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Rise of the African Tiger

Budget Options for 2015/16 and the Medium Term

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For more information, contact:

The Director,
Parliamentary Budget Office
Parliament of the Republic of Kenya
Protection House, 10th Floor
P.O. Box 41842 – 00100 GPO
NAIROBI, KENYA

Tel: +254-20-222-1291
Fax: +254-20-243-694

Email: pbo@parliament.go.ke

The document can be downloaded from
www.parliament.go.ke

Preamble

Kenya can become an "African Tiger." In the 1960s, the economies of Hong Kong, South Korea, Taiwan and Singapore were classified as underdeveloped. However, from that period through the 1990s, these four economies were able to achieve spectacularly high and sustained economic growth through rapid industrialization and specialization in areas of comparative advantage; thereby earning themselves the title of the 'Asian Tigers.' The high growth phenomenon in East Asia during this period has been termed as nothing short of miraculous and has generated significant interest in other countries seeking to replicate the Asian Miracle in their own economies.

Kenya's ascent to lower middle income status in early October 2014 following rebasing of the country's GDP, is a statistical milestone which, not surprisingly, has elicited a lot of controversy. The controversy stems from the underlying - though inaccurate - assumption that this development supposedly implies an improvement in the quality of life for the 40 million plus Kenyans, yet almost half of the populace is estimated to be poor. It is possible that Kenyans may have experienced a change in status in the period 2003 - 2007, when the economy grew consistently, culminating in a 7% growth in 2007. As such, the new status announced in 2014 may not mean much to many as the real change happened seven years ago.

It is also important to note that while rebasing tries to accurately capture the true picture regarding the size and structure of the economy; it is not a clear indicator of the economic wellbeing and quality of life of a country. Kenya's ability to not only sustain a higher growth trajectory but also ensure a greater quality of life for all its citizens in a manner befitting its middle income status will depend on the direction the country takes in relation to development policies and more importantly; the decisions on the budget for 2015/16 and the medium term. To become an "African Tiger", Kenyans must take hard decisions and positions about the economy.

This edition of the Budget Options is premised on the ideas and policies that presumably led to the Asian Miracle and how the four economies were able to navigate from underdeveloped to high performing economies in a span of just three decades. Specifically, focus will be on Kenya's macroeconomic performance over the last decade and how higher growth can be achieved through efficiency in public expenditure, rather than increased spending. Furthermore, this document gives various options that Kenya could adopt in the next one year and in the medium term to ensure that it becomes an African Tiger.

Acknowledgements

Overall Supervision	Phyllis N. Makau	Director, Parliamentary Budget Office
	Martin M. Masinde	Senior Deputy Director, Parliamentary Budget Office
Core Team	Millicent Ojiambo-Makina	Fiscal Analyst, Macroeconomic Analysis Division
	Benjamin Ng'imor	Fiscal Analyst, Macroeconomic Analysis Division
Key Contributors	Robert K. Nyaga	Chief Fiscal Analyst, Tax and Inter-Fiscal Relations Division
	Joseph Ndirangu	Fiscal Analyst, Macroeconomic Analysis Division
	Julie Mwithiga	Fiscal Analyst III, Macroeconomic Analysis Division
	Danson Kachumbo	Fiscal Analyst III, Macroeconomic Analysis Division
	Ali Salat Hussein	Fiscal Analyst III, Macroeconomic Analysis Division

List of Acronyms and Abbreviations

AIA/ A-in-A	Appropriations in Aid
BPS	Budget Policy Statement
BROP	Budget Review and Outlook Paper
CARB	County Allocation of Revenue Bill
CBA	Collective Bargaining Agreement
CBK	Central Bank of Kenya
CBR	Central Bank Rate
CBROP	County Budget Review and Outlook Paper
CFS	Consolidated Fund Services
CFSP	County Fiscal Strategy Paper
CoB	Controller of Budget
CRA	Commission on Revenue Allocation
DoRB	Division of Revenue Bill
EAC	East African Community
ERS	Economic Recovery Strategy
FDI	Foreign Direct Investment
FEWS	Famine Early Warning System
FY	Financial Year
GDP	Gross Domestic Product
GNI	Gross National Income
ICT	Information, Communication and Technology
IEBC	Independent Electoral and Boundaries Commission
ILO	International Labour Organization
IMF	International Monetary Fund
JKIA	Jomo Kenyatta International Airport
KBRR	Kenya Bank Reference Rate
KeRRA	Kenya Rural Roads Authority
KNBS	Kenya National Bureau of Statistics
KSH	Kenya Shillings
KURA	Kenya Urban Roads Authority
MDAs	Ministries, Departments and Agencies
MDGs	Millenium Development Goals
MDS	Macroeconomic Diagnostics
MIA	Moi International Airport
MTEF	Medium Term Expenditure Framework
MTP	Medium Term Plan
NIS	National Intelligence Service
PBO	Parliamentary Budget Office
PFM	Public Finance Management
PIN	Personal Identification Number
RDL	Railway Development Levy
REA	Rural Electrification Authority
SGR	Standard Gauge Railway
TA	Transition Authority
TFP	Total Factor Productivity
USD	United States Dollars
VAT	Value Added Tax
WEO	World Economic Outlook

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Chapter One:

Macroeconomic perspective: Diagnostics for Kenya's economy over the past decade

In Brief

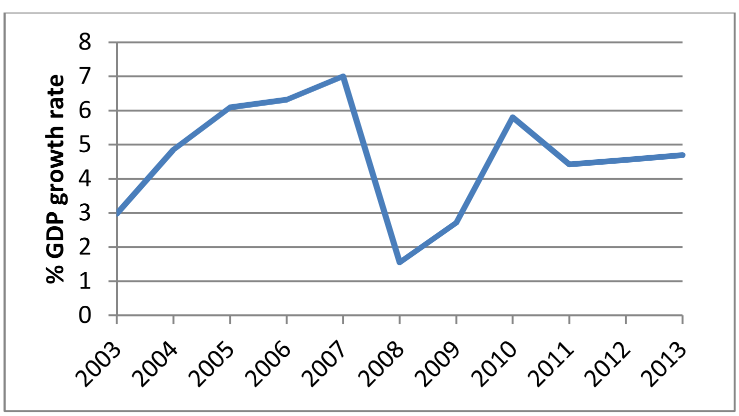
Kenya's economy has proved resilient over the last decade, weathering several shocks to grow at an average of 5 percent over the period 2003 – 2013. This growth is largely consumption driven with business investment lagging behind and net exports contributing negatively to growth. Furthermore, economic growth has been largely driven by expansionary fiscal policy which if not curtailed, is likely to increase Kenya's debt to unsustainable levels. Going forward, there is need to enhance investment levels, ensure efficiency in public spending, and improvement in export growth for sustainable GDP growth.

1.1. Economic Growth

Over the decade from 2003 to 2013, Kenya's economy grew steadily from 2.9 percent in 2003 to 7 percent in 2007- the highest growth to be achieved in that decade. This high growth trajectory has been attributed to factors such as a conducive business environment due to prevailing political stability which attracted investors, as well as implementation of the Economic Recovery Strategy (ERS). However, in 2008, political instability reversed the gains made and economic growth dipped to 1.5 percent. In the following years, modest growth was noted from 2009 to 2010 but it dipped again in 2011 most likely due to the ripple effects of the global recession.

In the period 2003 to 2007, the economy was able to achieve a high economic growth due to a stable macroeconomic environment and increased investor confidence.

Figure 1: GDP Growth for the period 2003 - 2013

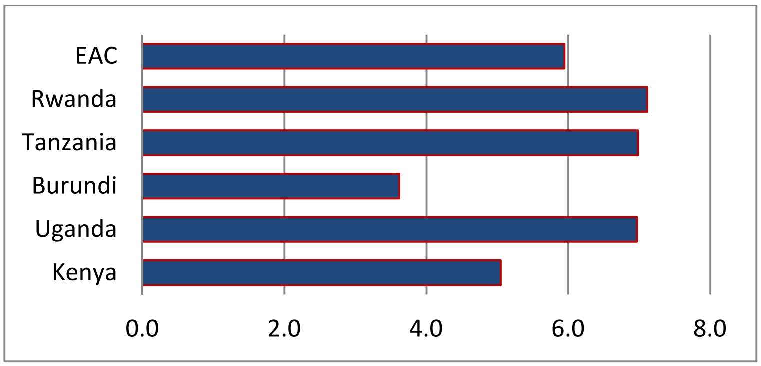


Source: Economic Survey (Various Issues)

Since 2008, the economy has been unable to reclaim its higher growth trajectory and continues to lag behind its East Africa Counterparts. On average, the economy grew by 5 percent over the period 2003 - 2013. This is much lower compared to Uganda's growth of 7%, Tanzania's growth of 7%, Rwanda's growth of 7.1% and the EAC average of 5.9% over the same period[1].

Kenya's economic growth rate lags behind that of its EAC counterparts with Rwanda registering the highest economic growth rate over the period 2003 - 2013

Figure 2: Average GDP Growth rate for EAC, 2003-2013



Source: World Bank

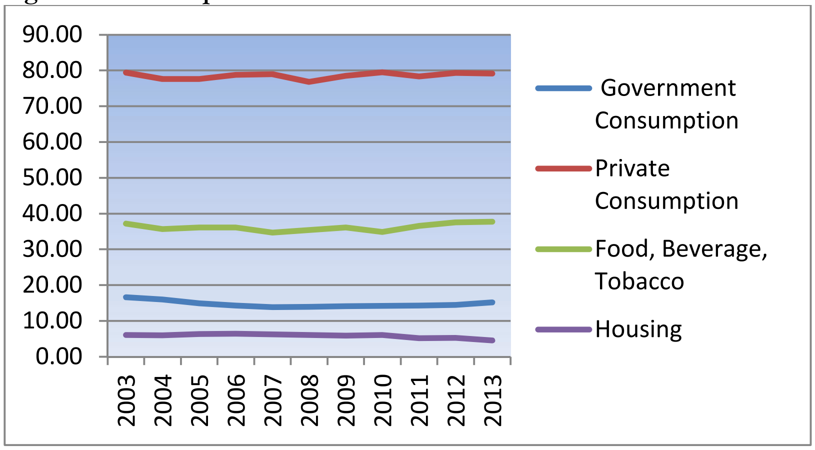
1.2. Consumption

Consumption – both government and private - is a key engine of economic growth in Kenya. In the period under review, private consumption as a share of GDP fluctuated between 76% and approximately 80%, making it a major component in Kenya's GDP and indicating robust domestic demand. Some components of private consumption include Food, Beverage and Tobacco which fluctuated between 35 per cent and 38 per cent in terms of contribution to GDP; as well as Housing consumption as a share of GDP which fluctuated between 5 and 6.5 per cent though it declined in 2013.

