ensure that tax laws remain applicable and facilitative in the ever changing business and technological environment.

113. Over the medium to longer term, tax revenues should grow to finance expenditure commitments. **This will require broadening of the tax base, driven by economic growth, higher employment and improved compliance.** If the current mix of tax instruments cannot provide sufficient resources, changes to tax policy, including higher taxes may need to be considered.

114. In view of the foregoing, the following options should be pursued:

i.) **Enhanced, robust and continuous taxpayers education.** Even though KRA has done relatively well in this programme, most taxpayers education activities have tended to only concentrate in major towns periodically. There is a great need to make the programme continuous and spread it out to cover all the counties in order to help shape the taxpayers' attitude throughout the country. Contrary to developing countries like Kenya, in developed economies, the citizens (taxpayers) are always eager to honour their tax obligations proudly. The ensuing contrasting scenario may be mainly because in the developed nations, taxpayers are able to see clearly where their tax is being utilized on, be it economic, social or any other sector and are abreast with the fiscal aspirations of their nation. Therefore, it is suggested that KRA ought to conduct various information dissemination clinics to help demystify taxation and inform the masses where their taxes are being utilized and the importance of each citizen supporting that course.

ii.) **Enhanced profiling of all eligible tax payers.** It is appreciated that KRA could be having profiling or risk management policy but its implementation is wanting. The daunting task of bringing more players into the tax net remains a major challenge as it has been difficult to profile most informal economic players like those in SMEs, i.e the self employed, domestic wage workers and their employers because of the nature of their operations; characterized by lack of book keeping and cash transactions. It can be remembered that sometimes back, KRA introduced turnover tax (TOT) but still, lack of proper profiling of taxpayers in this category is a big hindrance to effective tax collection. It is therefore suggested that all eligible taxpayers under this category be profiled by aid of information sharing among revenue stakeholders.

iii.) **Re-engineering the tax design and simplification of tax laws:** Many stakeholders and even the government agree that Kenyan tax laws need comprehensive reforms in line with modern day business and technological changes. Over time, the laws have been amended in isolation to the extent that a lot of distortions arising therein have opened many opportunities for tax abuse. Many taxpayers have utilized the window of intended tax interventions as opportunities to evade paying taxes. The re-engineering should ensure that various tax laws respond to the emerging business needs while comprehensive tax reforms should provide opportunities to correct some of the existing problems towards realizing government revenue. In addition, the government should work to reduce the number of taxes and levies that SMEs have to administer and move towards providing a mechanism like the 'single business permit' so that taxpayers and particularly SMEs reduce their compliance costs and visit KRA only minimally. A one stop shop especially with regard to licensing is desirable and will most likely encourage taxpayers to come forward as opposed to visiting many different offices for different tax liabilities.

iv.) **Transfer pricing: Transfer pricing manipulation is one of the ways that Kenya loses revenue** (Unlocking Revenue Potential in Kenya, PBO 2010). The government should design and put in place sound transfer pricing mechanisms to address issues of transfer pricing manipulation as well as tax incentives that are prone to abuse.

v.) **Conversion of certain Appropriations-In-Aid (A-in-A) into revenue:** There are a number of services whose payments are made as user charges. Consideration should be made so that a number of these with high turnovers are converted to revenue. Some of these include immigration collections pertaining to documents such as passports, visas, work permits and court fines, among others. It is proposed that these kinds of charges should be collected as revenue through designated bank accounts by administrative initiatives and progressive application of law. Further automation should be given prominence and completely eliminate personal collection and lengthy processes some of which involve the courts like traffic fines. Despite the fact that Parliament approved its Report on the 2011/12 Budget by recommending that various AIAs be turned into revenue, the implementation of this is not taking place as envisaged.

V. IMPACT OF THE 2012/13 BUDGET ON DEVOLUTION

5.1.Countdown to County Governments: The Cost of Devolution

115. **The new Constitution expanded political and economic structures of the country by establishing two levels of government: national and county.** The national and the county governments are distinct and interdependent levels of government, each with specified duties. The Fourth Schedule of the new Constitution provides that County governments are responsible for a range of service delivery functions such as agriculture, health, transport, trade regulation, county planning and culture while the national government is responsible for delivery of services such as foreign affairs, citizenship, defence, police services, courts, national health facilities, and national economic policy and planning. The two levels of government share responsibilities in some areas but generally, the national government is in charge of policy and oversight, while counties are responsible for implementation. The constitution states that both governments must consult and co-operate with each other.

116. The 2012/13 budget is indeed a transitional budget. **It marks the end of the first planning phase of Vision 2030, that is the first medium term plan (2008-2012). The 2012/13 budget will be implemented over a transitional period, from the current centralized government to a devolved government** which is expected after the forthcoming general elections. The government is therefore expected to draft a budget taking into consideration the two different implementation systems. Given that the date of the next elections is still uncertain[15], a difficult task lies on ensuring that a realistic budget is compiled within the set deadlines.

117. There are other challenges in ensuring that devolution is incorporated in the budget. These include:

a. **Heightened expectations that the 2012/13 budget will provide for full implementation by the county governments once they are in place.** Kenyans have embraced devolution with the hope that it would mark the end of inequitable distribution of national resources and inefficient administration. During the transition period, the national government should ensure that service delivery is not disrupted. It is therefore important that responsibilities are transferred to counties when they have capacity to provide the service. The key challenge is that the devolved units lack the capacity to deliver services. Though a number of key devolution laws have been enacted, they are yet to be operationalized.

[15]The Court ruled that General elections can be held within 60 days following the dissolution of the coalition government or on the expiry of current Parliament's term which will be in January 14th 2013.

b. **Cost of Devolution**[16]: The Constitution has created a bicameral Parliament. The import of this is that representation of the people at the national level has doubled from 222 members to about 410 members given gender equity requirement of Article 81(b) of the new constitution. The Senate, which is a new constitutional establishment, shall have 68 members. It is assumed that the 11th parliament will enjoy similar benefits as the current Parliament thereby raising the budget from Kshs.6.6 billion to Kshs.14.3 billion per year. More specifically:
    i. At the County level, each of the 47 county governments shall have an elected County Assembly. In addition, the law provides for a total of 1,450 wards in the country. However, assuming that the County Assembly shall cost half of the current expenditure per Member of Parliament, the County legislature is expected to cost at least Kshs.21.75 billion in a year. This cost could vary depending on factors like gender equity requirement under Articles 81 and 197 of the Constitution and unrealistic expectations from Members of the county assemblies.
    ii. Estimates of resources to the two levels of governments can be done using current allocations for responsibilities listed in the Fourth Schedule of the Constitution. Analysis of the 2011/2012 printed estimates shows that currently, the government is spending at least 19% of total ordinary revenues for services that have been devolved. This therefore means that the 15% minimum set by the Constitution may need to be enhanced. Effective coordination of the transition at both national and county levels will be crucial in ensuring that transition does not interrupt service delivery.

c. **Inadequate Capacity:** Infrastructure expected to support devolution is currently absent and there are no clear timelines as when this is likely to be in place. Rationalisation of staff at both national and county levels in line with the functions of both governments is likely to enhance service delivery and optimise on the structures yet to be put in place.

d. **Financial Implication of Legislation:** Article 114 of the Constitution provides that financial implication of Motion or Bills be sought from the relevant committee and the Treasury. This provision needs to be reinforced to guarantee the viability of proposed legislations.

5.2.Revenue allocation under the devolved government

5.2.1. Introduction

118. Article 203 of the Constitution provides that for every year, at least 15% of revenues collected nationally shall be allocated to the county government. It also further indicates that revenue shall be shared equitably through a criterion that will be approved by parliament once every five years.

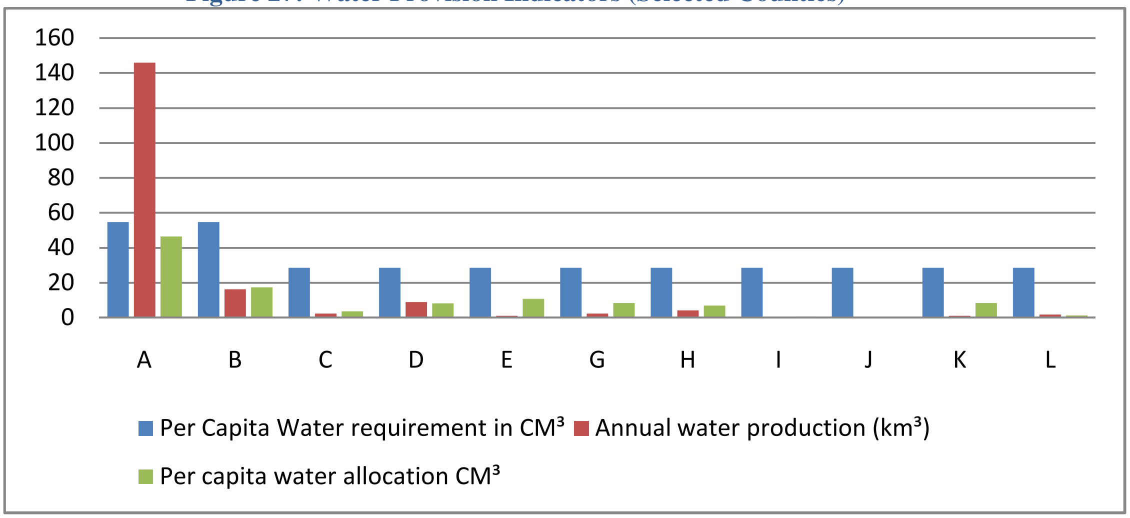
[16] This is an excerpt from a forthcoming paper on Cost of Devolution