Consumption as a share of GDP averaged 76% - 80% as a share of GDP over the last decade with the food component averaging 35-38% in terms of contribution to GDP

[1] Average economic growth for 2003 - 2013

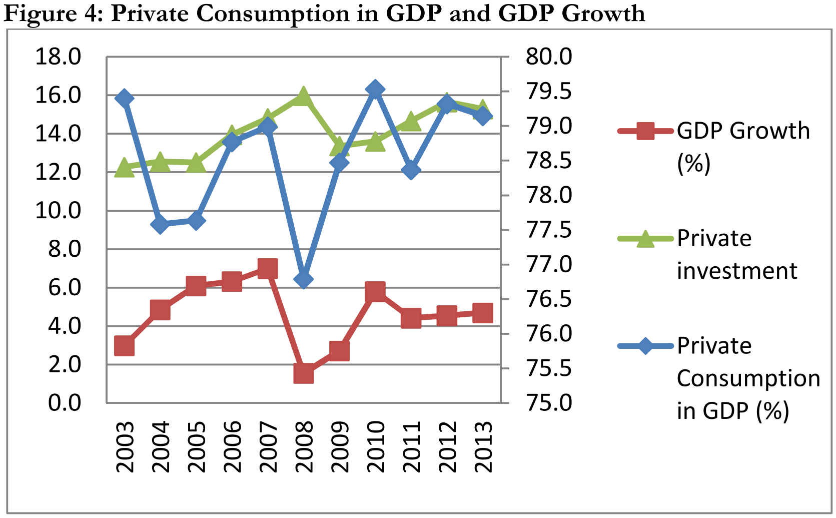
Figure 3: Consumption contribution to GDP



Source: Economic Survey (Various Issues)

Graph – contribution of consumption to economic growth

Figure 4: Private Consumption in GDP and GDP Growth



Source: Economic Survey (Various Issues)

Kenya's economic growth is driven by consumption indicating robust domestic demand and a thriving consumer base

As figure 4 suggests, Kenya's economic growth model is essentially consumption driven. While this has been able to propel growth in the economy, it should be noted that the years during which the country was able to achieve much higher, sustained economic growth (2003 – 2007) in the decade under review were the years during which private investment grew most rapidly and the overall deficit was the smallest including a surplus in the year 2005. The country's thriving consumer base is actually a key factor in promoting economic growth by spurring productive investment and growth in the economy to meet the demand. However, this has somehow not materialized, possibly due to a hostile business environment which inhibits investment growth.

It is important to also promote private investment as an alternative engine of growth in order to achieve sustainable growth

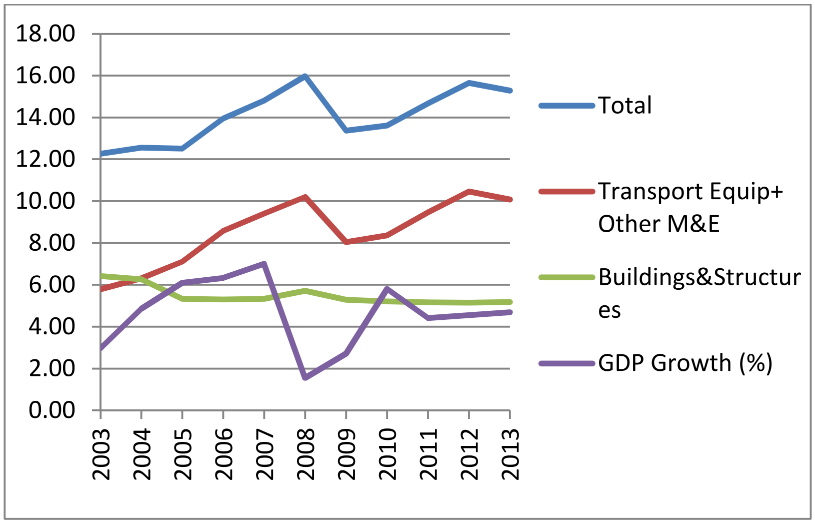
For a developing economy to mature, it is important to continuously invest in new capital, expand structures to make our environment more business friendly and produce more goods to be consumed in the economy. As it stands, the country relies heavily on import goods to bridge the gap in meeting the demand. Low investment levels have also inhibited the growth of exports in terms of quality and value addition hence the contribution of net exports to economic growth is negative.

1.3. Business Investment

Private investment has increased modestly, mainly driven by Transport Equipment and other machinery and equipment

Generally, though investment determines the productive capacity of the economy in the long-run, it tends to fluctuate more than the other components of GDP. Private investment as a share of GDP increased over the decade from 12.3% in 2003 to 15.3% in 2013. This increase was mainly driven by the Transport, Equipment and Other machinery & Equipment component whose contribution to GDP rose from 5.8% to 10%. Conversely, the contribution of Buildings & Structures to GDP declined from 6.4% to 5.2% during the same period.

Figure 5: Private investment contribution to GDP



Source: Economic Survey (Various Issues), MDS Model

Graph – private investment contribution to GDP

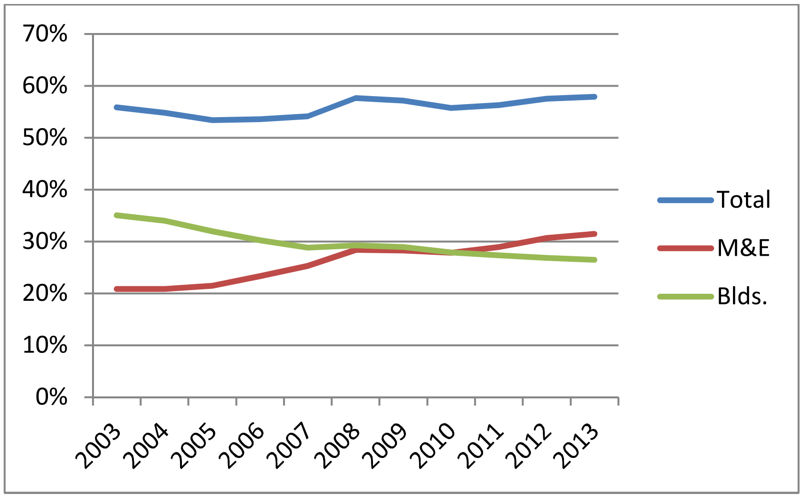
The increase in the contribution of Transport Equipment may be attributed to increased investment in infrastructure projects such as in transport, energy and ICT sectors; demand for vehicles during the elections period as well as acquisition of aircrafts by Kenya Airways that increased steadily from 17 in the year 2003 to 47 in year 2013. The decrease in the share of buildings and structures could have been as a result of high interest rates which discouraged the uptake of mortgages.

Contribution of Transport equipment to increased growth in private investment is partly attributed to increased demand for vehicles as well as acquisition of aircraft by Kenya airways

1.4. Business Capital Stock

The Capital- Output ratio is used to determine the efficiency of investment. Over the decade, there was an increase in the ratio for Machinery & Equipment, signifying declining efficiency in use of capital. On the other hand, the decrease in this ratio for buildings signifies increased efficiency in use of capital.

Figure 6: Capital- Output Ratio



Source: Economic Survey (Various Issues), MDS Model

To increase efficiency in use of capital will require adoption of new technology as well as improving both the technical capacity and knowledge of the workers.

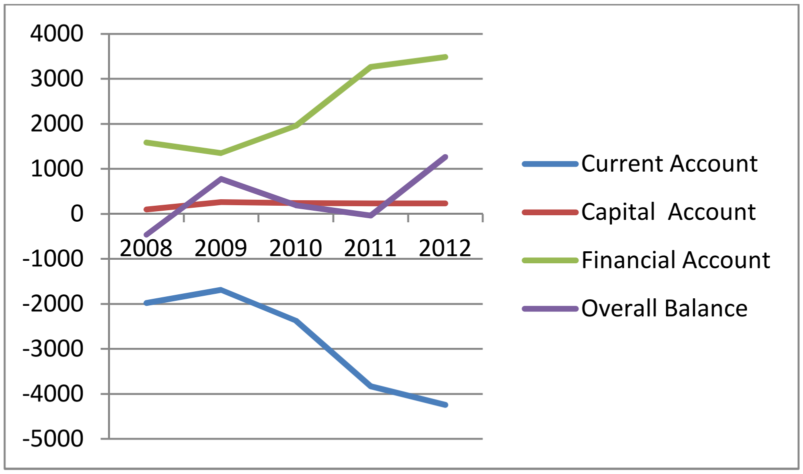
Higher contribution of investment to economic growth will entail enhancing the efficiency of capital through adaption of new technology as well as innovation

1.5. Balance of Payments

The current account balance improved significantly between 2008 and 2009, due to an improvement in the trade balance as imports declined on account of reduced aggregate demand. However, since then, it has declined progressively, largely on account of a worsening trade balance as the country's huge import bill continued to soar even as the export sector stagnated. A weak export sector implies reduced external competitiveness of the locally manufactured goods both domestically as well as in the international market. As such, many consumption goods are imported. Such a situation combined with a weakening shilling is likely to reduce foreign exchange earnings thereby worsening the current account balance.