5.2.2. Principles of a modern revenue sharing criterion

119. There are essentially four pillars of fiscal decentralization. These are ***the transfer to a local unit, the power of a local unit to raise tax***, ***the power of a local unit to borrow*** and ***the power of a local unit to make decisions and implement them.*** Ideally, the first of these pillars requires a criterion that will draw heavily on the other three pillars in order to ensure equity. This means that it should:

a) **Recognised that there are disparities in access to basic services occasioned by past allocations** as demonstrated below:

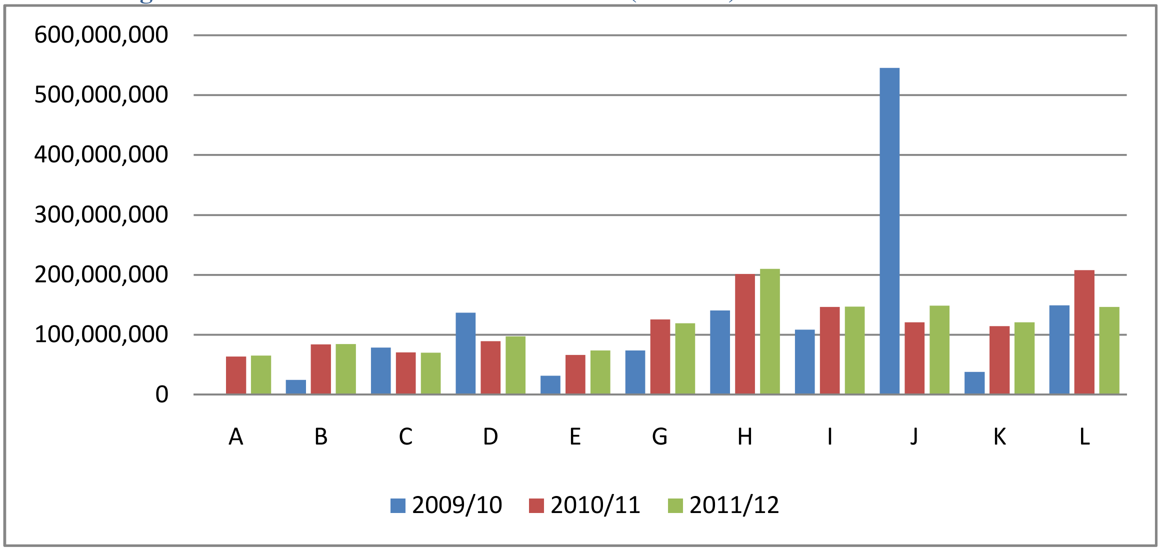
Figure 27: Water Provision Indicators (Selected Counties)



Source: Parliamentary Budget Office, 2012
A – L represent the selected Counties

120. From figure 27 above, it is clear that counties are at different levels in terms of access to water resources. For example, County A has a per capita water requirement of 56 cubic meters yet it is only able to access 42 cubic meters. The gap between need and actual access differs across other counties.

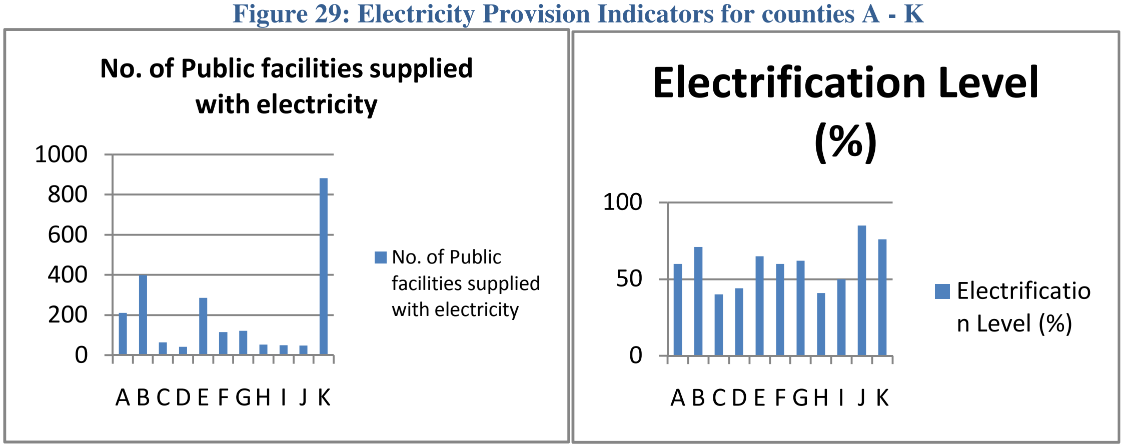
Figure 28: Allocation of resources for Water (in Kshs.) for counties A - L



Source: Parliamentary Budget Office, 2012

From figure 28, it is clear that in the past, the allocation of resources has not been informed by the water requirements and production levels.