The current account balance continued to worsen due to a worsening trade balance as the import bill increased and the export sector stagnated

Figure 7: Balance of Payments (Millions of USD)

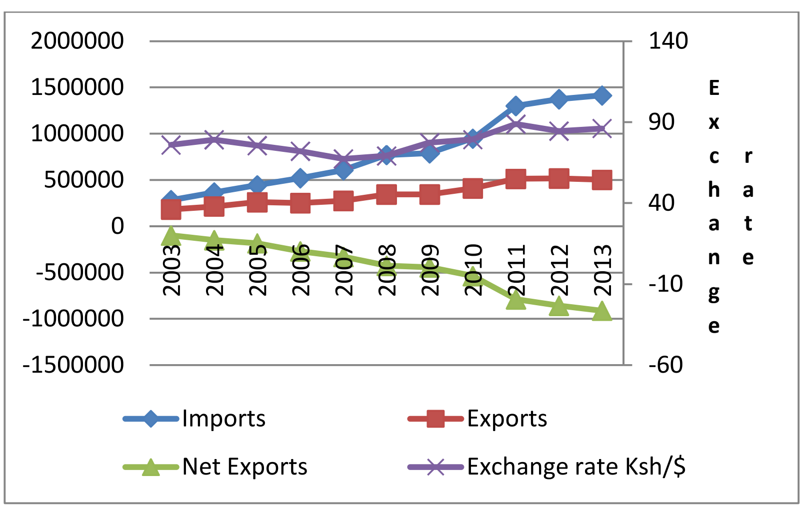


Source: Economic Survey (Various Issues)

Though the widening current account deficit has typically been offset by a capital and financial account surplus reliance on hot money has an inherent risk due to its volatility

Notably, the widening current account deficit has typically been offset by a capital and financial account surplus on account of short term foreign inflows from portfolio investments ('hot money'), as well as loans; resulting in a balance of payment surplus. However, reliance on hot money has an inherent risk due to its volatility as it can reverse quickly based on investor sentiments causing serious disruption in the financial market. This is a potentially destabilizing factor that has rendered the country susceptible to any adverse shocks to the economy.

Figure 8: Net Exports



Graph – trend in Net Exports

Source: Economic Survey (Various Issues)

It is worth noting that Kenya's strong economic performance in the period 2003-2007, was marked by a narrow gap between the exports and imports- a likely effect of a strong shilling in the same period. However, this gradually worsened in the subsequent years on account of robust domestic demand as the economy grew rapidly which resulted in increased importation of goods and services.

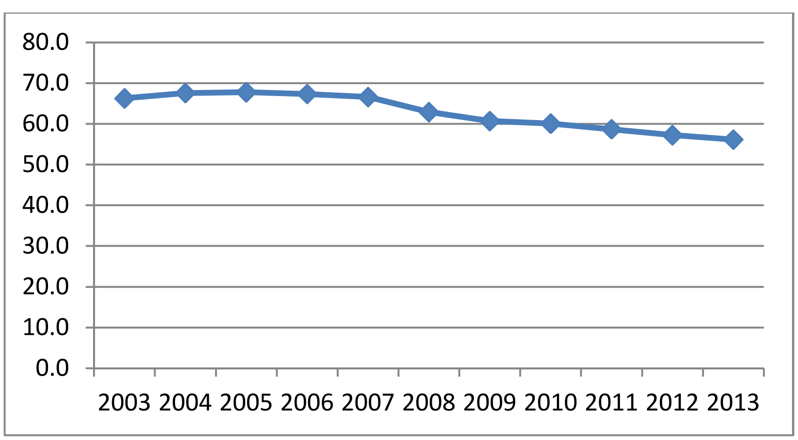
Kenya's strong economic performance over the last decade was marked by a narrow gap between exports and imports

1.6. Total factor productivity

Total Factor Productivity (TFP) is the efficiency with which goods and services can be produced with a certain amount of factor inputs (labour and capital) over a certain period of time. TFP measures long-term technological changes and efficiency; and is therefore important to long-term improvement in standards of living. Productivity, unlike production, measures the efficiency of the production process. Therefore, productivity increases when the inputs in the production process are optimally utilized to achieve greater levels of output.

Total factor productivity (TFP) measures efficiency in the production process

Figure 9: Total Factor Productivity (TFP)

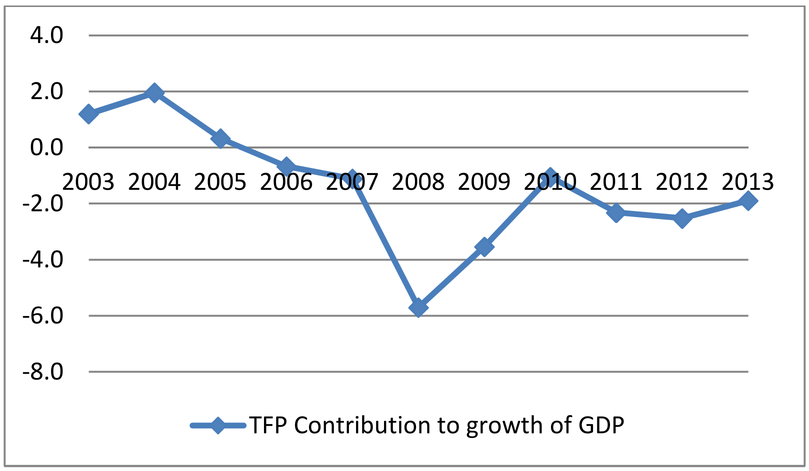


Source: Economic Survey (Various Issues), Macroeconomic diagnostic model

TFP gradually declined from 2007 to 2013 implying declining efficiency in production. This can be attributed to low uptake of new technology in production/manufacturing; that is, the available physical capital is old and has reached its maximum productive capacity. Also, high labour costs and declining labour productivity due to mismatch of skills in the job market as well as the quality of governance in our institutions due to corruption have contributed to the declining TFP.

Decline in Total Factor Productivity is observed from 2007 to 2013; attributed to low uptake of new technology, high labour costs and declining labour productivity

Figure 10: TFP Contribution to GDP Growth



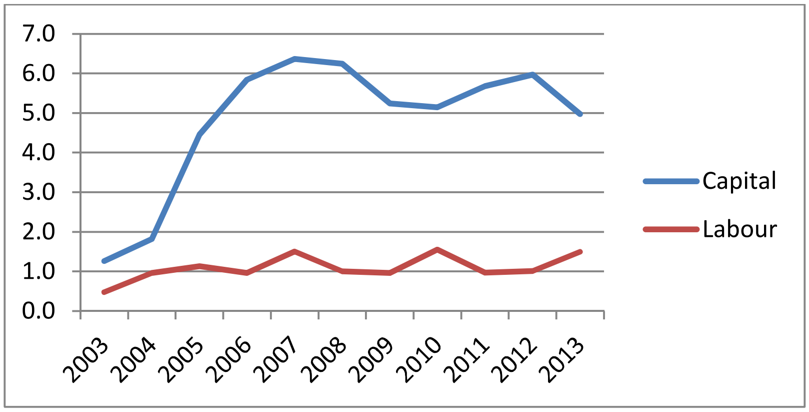
Source: Economic Survey (Various Issues), Macroeconomic diagnostics model

Even though the contribution of Total Factor Productivity to growth of GDP seems small, its impact on economic growth is very important. It is a compounding measure which means that small annual increases add up over longer periods of time and therefore sustain long-term growth. The reverse is also true.

TFP contribution to GDP growth has been declining and is currently negative; implying declining efficiency in the country's production process

It can also be observed that TFP contribution to growth of GDP tends to be pro-cyclical; it is higher when GDP is steadily expanding and declining when in a recession. Overall, the TFP contribution to growth of GDP has been negative since 2005 implying declining efficiency in the country's production process.

Figure 11: Capital and Labour Contribution to GDP Growth



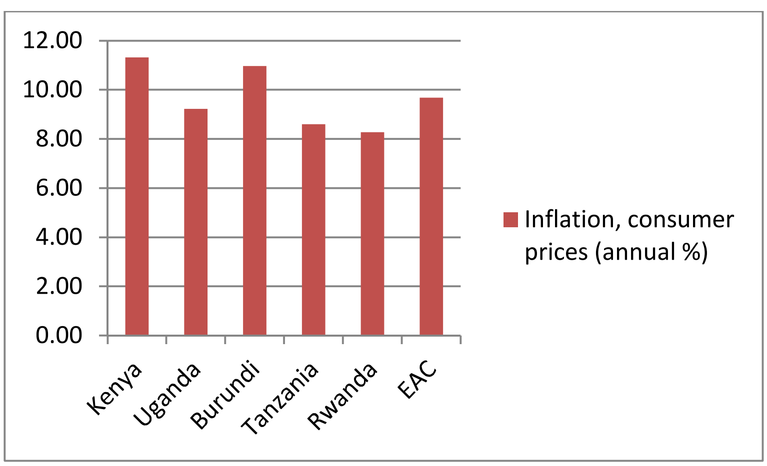
Source: International Labour Organization (ILO), Macroeconomic diagnostics Model, Economic Survey (Various issues)

Kenya's economic growth is more capital driven than labour driven suggesting that our human capital development does not match with the contemporary trends

Over the decade, it can be observed that GDP growth was generally more capital driven than labour driven. **This suggests that our human capital development has not matched with the contemporary trends.** The quality of our education system should be tailored to meet the requirements in the job market. Moreover, it should also support students from a tender age to be innovative and specialize in a particular area of interest.

1.7. Inflation

Figure 12: EAC Annual Average Inflation 2003 - 2013



Source: World Bank

Graph – Annual inflation in EAC countries over the period 2003 - 2013

Kenya's annual average inflation over the period under review was the highest at 11.32%. This is higher than EAC's single–digit average of 9.68%. Rwanda had the lowest average of 8.27%. Inflationary pressure in this period was due to global commodity price spikes, temporary price shocks associated with elections, the negative ripple effects of the 2008 global financial crises and erratic weather that depressed agricultural output.

Kenya's annual inflation over 2003 – 2013 was higher than the EAC average over the same period

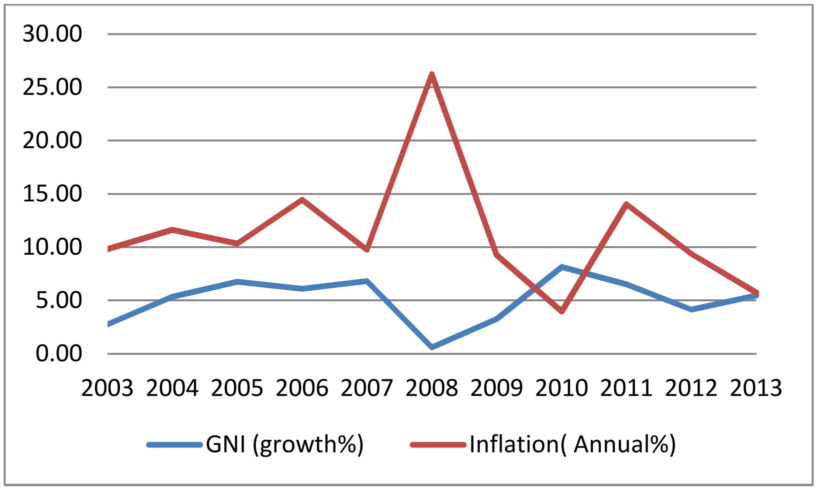
Table 1: Contribution to Inflation for FY 2007/2008 - 2012/2013

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Food & Non-Alcoholic Beverages	55.9	58.4	55.7	53.3	30.0	52.3
Alcoholic Beverages, Tobacco & Narcotics	2.7	2.3	3.1	1.5	1.6	2.0
Clothing & Footwear	2.3	3.6	4.7	3.4	9.5	6.2
Housing, Water, Electricity, Gas and other Fuels	15.2	13.8	15.5	14.2	19.7	13.8
Furnishings, Household Equipment and Routine Household Maintenance	3.3	6.3	2.9	3.4	8.1	3.8
Health	0.9	2.9	3.4	1.5	2.4	2.1
Transport	15.8	2.0	8.3	12.6	5.7	7.3
Communication	0.2	0.2	-0.6	-5.9	3.5	-0.1
Recreation & Culture	0.5	0.8	0.5	1.1	2.7	1.5
Education	0.2	0.2	0.4	0.8	2.9	2.5
Restaurant & Hotels	1.0	5.6	3.6	11.9	8.3	5.1
Miscellaneous Goods & Services	1.9	4.0	2.4	2.2	5.6	3.3
All items	100.0	100.0	100.0	100.0	100.0	100.0

The food and non-alcoholic beverages category has been the key contributor to the overall inflation, followed by the housing, water, electricity, gas and other fuels category. These two categories comprise the basic necessities of every household in the country and in turn determine the standards of living.

The key contributors to inflation are food as well as fuel

Figure 13: Kenya Average GNI & Inflation rates, 2003-2013



Source: World Bank

Graph – trend in growth of Gross National Income as well as inflation from 2003 - 2013

Inflation reflects the increase in the cost of a certain set of goods and services, in a given period. A consumer's cost of living depends on the prices of the many goods and services they consume and the share of each good or service in the household budget. Inflation affects the real income of a consumer and is a proxy for the standard of living. When real incomes are rises, so does the standard of living, and vice versa. The real income is measured by the Gross National Income (GNI) that is adjusted for inflation.

Increased inflation denotes increased cost of living as it affects the real income of a consumer. There is need therefore to ensure that inflation remains within the set target of 5 percent

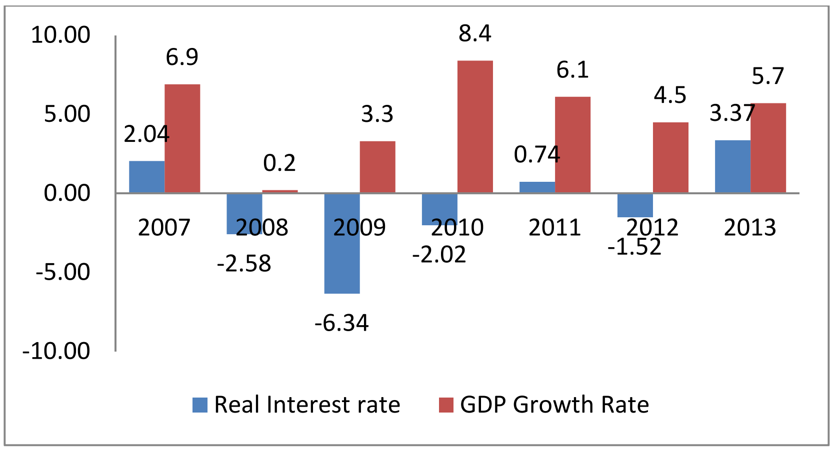
In the period under review, the GNI growth rate was lowest when the inflation was highest during the post-election violence; the standards of living were very low. Indeed, inflation is the worst enemy of the poor. The highest standards of living were experienced in the year 2010, when annual inflation was at its lowest single-digit level. It then declined in 2011 and 2012, as annual inflation increased. It should be noted that inflation is a key determinant of the standards of living in the country and therefore amid external and internal shocks, the monetary authorities should ensure that inflation remains within the set target of 5% (+ or – 2.5%).

1.8. Debt Dynamics

Debt dynamics looks at the capacity of a country to repay its debt. The two main factors to look at are; the comparison between the real interest rate and GDP growth rate; and the primary balance (before interest payments) as a percentage of GDP.

In order to determine the capacity of the country to repay its debt, we compare the real interest rate and the GDP growth rate

Figure 14: Kenya Real Interest Rate & GDP Growth (2007-2013)



Source: KNBS

The real interest rate in this case is the annual average interest rate on the 91 day Treasury bills, adjusted for inflation. When the real interest rate is less (more) than the GDP growth rate, then the debt is sustainable (unsustainable). In the period under review, the real interest rates have been lower than the GDP Growth rates, illustrating that debt has been sustainable over the past years. However, increasing fiscal pressures with implementation of devolution and huge infrastructure projects have increased the government's appetite for borrowing which could easily push debt to unsustainable levels.

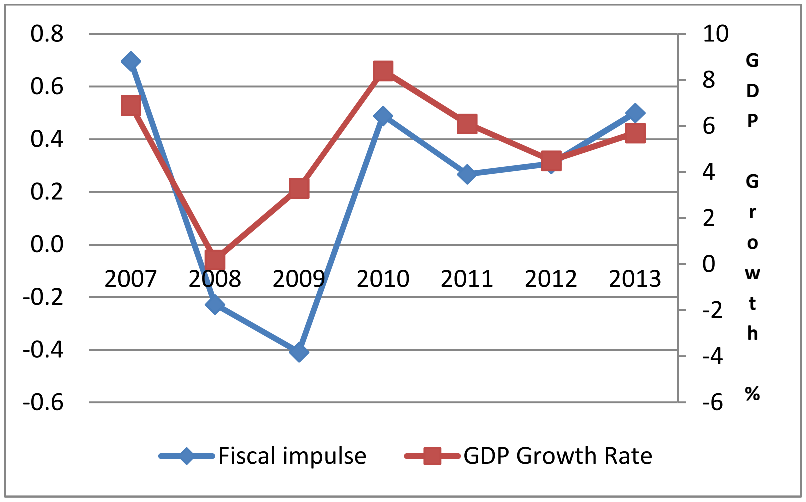
Analysis indicates that Kenya's debt has been at a sustainable level over the last decade but this position is being threatened by rising fiscal pressures

1.9. Fiscal impulse

Fiscal impulse is a key indicator of the fiscal policy of a country, measured by the changes in the primary balance. Fiscal policy is tight (contractionary) when the fiscal impulse is negative and loose (expansionary) when the fiscal impulse is positive.

A review of the country's fiscal impulse indicates that the country has been pursuing expansionary fiscal policy

Figure 15: Fiscal Impulse, 2007 - 2013



Source: National Treasury, Macroeconomic diagnostics model

The trend as observed from 2007 to 2013 displays a generally loose fiscal policy except in the period 2008-2009 as shown by a negative fiscal impulse. Implementation of the fiscal stimulus in 2009 to 2010 in order to boost the economy following the adverse economic shocks from the post election violence as well the global financial crisis marked a change in fiscal policy as government expenditure escalated. This resulted in increasing GDP growth. However, as shown in the diagram, with fiscal impulse continues to rise indicating increasing government expenditure and a widening primary balance as the country continues to borrow to fund its spending activities. In the long run therefore, expansionary fiscal policy may prove to be unsustainable.

Fiscal stimulus boosted economic growth following a dip in economic growth in 2008 to 2009. However, continued fiscal expansion is likely to increase borrowing and may eventually be unsustainable

1.10. Fiscal Sustainability

Government expenditure has grown exponentially since implementation of the fiscal stimulus in 2008 following a dip in economic performance after the 2007/08 post election violence as well as the global economic downturn which had further dampened the country's growth prospects. The stimulus was expected to rejuvenate the economy to grow faster. Since then, government expenditure has continued to grow causing the country's fiscal deficit to widen gradually; from 4.91 percent of GDP in 2002/03 to 6.49 percent of GDP in 2013/14 as the country continues to borrow amidst rising fiscal pressures.

Government expenditure continues to grow exponentially, causing the fiscal deficit to widen

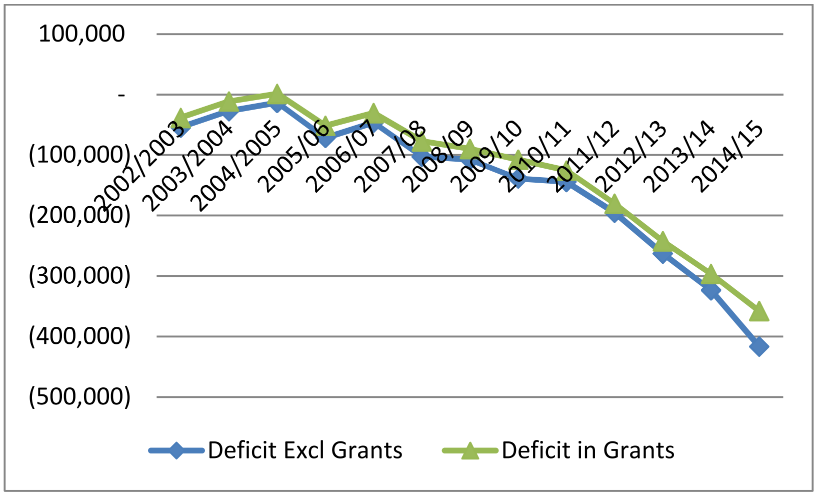
The latest figures from the National Treasury indicate that government revenues have grown from 19.39 percent of GDP in 2002/03 to around 19.55 percent of GDP in FY 2013/14. In contrast, government expenditures grew from 24.31 percent of GDP in FY 2002/03 to 26.03 percent of GDP in FY 2013/14. The structural imbalance between fiscal expenditure and revenue collection could have serious ramifications by driving debt to unsustainable levels. In effect, this will reduce the level of national savings due to increased interest payments as the country seeks to offset the debt. The decreased fiscal space will also limit the government's ability to respond to economic shocks and result in even higher fiscal pressures as the country struggles to repay the debt while at the same time meeting the needs of the Kenyan population. Under such circumstances, achievement of a high growth trajectory is very unlikely.