Figure 29: Electricity Provision Indicators for counties A - K

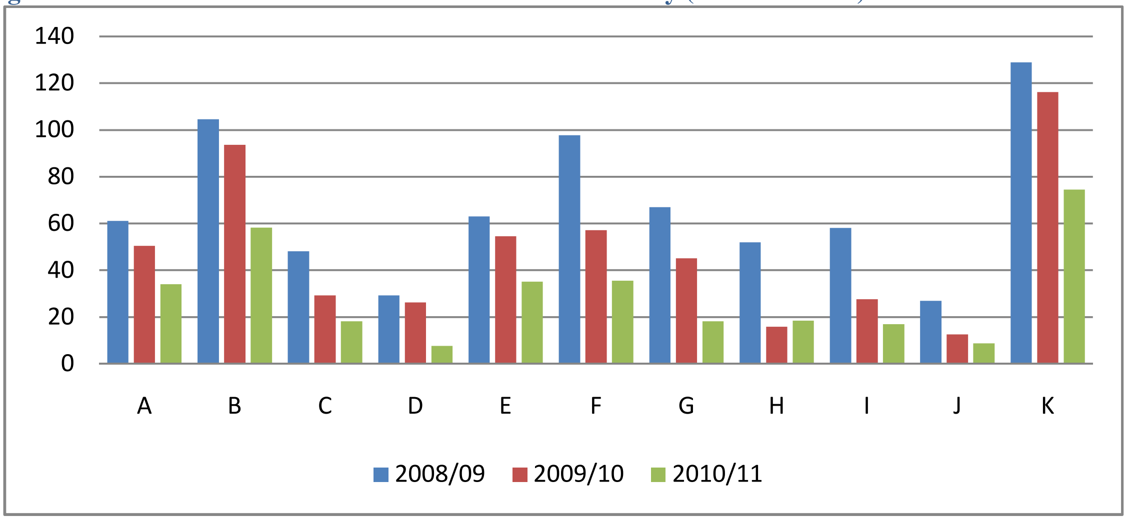


Source: Parliamentary Budget Office, 2012

N/B: Electrification Level is calculated by dividing the total Number of public facilities in a County connected to electricity by total number of public facilities in the County

The allocations for these same counties for provision of electricity are shown below.

Figure 30: Allocation of resources for Provision of Electricity (Kshs. Millions) for Counties A -K



Source: Parliamentary Budget Office, 2012

From examining figures 29 and 30, it is evident that the counties that already have high electrification levels have continued to receive high allocation of resources over the years.

b) **Provide incentives to instil best practice amongst the counties:** A performance criteria should be built into the formula for distribution of resources based on the performance in past years *(principle of derivation).*

c) **The ability to raise resources:** Some counties have *established structures in place* for the collection of revenue and they also have *wider* tax bases.

121. The formula resource allocation should therefore ensure past inequalities and the assumptions of trickledown effect do not continue to haunt the Counties. Specifically, the formula should take into consideration the following issues:

(a) **Population** (which in most cases is the major reason for disparity and which should not exceed 30% of what is being distributed otherwise this is likely to create further disparity particularly among the marginalized Revenue raising capacity of counties (varying levels of opportunities).

(b) **Expenditure needs and in particular basic needs and services**. For example, a study done recently shows major variations as relates to access to water or electricity. Whereas some constituencies have over 90% access to electricity, others have less than 30% access. Thus expenditure needs of a county should be a factor to consider.

(c) **Inclusion of incentives related with performance**.

(d) **Equity** must be maintained, indeed, the basic principle guiding the criteria should be the principal of "fiscal equalization" – that is, that each County should be able to provide the same range and level of services as every other without imposing higher taxes and charges.