The structural imbalance between government expenditure and revenue collection is likely to drive debt to unsustainable levels

Thus we need to target revenue driven expenditure and in fact balance the budget. A gradual fall in the size of government spending and reorienting expenditure from recurrent type to more capital outlays with likelihood of high returns on

There is need to target spending within our capacity to collect revenue as well as reorient expenditure to high return investments investment is the best option of reducing the widening fiscal deficit.

Figure 16: Trends of Budget Deficit from 2002/03 - 2014/15



Source: National Treasury

Graph – increasing fiscal deficit over the period 2002/03 to 2014/15

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How serious is Kenya on Fiscal Deficit?

Kenya's set fiscal deficit targets in the budget have been proven to be moving targets

A glimpse of various policy documents such as the BROP and BPS of previous years indicate that the set fiscal deficit target in the budget and over the medium term as shown on Fig. 2 below are not adhered to. This poses a serious question on the effectiveness of these policies on fiscal deficit over the medium term. For instance, the deficit (commitment basis excl. grants) for 2012/13 set in BPS 2010 and 2013 was -5.2 percent and -7.0 percent respectively.

Table 2: Trend in fiscal deficit from 2007/08 - 2016/17

	Financial Years	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
BPS 2010	Balance(Commitment basis excl grants)	-5.2%	-5.1%	-8.0%	-6.9%	-6.2%	-5.2%			
	Balance(Cash basis incl grants)	-3.5%	-3.6%	-6.6%	-5.5%	-4.8%	-3.8%			
BPS2011	Balance(Commitment basis excl grants)		-5.2%	-7.4%	-7.3%	-6.6%	-6.1%	-5.2%		

	Financial Years	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
BPS2011	Balance(Cash basis incl grants)		-4.4%	-6.5%	-6.0%	-5.0%	-4.7%	-3.9%		
BPS2012	Balance(Commitment basis excl grants)			-7.2%	-5.2%	-6.3%	-5.6%	-4.9%	-4.6%	
	Balance(Cash basis incl grants)			-6.4%	-4.5%	-4.8%	-4.3%	-3.8%	-3.5%	
BPS2013	Balance(Commitment basis excl grants)				-5.5%	-6.1%	-7.0%	-5.5%	-4.9%	-4.8%
	Balance(Cash basis incl grants)				-4.8%	-5.6%	-4.9%	-4.3%	-3.7%	-3.6%
BPS2014	Balance(Commitment basis excl grants)					-6.2%	-7.4%	-10.8%	-7.9%	-7.2%
	Balance(Cash basis incl grants)					-5.5%	-6.8%	-8.9%	-6.3%	-5.4%

Source: Various BPS

Ceteris Paribus: for set fiscal deficit policies to be effective there has to be consistency in the set targets. This will enable revaluation of set policies in order to strengthen them so as to achieve the desired target. Indeed, the PFM Act 2012 had indicated the need to firm up the figures for the outer years. However, from the above, it is clear that the provisions of this law are not adhered to. This implies that the commitments that are more than one year may not be met when major changes are made in the budget.

It is important for set fiscal deficit targets to be adhered to so as to achieve targeted growth but within sustainable debt levels

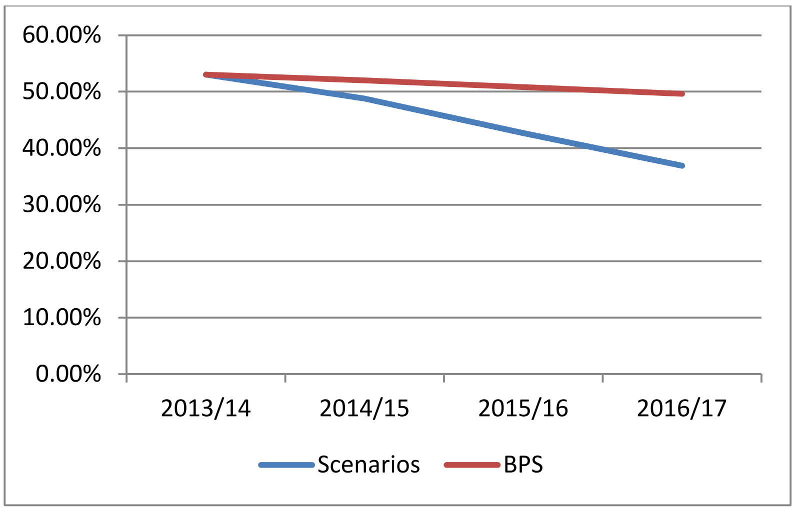
Based on our simulations using the debt stabilizing primary balance analysis, it is estimated that to ensure fiscal sustainability, the debt to GDP ratio should decrease considerably over the medium term. The Debt Stabilizing Primary Balance analysis helps in ascertaining whether the resources available in the country in the future are able to service the debt that has built up in the past. Analysis shows that the primary balance required to keep debt/GDP ratio sustainable at its 2014/15 level is at 3.0 percent. However the envisaged primary balance given in the BPS is about 3.3 percent. Thus, for debt to be within sustainable levels, it is expected that

Analysis using the debt stabilizing primary balance indicates that the country will need to reduce debt levels over the medium term in order to achieve higher economic growth debt for 2015/16 and medium term will have to slow down.

For projection of debt level until 2016/17, the results indicate that the debt stabilizing primary balance will need to reduce from 53.3 percent in 2013/14 to 37 percent in 2016/17 in order to achieve the optimistic GDP growth rate of 7.0 percent, 7.1 percent and 7.0 percent respectively in 2014/15, 2015/16 and 2016/17 as envisaged in the BPS.

Graph- debt to GDP ratio as proposed in the BPS vis-à-vis the debt stabilizing primary balance to achieve higher economic growth

Figure 17: Debt to GDP ratio (BPS, 2014 vs. Debt Stabilizing Primary Balance Analysis)



Source: Macroeconomic diagnostics model

International Comparisons

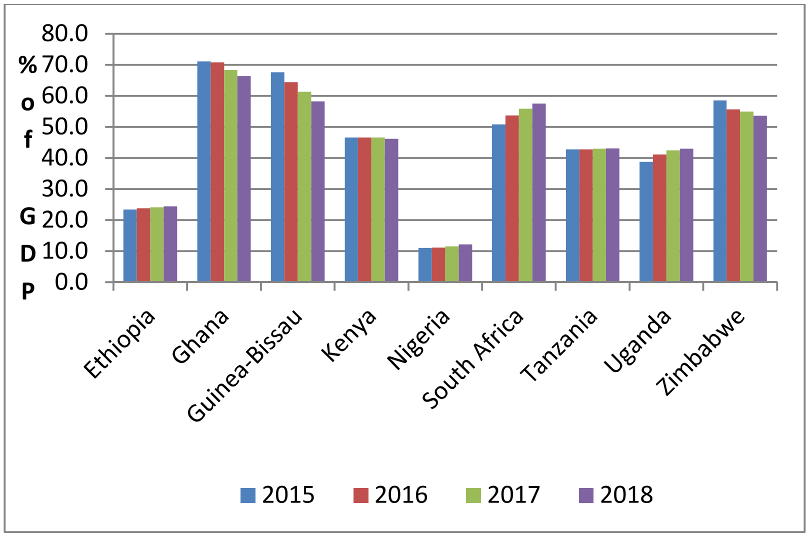
The IMF projections as contained in the WEO indicate a slight reduction in the government net debt forecast to achieve a growth of approximately 6.5 percent in the medium term

In order to bench mark forecasted debt burdens to GDP, IMF figures were used. The IMF publishes estimates of general government net debt for different countries in its World Economic Outlook (WEO). Figure 4 shows the IMF's latest forecasts for 2015-2018 for selected African countries. These figures were taken from the October 2014 WEO. On this measure, Kenya general government net debt forecast will be 46.6 percent of GDP in 2015 and is set to reduce to 46.1 percent in 2018. This forecasted GDP to Debt ratio is anchored on GDP growth rate of 6.15 percent, 6.38 percent, 6.48 percent and 6.55 percent for 2015, 2016, 2017, and 2018 respectively.

Countries which have been forecasted to have high debt ratio to GDP such as Ghana have low GDP growth rates. It is forecasted that in 2015, Ghana Debt to GDP ratio will be 71 percent and the expected growth shall be 4.6 percent. Conversely, Nigeria which has the lowest debt to GDP ratio of about 11 percent will have GDP growth rate of about 7.2 percent.

A high debt to GDP ratio is positively related to low GDP growth rate

Figure 18: Forecast of Debt to GDP for Selected African Countries



Source: IMF, World Economic Outlook, October 2014

Graph - Forecasts of Debt to GDP ratio for selected African countries

Table 3: Debt to GDP vs. GDP growth rates for Ghana & Nigeria

		2015	**2016**	**2017**	**2018**
Ghana	GDP (%)	4.69	7.18	6.35	5.77
	Debt to GDP (%)	71.06	70.81	68.32	66.32
Nigeria	GDP (%)	7.28	7.18	7.07	6.88
	Debt to GDP (%)	11.10	11.15	11.62	12.20

Source: IMF, World Economic Outlook, October 2014

Chapter Two:

The Great Leap Forward: What lies ahead and how to become a high performing economy

In Brief

Having attained Middle Income Status, Kenya's economy is at a vantage position for take-off to reach double digit growth and improve the socio-economic status of its people. In the face of macroeconomic stability, Kenya's economic growth prospects remain promising. However, deliberate policy measures will have to be undertaken reduce fiscal deficit and enhance productivity growth and efficiency in utilization of productive capacity. In particular, Total Factor Productivity must improve and growth be led by the private sector in order to achieve a more sustainable growth pattern. There is need also for an attitude change among Kenyans to contribute to economic growth through own efforts rather than relying on the government for everything.

2.0. Maintaining macroeconomic stability

Having become a lower middle income economy, the onus on Kenyans is to ensure that this milestone translates into practical social and economic development. Kenya, like most African Middle Income Countries, still remains vulnerable to the numerous challenges it faced as a low income country due to factors such as limited product diversification and modest export earnings, huge import bills, exchange rate volatility, fluctuating price levels, hostile business environments as well as structural inefficiencies in various sectors of the economy. Importantly, maintaining a stable macroeconomic environment is the biggest challenge in these economies.