VI. SUMMARY: ALTERNATIVE BUDGET OPTIONS

The following are options for the annual budget for 2012/2013 and the medium term:

a) **General administrative structures:** A prerequisite for smooth transition to county governments will be how prepared the country is in terms of putting in place the required administrative institutions. Secretariats of the various county assemblies, for example, should be put in place by October 2012 to prepare for the county assembly members.

b) **Reduce the widening financing gap:** The government must take adequate measures to address the huge budgetary deficit. It is clear from the paper that Kenya's economic growth is consumption driven; a trend that is unsustainable in the long term and therefore calls for promotion of investment. Key to sustained growth is to reduce the appetite for resources to finance administrative structures. As shown in Annexes 3 and 4, expenditure and net lending should be maintained at not more than 29 percent of GDP with more resources being channelled to infrastructure development as opposed to consumption based expenditures.

c) **Over-estimation in revenue targets:** Past data indicate revenue trends that are ambitiously forecasted casting doubt on their attainment. It is recommended that the Treasury pursues a cautious and guarded approach going forward. Indeed, it is bad public finance practice to overestimate revenues as this leads to unpredictability in resource flow across spending agencies. The MTEF budget principle of linking planning and budgeting has not achieved its intended purpose of increasing efficiency and improving service delivery owing poor performance revenues collection. Realistic forecasts will inject the necessary predictability for spending units.

d) **Develop guidelines for benefits for office holders:** Need to establish guidelines on allowances and terms and conditions of service equivalent to those of the Canadian Treasury Board. This will streamline the privileges of key office holders across Government and consequently create some savings. Given the ballooning budget requirements occasioned by the cost of devolution, such savings can be allocated to key priority areas.

e) **Voluntary Early Retirement and/or staff rationalization:** The envisaged reduction in the number of ministries as per the new constitution means that the national executive will need to be trimmed down and hence the need for resources to undertake staff rationalization.

f) **Population control:** From the previous sections it is evident that the persistent growth in population has had a substantial strain towards provision of basis services such as health, education, and water. This has been occasioned by the high overall population growth rate; indeed, Kenya's fertility rate[17] which stands at about 5 children is unsustainable. According to Thugge[18] (2010), the population aged 5-14 - the prospective primary and secondary

[17] This entry gives a figure for the average number of children that would be born per woman if all women lived to the end of their childbearing years and bore children according to a given fertility rate at each age.
[18] Fiscal Policy in Kenya: Looking Toward the Medium-to Long-Term

school-age groups - is anticipated to rise during 2005-2030 by at least 60 percent (more than 5.2 million children). This therefore implies that there will be an increase in spending on Kenya's primary and secondary school system. Further, substantial expansion will be required for tertiary education facilities. These will exert enormous fiscal pressure to the already bloated recurrent expenditure. Going forward, the 2012/13 budget should provide additional resources towards family planning initiatives alongside clear policies on control of population by Government.

g) **Rapid urbanization:** As mentioned elsewhere in the paper, Kenya's ICOR has averaged 6.1 over the period 2005 to 2007. This implies that the Vision 2030 of attaining sustainable economic growth of 10 percent is unlikely to be attained. Thus, with higher than expected urban population growth, the 2012/13 budget needs to tackle this phenomena by increasing resources towards urban planning & physical as well as resource mapping.. In addition, with the advent of county governments, there is need for a deliberate policy on urban development. The concept of villagization should be embraced at the lower levels (county). This will bring forth economies of scale in the provision of social amenities. Indeed, it is easier to provide a particular service such as the provision of water and electricity to a group of people as opposed to spreading thinly across a geographical region. The current land legislation before parliament should consider providing for land consolidation.

h) **Fast tracking the use of modern technology in tax collection:** In the report on the Budget Policy Statement for 2011/12 the Budget Committee did recommend for modernization of Electronic Tax Register (ETR) machines to include General Packet Radio Service (GPRS). However, no progress has been made on this account. As a policy option to increase domestic tax base particularly VAT, it is proposed that the use of GPRS be considered as a matter of priority.

i) **Youth Capacity Building and employment Creation:** To address youth unemployment and build capacity of the youths, more resources should be allocated to develop science and industrial polytechnics across the country to build the capacity of youths. 2012/13 budget should allocate ***Kshs.5.2 billion*** to revitalize the 520 registered youth polytechnics across the country. The funds should be allocated towards purchase of equipment, physical infrastructure development and hiring of qualified technical instructors. Increasing tuition support for students enrolled in youth polytechnics to Kshs.2 billion from Kshs.890 million allocated in 2011/12 will go a long way in ensuring the youth acquire the requisite skills.

j) **Innovative policies that support SMEs:** The government should promote SMEs through creating local markets for SME products and service. It is proposed that various local authorities should amend their by-laws to encourage use of open streets for small scale trading at given times of the day or week. This will increase trading and economic activities and also generate employment among the youth.

k) **Wage reforms:** the government should rationalize wages across the public sector in order to address income inequities and reduce the cost of labour thereby increasing employment. This includes standardization of wages as well as introduction of a system of contractual work to increase job mobility and probably reduce labour costs.

l) **Expand the manufacturing sector and modernize agriculture:** the government should reinvest in the manufacturing sector, reviving dormant industries such as textile industries; as well as dormant vehicle assembly plants. Furthermore, substantial funds be allocated to the Numerical Machining Complex. A well funded NMC is likely to strengthen Kenya's manufacturing industry through provision of mechanical and engineering services to the Agriculture and Industrial sectors.