Though Kenya is a lower middle income country, it remains vulnerable to most of the challenges it faced as a low income economy

The general outlook for the Kenyan economy remains promising with the potential of achieving stronger, sustainable growth based on solid macroeconomic outcomes if the various key challenges are adequately addressed and dealt with over the medium to long term. Quality, sustainable and all inclusive economic growth can be achieved through intensive saving and investing particularly in the private sector as well as inculcating an entrepreneurial culture and supporting creation of an

Higher economic growth can be achieved through intensive saving and investing, particularly in the private sector entrepreneurial class. Furthermore, productivity in the labour market will have to be much higher to encourage labour driven growth as well as higher employment levels. But for any of this to be achieved, the security situation must improve.

For higher employment levels, productivity in the labour market has to improve

2.1. Medium Term Economic Outlook

2.1.1. Inflation, Interest rate and Exchange Rate

Inflation: Food, electricity and fuel prices have been on the decline in the last quarter of 2014 resulting in low inflation levels. If the trend persists in 2015, inflation is likely to decelerate further to the policy target of 5% or at least remain within the single digits. However, there still remains a likelihood of shocks which can adversely affect the inflation rate. According to the Famine Early Warning System (FEWS) report (Dec 2014), the short rains experienced in October to December were below average. Thus food security outcomes may not be very positive as food production between January and March 2015 is expected to be below average.

Inflation remains within the single digits due to declining food and fuel prices; however, likelihood of below average food production remains a threat to inflation

However, the threat of rising food prices may be offset by the declining oil prices which will have significant impact in reduction of transportation as well as production costs. The falling oil prices are due to falling prices of crude oil currently at $51 per barrel. Furthermore, electricity prices were expected to come down significantly following injection of an additional 280 Megawatts to the National grid from geothermal production notably the recently launched Olkaria power plant. The declining oil prices will also reduce the fuel cost adjustment component which is a major cost item of electricity bills. *Based*

Declining oil prices have significantly reduce inflationary pressures; electricity prices are also expected to decrease significantly *on these developments; inflation is likely to remain within the single digits, averaging 5 - 7% in 2015.*

The benefit of low and stable price levels is that Kenyans will have a higher real income and increased purchasing power due to a lower cost of items. This is likely to stimulate aggregate demand and with it, increased production to meet the increased demand, as well as higher employment levels to be able to meet the production needs.

Low inflation is likely to stimulate higher demand for goods; create conducive macroeconomic environment for investment

Furthermore, low and stable inflation will create a more conducive environment for investing due to the confidence of stability in prices which means one can make proper borrowing and lending decisions without fear of price instability eroding profits. Increased investment will also eliminate volatility in output growth and reduce cyclical fluctuations in the economy. Low inflation also means our exports will be more competitive as the price of domestically produced goods remains low relative to prices of goods produced in other markets. This will promote our alternative scenario policy of increasing private investment and exports as well as attracting Foreign Direct Investment.

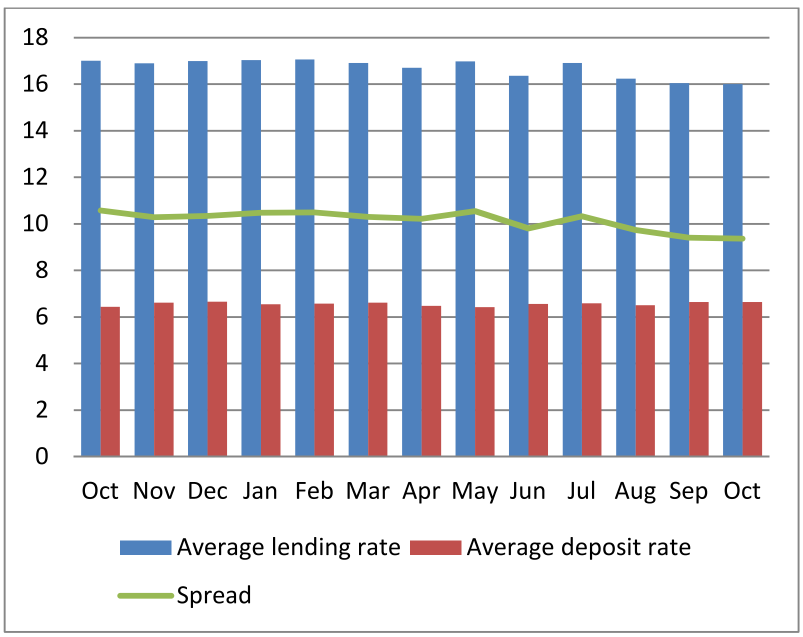
Central Bank has maintained the CBR at 8.5 percent in order to keep inflation in check but will have to consider steps to be taken to increase credit access to the private sector

Interest Rates: The Central Bank has maintained a tight monetary policy with the CBR rate retained at 8.5 percent since May 2013 in order to rein in inflation. However, given the declining trend in inflation, the CBK is in a position to ease the CBR rate in order to afford more credit to the private sector. However; it is worth noting that an increase in private sector credit may reverse the gains made in reining in inflation as more money goes into circulation. Thus the CBK will have to walk a tight rope in balancing increases in private sector credit while maintaining inflation at a low level.

It is expected that the open pricing system of private sector credit following introduction of the Kenya Bank Reference Rate (KBRR) in July 2014 - a base rate above which commercial banks can add their own premium based on their costs of deposits, overheads, and borrowers risks - will not only foster transparency in the bank transactions but also trigger bank competition with customers going to banks that offer lower rates thereby forcing other banks to lower their loan prices. According to the Credit Survey Report (September 2014), the KBRR is cited as one of the main factors increasing demand for credit.

Introduction of the KBRR is expected to foster transparency in the Bankng sector and also increase credit access to the private sector

Figure 19: Graph showing Interest rate Spread Oct 2013- Oct 2014



Data Source: CBK Monthly Bulletin, Oct 2014

Graph – Interest rate spread Oct 2013 – Oct 2014

However, whether this measure will yield expected results remains to be seen. So far, small improvements have been observed in the bank's lending rates with a slight drop in the interest rate spread. The CBK lowered the KBRR to 8.54 percent in January 2015, down from 9.13 percent set in July 2014. To maintain a low KBRR, the Government will have to keep its appetite for credit in check especially given that the T-

So far, there is noted a slight decrease in the bank lending rates since introduction of the KBRR

Bill rate is a key factor in determining the KBRR. Government policies like borrowing externally may augur well for the economy with likelihood of interest rates coming down. However, citing borrower's risks and other cost factors which remain unchanged in the banking sector, the bank's lending rates are likely to only reduce by the difference of 0.59 percent achieved through setting of the new KBRR. *Therefore, commercial bank lending rates are likely to average 14% to 15% through year 2015, whereas the deposit rates are likely to remain unchanged, averaging 6.5% to 7.5%.*

Despite the measures put in place, bank lending rates may not decrease significantly due to other factors such as borrower's risks which increase cost of borrowing

The slight decrease in interest rates may not have any significant impact on the market and borrowing by businesses and households is likely to remain rather low. This will impact negatively on private sector investment. In future, given the declining inflation, the CBK may eventually have to reduce the CBR rate in order to decrease the lending rates further.

Exchange Rate: The positive outlook for inflation on account of decreasing fuel prices may be negatively impacted by the exchange rate if the current trend continues. Indeed, the shilling has been depreciating since October 2013 and currently stands at Ksh. 91 to the dollar with a possibility of declining further. A weaker shilling is likely to offset the gains made from the declining fuel prices as it implies more expensive imports. The weakening shilling has been attributed to decreased foreign exchange inflows as the tourism sector suffers as well as the decline in tea prices - from Ksh. 235 per kg in January 2014 to approximately Ksh. 180 per kg by September 2014 [2]. Furthermore, the tourism sector has recorded significant decline

The shilling is currently exchanging at approximately Ksh. 90 to the dollar; attributed to decreased foreign exchange inflows

[2] Leading Economic Indicators, KNBS, November 2014

in tourist arrivals compared to the same period last year. This is indicated in table 3 below.

Table 4: Visitor arrivals (excluding Kenyans) through JKIA and MIA (Numbers)

Month	2013	2014	% change on same month last year
January	111,984	95,759	-14.5
February	73,001	68,604	-6.0
March	69,953	91,602	30.9
April	68,424	66,650	-2.6
May	74,523	58,301	-21.8
June	97,775	47,307	-51.6
July	123,812	86,666	-30.0
August	57,083		
September	95,707		
October	101,407		
November	100,310		
December	128,673		

*Data from August to December not available
** Data Source: Kenya Tourism Board (as cited in Leading Economic Indicators, KNBS, November 2014)

Table – visitor arrivals excluding Kenyans through JKIA and MIA

Nevertheless, the re-opening of the Eurobond in December 2014 has greatly improved Kenya's foreign exchange reserves with a total of Ksh. 67 billion raised. This is likely to cushion the shilling against further shocks. *Thus the exchange rate is likely to average Ksh. 90 to the dollar in 2015.*

Structural imbalance in the economy due to trade imbalance renders the country vulnerable to shocks that may affect foreign exchange inflows and therefore the exchange rate.

It is worth noting that a weakening exchange rate is not necessarily bad for the economy as it reduces the price of our exports in the global market therefore making our exports more competitive. However, unless the inherent structural weaknesses in Kenya's economy on account of too much imports, too little exports is addressed, the country will remain vulnerable to shocks that may affect foreign exchange inflows and therefore the exchange rate.

2.1.2. Exports, Imports and the Current Account

Exports: Kenya prides itself in being a key exporter of tea, coffee, horticulture as well as tourism. However, these key export sectors continue to grapple with serious challenges which have inhibited the export sector from growing and making any meaningful contribution to the GDP. In 2014, the tea sector suffered a huge setback in terms of falling prices with farmers threatening to uproot the crop and replace it with a higher yield. This has been attributed to a glut in the production of tea which led to it being priced too low.