ANNEXES

Annex 1: Macroeconomic outlook of Kenya's Key Trading Partners in Sub-Saharan Africa

	Bloc	2009	2010	2011 (Prov)	2012 (Proj)
Real GDP Growth (Percent)	SSA	2.7	5.4	5.2	5.8
	EAC-5	5.1	5.8	5.9	6.0
	SADC	-0.1	3.6	3.9	5.0
	COMESA	5.3	5.9	5.8	5.4
	KENYA	2.6	5.6	5.3	6.1
Real Per Capita GDP growth (Percent)	SSA	0.6	3.2	2.9	3.5
	EAC-5	2.3	3.0	3.1	3.2
	SADC	-1.6	2.1	2.3	3.4
	COMESA	2.6	3.4	3.2	2.8
	KENYA	-0.4	2.5	2.3	3.1
Consumer Prices (Annual Average, percent change)	SSA	10.6	7.5	8.4	8.3
	EAC-5	11.8	7.2	8.5	10.2
	SADC	9.1	6.9	7.7	7.0
	COMESA	19.7	6.2	11.9	15.8
	KENYA	10.6	4.1	12.1	7.4
Government Debt (percent of GDP)	SSA	31.7	31.4	-	-
	EAC-5	37.5	39.7	-	-
	SADC	35.5	34.4	-	-
	COMESA	46.7	39.2	-	-
	KENYA	47.6	50.4		

SSA – Sub- Saharan Africa
EAC – East African Community
SADC – Southern African Development Community
COMESA – Common Market for East and Southern Africa

Data Source: IMF Regional Economic Outlook, Sub-Saharan Africa, October 2011

Annex 2: Key Macroeconomic Indicators (2008/09 - 2014/15								
		2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
		Act	Act	Est.	Proj.	Proj.	Proj.	Proj.
		(percent change)						
Real Indicators								
	Real GDP (% growth)	2.1%	4.1%	5.0%	4.7%	5.1%	5.5%	6.1%
	CPI Inflation (percent), average	12.8%	7.3%	9.0%	13.4%	11.0%	8.0%	7.0%
	CPI Inflation (percent), eop	11.6%	4.9%	11.5%	14.8%	9.5%	7.5%	6.5%
	GDP deflator (percent)	11.3%	5.7%	7.4%	13.9%	12.1%	8.2%	7.4%
	Ksh per US $ (eop)	76.8	78.3	82.9	86.0	88.7	91.7	93.9
	Ksh per US $ (avg)	73.3	78.3	84.1	87.0	87.0	90.4	93.0
	REER (average, index Jan 2000=100, decrease=appreciation)	68.9	66.7	65.5	65.5	65.5	65.5	65.5
		(percent of GDP)						
	GDP	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
	Consumption	92.7%	94.2%	94.9%	94.0%	90.5%	86.7%	83.7%
	Investment	19.3%	19.5%	20.6%	20.3%	20.8%	22.9%	24.5%
	Central Government	7.3%	8.1%	8.7%	9.2%	9.4%	9.6%	9.9%
	Other	12.0%	11.4%	11.9%	11.1%	11.4%	13.4%	14.6%
	Gross National Disposable Income (GNDI)	107.4%	106.9%	106.2%	105.3%	104.6%	104.4%	104.1%
	Savings = GNDI - Consumption	14.6%	12.7%	11.3%	11.3%	14.1%	17.7%	20.4%
Fiscal (Central Government Budget)		(percent of GDP, except as noted)						
	Revenues	21.8%	22.9%	23.8%	23.1%	22.2%	21.7%	21.0%
	Expenditures and net lending	27.3%	28.8%	29.6%	28.8%	27.8%	26.9%	26.0%
	Wages and Salaries	7.0%	7.1%	7.1%	6.7%	6.3%	6.2%	6.1%
	Development expenditures	7.4%	8.2%	8.8%	9.2%	9.4%	9.6%	9.9%
	Interest/current expenditures (percent)	22.3%	23.2%	23.6%	22.9%	22.7%	21.9%	20.7%
	Overall balance (commitment basis) incl. grants	-5.4%	-6.0%	-5.8%	-5.7%	-5.6%	-5.2%	-5.1%
	Overall balance (commitment basis) excl. grants	-4.5%	-5.2%	-4.9%	-4.6%	-4.4%	-4.0%	-3.8%
	Net domestic borrowing	0.5%	0.8%	1.6%	2.5%	2.7%	2.6%	2.5%
	Total Donor support (grants & loans)	1.4%	1.6%	2.4%	3.6%	3.9%	3.8%	3.8%
	General Government Debt/GDP	40.3%	44.7%	48.0%	46.2%	44.7%	45.1%	44.7%
	Domestic	18.4%	21.2%	22.1%	20.3%	19.3%	19.5%	19.7%
	External	21.9%	23.6%	25.8%	25.9%	25.4%	25.5%	25.0%
External								
	Current account (% of GDP)	-6.9%	-7.6%	-9.7%	-9.0%	-6.6%	-5.3%	-4.0%
	Excluding official transfers	-6.8%	-7.5%	-9.6%	-8.9%	-6.6%	-5.2%	-4.0%
	Total external debt (% of GDP)	23.5%	25.4%	28.6%	30.3%	30.3%	31.5%	31.7%
	Total external debt (% of exports G&S)	92.1%	98.3%	100.0%	109.3%	116.4%	120.4%	120.4%
	Debt service (% of exports G&S)	5.7%	5.7%	5.4%	5.9%	6.5%	7.2%	7.9%
	Reserves (months of next years imports G&S)2	3.4	3.8	3.6	4.0	4.6	5.1	5.3
	Exports of goods and services, US$ value	4132	5048	4528	5225	5837	6542	7130
	Imports of goods and services, US$ value	9115	11141	10188	11957	14061	14639	15377
Monetary								
	Extended Broad Money (M3)[3]	24.0%	20.0%	18.2%	17.1%	17.5%	17.2%	16.7%
	Net foreign assets	2.3%	0.0%	2.3%	4.9%	5.5%	6.1%	6.8%
	Net domestic assets	21.6%	20.0%	16.0%	12.2%	12.0%	11.1%	9.8%
	o/w Net credit to government	8.3%	6.4%	3.0%	1.7%	1.9%	1.5%	1.3%
	Credit to rest of economy (% real change)	22.2%	15.4%	18.3%	17.8%	15.8%	14.6%	13.7%
	M3 velocity (average)	2.28	2.09	1.99	2.02	2.03	1.98	1.93
	Reserve money (annual percentage change)	22.8%	17.2%	12.4%	12.1%	16.4%	17.2%	16.7%