Kenya's export sector continues to grapple with serious challenges which have inhibited the export sector from contributing significantly to economic growth

The challenges facing the export sector emanate from a business as usual approach inherent in this sector. The export products largely remain unchanged – tea, coffee, horticulture, tourism – with little value addition that could make them more competitive in the global market. Our export market is also severely limited to the traditional markets of Europe, Egypt, Pakistan with the EAC consuming majority of our exports. As such, turmoil in any of these countries is likely to significantly affect the country's foreign exchange earnings. *Barring any significant improvements in Kenya's export market, the volume of exports is expected to grow by 5.9 percent in 2014/15, 6.4 percent in 2015/16 with a slight decrease to 4.3 percent in 2016/17. The value of exports as a percentage of GDP is expected to average 19.3 percent over the period 2014/15 to 2015/16, with a slight drop to 18.7 percent in 2016/17. The decrease in 2016/17 is on account of challenges associated with the general elections which are likely to adversely affect the business environment.*

Challenges inherent in the export sector that have weakened competitiveness of Kenya's export products include little product diversification as well as limited markets

Kenya's export sector could benefit from penetration of other markets, diversification of export products and compliance to global standards. This entails increasing productivity of the manufacturing sector with emphasis on value addition. For instance, instead of exporting raw tea and coffee, we could consider processing and producing a Kenyan made brand. Fruits and vegetables can be canned and exported. This will however entail significant adjustments in the manufacturing sector as well as stock of human capital as we move towards investing in knowledge workers in an effective knowledge based economy.

Imports: The declining shilling means that imports will be more expensive thereby offsetting the gains made by the reducing import bill on account of declining oil prices. Huge imports are expected over the medium term due to ongoing mega infrastructure projects in the country such as the Standard Gauge Railway as well as Roads. *Thus the volume of imports is expected to grow by 6.3 percent in 2014/15, increasing by 6.8 percent and 7.7 percent in 2015/16 and 2016/17 respectively. In terms of imports as a percentage of GDP, the figure is expected average 34.8 percent over the period 2014/15 to 2016/17.*

The country's import bill is likely to continue to grow due to ongoing mega infrastructure projects

2.1.3. Consumption and Investment

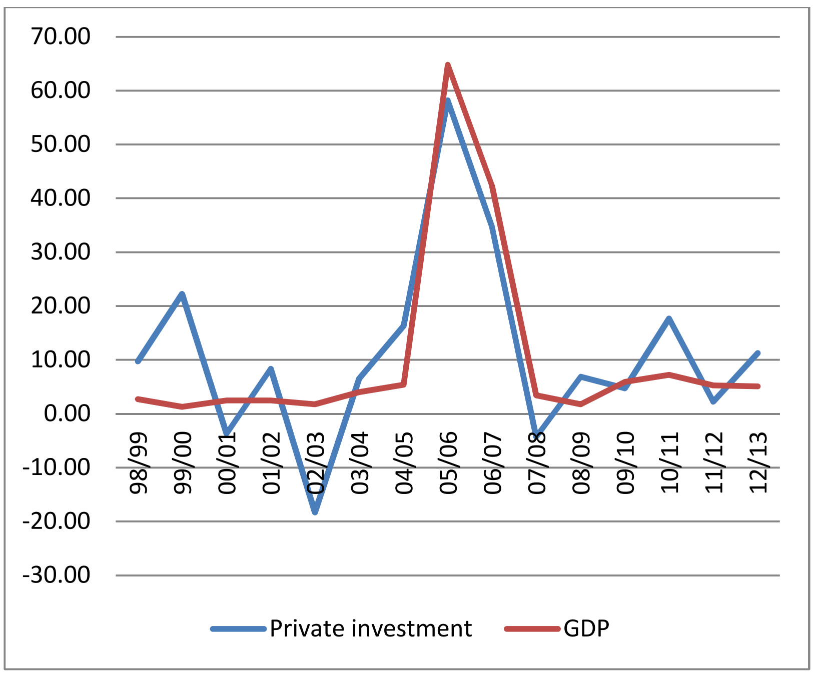
Kenya is a consumption driven economy fueled by increasing consumerism and importation of goods for several development projects in the country. Local industries can't meet domestic demand hence the growth of imports. Thus there is need to promote investments so as to not only enable the local industries to meet the local demand, but also to increase our export products thereby increasing foreign exchange earnings. The middle income status is a boon to investment as it positions Kenya as an attractive destination for investors. Indeed, Kenya has been portrayed as having, *"a strategic location, a port and a coastline, a broad manufacturing base and the best business infrastructure*

Promotion of private investment will not only meet local demand but will also add value to our export products and increase foreign exchange earnings *coastline, a broad manufacturing base and the best business infrastructure in the region, (as well as) excellent resources for agriculture and tourism".*[3]

However, despite the evident investment opportunities, the country still remains unable to achieve broad based, investment driven growth; attributed to other factors such as a rigid and cumbersome legal and regulatory environment, infrastructure bottlenecks, and high cost of utilities notably electricity which increase the cost of doing business.

There is need to address factors which contribute to high cost of doing business such as rigid regulatory environment and high cost of utilities which increase cost of doing business

Figure 20: Relationship between Private Investment Growth and GDP growth



Source: PBOM

Graph – relationship between private investment growth and economic growth

As figure 20 suggests, there is a positive link between growth in private investment and GDP growth. The advantage of a private investment growth model vis-à-vis the consumption driven growth model is that the former will not only drive a higher economic growth agenda but will also enhance productivity growth and technology improvement as firms become more

Growth of private investment will drive a higher economic growth agenda as well as enhance productivity thereby increasing employment opportunities

[3] An Investment guide to Kenya: Opportunities and Conditions, UNCTAD 2012

competitive, ultimately increasing employment opportunities and lifting the standards of living for majority of the people.

Assuming no policy change, private investment is projected to grow by an average of 5.6 percent in 2014/15 through 2015/16. Government investment will be much higher with a growth of approximately 24 percent over the same period as the government continues to drive its infrastructure investment agenda.

To increase private investments in the economy, the country will need to undertake significant policy changes to improve the business environment

To increase the level of private investments in the economy including FDI, the country will need to undertake significant policy changes to address the investment constraints. This includes, first and foremost, putting in place regulatory reforms that will improve our doing business indicators. This includes measures to address corruption, bureaucracies and the red tape which have been cited as key factors behind the high cost of doing business. This has also greatly contributed to small businesses choosing to 'remain small' in order to evade taxation which is perceived to increase transaction costs. Simplification of taxation procedures as well as administration of taxes through computerization of all payments procedures will reduce leakages.

Access to credit remains a challenge to businesses with banks citing high risk profiles of borrowers as the cause of high lending costs

Access to finance for small businesses has also been cited as a grave challenge. Though the lending rates by the banks appear to somewhat be reducing, high risk profiles of the borrowers are likely to keep lending costs high. One important underlying factor is the issue of land which can be used as collateral but which is fraught with many challenges. The clean-up exercise in the lands registry as well as digitization of land records will go a long way in improving the use of land as collateral for those seeking financing from banks.

2.2. Economic growth Projections

Kenya's economy is primed for higher growth. Factors likely to propel this growth include a stable macroeconomic environment given the low inflation and stable exchange rate, maintenance of macroeconomic stability to a greater extent, resilience in the face of shocks to the economy as well as investment in infrastructure. However, serious downside risks remain such as the worsening insecurity, low absorption of development funds and inefficiency in utilization of resources.

Stability in the macroeconomic environment is likely to foster higher economic growth; however, insecurity and inefficiency in utilization of resources is likely to dampen these growth prospects

During the review of the first Medium Term Plan under the Vision 2030 blueprint, failure to achieve the 10 percent growth was attributed to a myriad of challenges; notably, low domestic savings and investments with Kenya's saving rate cited at 13 percent of GDP which is just half of the average for low income countries, and less than the 17 percent of the Sub-Saharan Africa average. In addition, high energy costs, high cost of private sector credit, narrow range of exports and slow growth in their value as well as high unemployment and poverty levels were cited as challenges which prevented achievement of higher economic growth.

Failure to achieve high economic growth has been attributed to low domestic savings and investment ; narrow range of exports, high business costs

Achievement of higher growth, therefore, means that these challenges have to be adequately addressed. The proposed sustainable growth formula is not through additional government expenditure but rather, increased productivity through enhancing efficiency in utilization of existing capacity as well as private sector development. This section provides three different scenarios that the country's growth trajectory is likely to follow depending on the decisions the country makes in terms of fiscal policy.

Sustainable higher growth formula entails increased productivity through enhancing efficiency in utilization of existing capacity

2.2.1. Baseline Scenario: Business as Usual

(Key words: No policy change, incremental budgeting)

The following assumptions are made:

i) *No significant change in government policy*

ii) *Government expenditure increased based on slight changes from the previous year's budget*

Baseline scenario assumes no policy change to the economy and government expenditure remains incremental

Under the baseline scenario, barring any adverse shocks to the economy, it is expected that the GDP will grow by 5.5 percent in 2014/15. In the medium term, the economy is expected to grow at 6.3 percent in 2015/16 rising to 6.6 percent in 2016/17 and 2017/18. The key feature under this scenario is that the government simply continues to make progress on the policies that have been put in place in previous years. The pace of growth is therefore likely to remain, on average, on the same level it has been in the previous years.

Economic growth in this scenario is therefore driven by continued fiscal expansion by government due to continued investment in infrastructure projects as well as stability in inflation and exchange rate with the food and fuel prices expected to remain low. The ICT sector and services have emerged as the basis of higher growth following the rebasing of GDP and is also expected to continue driving growth.

Under this scenario, the economy will grow following the usual historical trend but is likely to be enough to improve the standard of living of Kenyans

However, risks to this outlook include the ongoing security concerns which have dampened the outlook of investments as well as the tourism sector, poor absorption of development funds especially at the county level and a likelihood of below average rainfall in some parts of the country. In addition, the fiduciary risk is increasingly worrying due to issues related to transparency and accountability of public resources.

2.2.2. Worst Case scenario: Reversal in Gains

(Key words: fiscal expansion, growing fiscal deficit, reduced private investment)

The following assumptions are made:

i) *Government expenditure continues to increase significantly*

ii) *The trend of poor absorption of development funds continues resulting in delayed projects*

iii) *Increased domestic borrowing crowds out the private sector resulting in reduced private investments*

iv) *Soaring budget deficit*

Worst case scenario assumes increasing government expenditure with inefficiency in utilization of resources and high budget deficit

In this scenario, simulations indicate that the economy is likely to expand in the initial year, growing by 7.0 percent in 2015/16 but the growth dips in the subsequent years to 6.5 percent in 2016/17 and 6.4 percent in 2017/18 with a likelihood of decreasing even further in the outer years.