Source: MOF (Historical), PBO (Forecast)

Annex 3: Central Government Operations 2009/010 - 2014/15 (in Millions of Kenya Shillings)							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Act	**Act**	**Est.**	**Proj.**	**Proj.**	**Proj.**	**Proj.**
TOTAL REVENUE	**488,396**	**548,680**	**669,076**	**760,167**	**872,377**	**968,195**	**1,068,057**
Ordinary Revenue (excl. LATF)	455,779	507,464	609,224	686,210	785,220	871,038	960,900
Income tax	184,447	209,098	258,651	305,728	347,000	392,962	440,635
Import duty (net)	36,181	41,271	46,072	51,934	55,627	59,982	64,355
Excise duty	69,872	74,112	80,567	74,715	95,302	102,154	109,443
Value Added Tax	126,854	141,971	171,881	177,984	205,336	228,397	252,666
Investment income	6,919	8,354	11,086	11,700	13,700	15,400	17,300
Other	31,507	32,658	40,967	64,149	68,256	72,143	76,500
LATF	9,708	11,005	13,613	16,091	18,263	20,682	23,191
Ministerial and Departmental fees (AiA)	22,909	30,211	46,239	57,866	68,894	76,475	83,966
EXPENDITURE AND NET LENDING	**595,719**	**719,119**	**804,080**	**959,363**	**1,163,714**	**1,281,895**	**1,430,647**
Recurrent expenditure	435,542	504,376	584,658	642,453	789,535	839,483	917,402
Interest payments	47,877	52,058	63,523	76,198	84,573	141,643	125,064
Domestic interest	42,181	45,949	57,382	69,209	76,558	129,421	111,281
Foreign interest	5,696	6,109	6,141	6,989	8,015	12,222	13,782
Wages and benefits(civil service)	145,996	155,220	172,609	198,549	222,562	239,464	272,717
County Legislature					10,875	21,750	22,838
Development and Net lending	160,176	214,743	219,422	322,296	363,304	420,662	513,245
Balance (commitment basis excl. grants)	(107,323)	(170,439)	(135,004)	(199,196)	(291,336)	(313,700)	(362,591)
Adjustment to cash basis	-	-	-	-	-	-	-
Project grants	18,065	20,710	18,769	41,112	43,168	54,212	64,422
Programmme grants	-	-	-	-	-	-	-
Balance (cash basis including grants)	(89,258)	(149,729)	(116,235)	(158,084)	(248,169)	(259,488)	(298,169)
FINANCING	**78,696**	**153,675**	**110,209**	**158,084**	**211,599**	**178,245**	**193,585**
Net foreign financing	9,269	20,164	28,146	101,784	128,864	118,067	130,563
Project loans	22,573	27,777	39,811	48,245	128,864	128,213	152,884
Programme loans / Commecial Financing	-	-	-	52,200	-	45,186	25,696
Privatization proceeds	-	-	-	-	-	-	-
Net domestic borrowing	69,427	133,511	82,063	56,300	82,735	60,178	63,022
Financing gap / Policy Measures	0	3,946	-	-	(36,570)	(81,243)	(104,584)
Domestic Debt (gross) as % of GDP	23.3	26.9	26.9	27.5	24.6	22.8	21.4
Nominal GDP	2,238,313	2,458,307	2,775,054	3,333,066	3,953,939	4,512,094	5,139,168
Source: Historical (Ministry of Finance), Forecast (Parliamentary Budget Office)							

Annex 4: Central Government Financial Operations, 2008/09 - 2012/13 (in percent of GDP)							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Act	Act	Est.	Proj.	Proj.	Proj.	Proj.
TOTAL REVENUE	**21.8%**	**22.3%**	**24.1%**	**22.8%**	**22.1%**	**21.5%**	**20.8%**
Ordinary Revenue (excl. LATF)	20.4%	20.6%	22.0%	20.6%	19.9%	19.3%	18.7%
Income tax	8.2%	8.5%	9.3%	9.2%	8.8%	8.7%	8.6%
Import duty (net)	1.6%	1.7%	1.7%	1.6%	1.4%	1.3%	1.3%
Excise duty	3.1%	3.0%	2.9%	2.2%	2.4%	2.3%	2.1%
Value Added Tax	5.7%	5.8%	6.2%	5.3%	5.2%	5.1%	4.9%
Investment income	0.3%	0.3%	0.4%	0.4%	0.3%	0.3%	0.3%
Other	1.4%	1.3%	1.5%	1.9%	1.7%	1.6%	1.5%
LATF	0.4%	0.4%	0.5%	0.5%	0.5%	0.5%	0.5%
Ministerial and Departmental fees (AiA)	1.0%	1.2%	1.7%	1.7%	1.7%	1.7%	1.6%
EXPENDITURE AND NET LENDING	**26.6%**	**29.3%**	**29.0%**	**28.8%**	**29.4%**	**28.4%**	**27.8%**
Recurrent expenditure	19.5%	20.5%	21.1%	19.3%	20.0%	18.6%	17.9%
Interest payments	2.1%	2.1%	2.3%	2.3%	2.1%	3.1%	2.4%
Domestic interest	1.9%	1.9%	2.1%	2.1%	1.9%	2.9%	2.2%
Foreign interest	0.3%	0.2%	0.2%	0.2%	0.2%	0.3%	0.3%
Wages and benefits(civil service)	6.5%	6.3%	6.2%	6.0%	5.6%	5.3%	5.3%
County Legislature	0.0%	0.0%	0.0%	0.0%	0.3%	0.5%	0.4%
Development and Net lending	7.2%	8.7%	7.9%	9.7%	9.2%	9.3%	10.0%
Balance (commitment basis excl. grants)	-4.8%	-6.9%	-4.9%	-6.0%	-7.4%	-7.0%	-7.1%
Adjustment to cash basis	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Project grants	0.8%	0.8%	0.7%	1.2%	1.1%	1.2%	1.3%
Programmme grants	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Balance (cash basis including grants)	-4.0%	-6.1%	-4.2%	-4.7%	-6.3%	-5.8%	-5.8%
FINANCING	3.5%	6.3%	4.0%	4.7%	5.4%	4.0%	3.8%
Net foreign financing	0.4%	0.8%	1.0%	3.1%	3.3%	2.6%	2.5%
Project loans	1.0%	1.1%	1.4%	1.4%	3.3%	2.8%	3.0%
Programme loans / Commecial Financing	0.0%	0.0%	0.0%	1.6%	0.0%	1.0%	0.5%
Net domestic borrowing	3.1%	5.4%	3.0%	1.7%	2.1%	1.3%	1.2%
Financing Gap / Policy Measures	0.0%	0.2%	0.0%	0.0%	-0.9%	-1.8%	-2.0%
Nominal GDP	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Source: Historical (Ministry of Finance), Forecast (Parliamentary Budget Office)							