Under this scenario, economic growth will be quite high in the initial year but will dip in the subsequent years

The problem with economic growth in this scenario is that it appears to be unsustainable, with an initial boom in the year of excess government expenditure after which economic growth gradually declines prompting the government to spend even more to spur growth. However, since this increased expenditure cannot be met through taxes, the result is soaring deficits and unsustainable debt levels.

2.2.3. Best Case Scenario: Roadmap to Sustainable Economic Growth

(Key words: Fiscal consolidation; lower fiscal deficit, Private sector driven growth)

The following assumptions are made:

i) recurrent expenditure is reduced and the savings therein are transferred to development expenditure

ii) No new contracting of loans

iii) Efficiency in utilization of resources increases with improved absorption capacity of development funds

iv) Reduced domestic borrowing increasing credit access to the private sector thereby spurring private investments

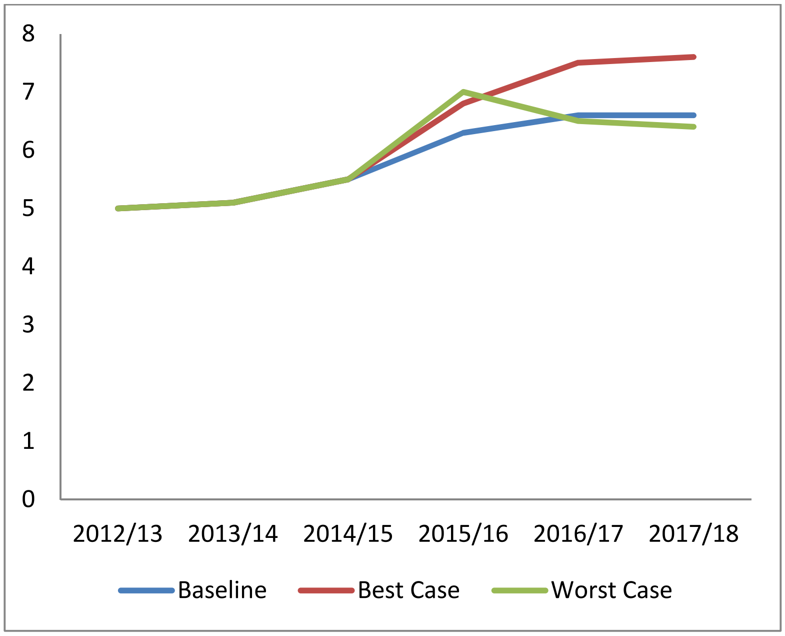
v) Enhanced total factor productivity through leveraging research, development, technology and innovation

In the best case scenario, government expenditure is curtailed but there is increased efficiency in utilization of available resources

In this scenario, simulations indicate that the economy is likely to grow by 6.8 percent in 2015/16, rising to 7.5 percent in 2016/17 and 7.6 percent in 2017/18. The defining feature of this growth is that it grows higher over the medium term and therefore appears to be sustainable. Private sector led growth is likely to trigger increased employment and increase per capita income. Quality as well as volume of exports is also likely to increase as the economy produces more to meet both domestic and foreign demand. Increased competitiveness will ensure quality. Should this materialize, it will greatly improve the trade balance and therefore the current account deficit. This will rebalance the economy and contribute to macroeconomic stability which is essential for even more enhanced economic growth.

In this scenario, economic growth will be private sector led and is likely to be sustainable over the medium term

Figure 21: Growth Projections (Baseline, Best Case, Worst Case)



Source: PBO

Graph – growth projections under the baseline, best case and worst case scenarios

2.3. Achieving High Total Factor Productivity Growth

Under growth accounting, production of goods and services is attributed to three elements: labour, capital and technology. Broadly speaking, labour and capital are the factors of production on which technology is applied in order to produce goods and services. Total factor productivity basically refers to improvement in efficiency of production processes, mostly attributed to changes in technology. Due to efficiency in utilization of input, one is able to produce more of the same product using the same level of existing labour, capital and other economic inputs. Total factor productivity is therefore output which is attributed to efficiency in utilization of input in the production process.

Efficiency in utilization of input enables one to produce more of the same product using the same level of existing labour, capital and other economic inputs

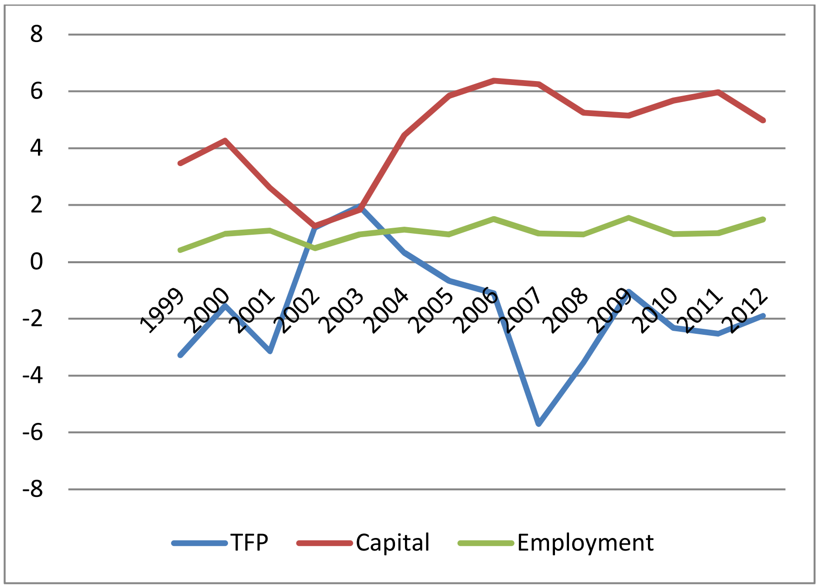
Basically, TFP is economic growth that is technology driven. TFP growth measures how much productivity grows or declines over time. In order to enhance TFP growth, there is need to focus on the following:

i) Economic restructuring:

Figure 22 shows the contribution of capital, labour and total factor productivity to economic growth:

Graph – contribution of capital, labour and total factor productivity to economic growth

Figure 22: Contribution of Capital, Labour and Total Factor Productivity to economic growth



Source: PBO (Macroeconomic diagnostics)

Economic growth is substantially capital driven while contribution of labour has stagnated over the past decade

From the figure, it is apparent that over the last decade, economic growth in Kenya has been substantially capital driven. This is especially true in the period from 2003 to 2007 whereby contribution of capital to economic growth grew significantly. It is noted that the period 2003 to 2007 was marked by high economic growth until a dramatic dip in economic growth in 2008 marked by a corresponding decline in capital as a percentage of GDP.

On the other hand, contribution of labour to economic growth has stagnated over the past decade and is not as significant in promoting economic growth compared to capital. The growth rates of both capital and labour appear to have a negative impact on the total factor productivity. The negative trend in TFP growth has persisted since 2005 with the lowest dip noted in 2008, probably due to the political shocks that characterized that time period.

Total factor productivity contributes negatively to economic growth implying declining efficiency in utilization of resources

To ensure longer term productivity for a sustained high level of economic growth, we must therefore enhance productivity of both capital and labour.

2.3.1. Productivity of Capital

Enhanced productivity of capital can be achieved through policies that promote capital deepening. This entails policies to enhance investment levels in the country. As such there is need to increase domestic savings so as to be able to fund investment from domestic rather than foreign markets. Increasing domestic savings entails making the banking system more accessible to the non-traditional savers to increase the level of financial savings.

Productivity of capital can be enhanced through capital deepening; increasing domestic savings to facilitate investment; enhanced FDI; research and innovation

Enhanced production processes also entail, proper economic policies aimed at enhancing trade and foreign direct investment. Enhanced FDI will lead to increased capital in the country which can enhance capital productivity. To this extent, Research and innovation must take centre stage to ensure improvements in production by ensuring efficiency in utilization of capital.

2.3.2. The Labour Market

Labour market suffers from unskilled labour force and inefficiencies in operations

The Kenyan labour market has been plagued by many challenges which inhibit productivity growth in the sector with an adverse effect on economic growth and development.

Broadly, the challenges facing the labour market are twofold: an unskilled labour force as well as inefficiencies in the running of the employment sector.

The Cost of Industrial Disputes

Inefficiencies in the running of the employment sector have resulted in numerous industrial actions and trade disputes which are an impediment to economic growth. Industrial action in Kenya is particularly common in the crucial health and education sectors and is seen by the proponents as an effective way of compelling the government to give in to their demands for wage increments as well as better working conditions. As a result, industrial action in the Health and Education Sectors has become a vicious cycle.

Industrial action especially in the health and education sectors is an impediment to economic growth

However, regular strikes come at a cost to the economy as they interrupt the production process meaning that required goods and services in the striking sector are not available or can only be found at a higher price in private institutions. This will eventually reduce total output. The disruption in provision of crucial services means that the needs of citizens are not met. Many are the times when hard working Kenyans and family breadwinners have lost their lives or had their health conditions deteriorate as health professionals go on strike. This is costly to the economy in terms of decimating the labour force as well as reducing productivity as an ailing population labour force cannot be a productive one. The impact is therefore felt not just in the health sector but in other sectors as well whose workers cannot work as they are incapacitated.

Regular strikes disrupt provision of crucial services and reduce productivity and total output

Instability in labour relations also creates a hostile investment climate resulting in reduced Foreign Direct Investment as investors shun Kenya as a favourable destination. Strikes in Kenya are characterized by regular marches and protests in the streets, occasionally turning violent and disrupting other businesses. This not only results in loss of precious man hours, but also breeds an air of uncertainty in the business environment which is not conductive especially when trying to woo potential investors.

Regular strikes are also disruptive to the business environment and may scare away investors

Furthermore, labour instability is likely to encourage capital driven growth as profit maximizing employers avoid the costly conflicts of the labour market. This is likely to reduce employment opportunities in the private and even the public sector thereby worsening an already bad employment situation.

In the education sector, a disruption in learning processes is likely to reduce the quality of the labour force and produce half baked workers. When education professionals are on strike, the learning programme is disrupted. However, rarely, if ever is the school calendar extended to be able to cater for the lost time. Thus depending on the length and frequency of the disruptions, the students are unable to gain the requisite skills within the given time frame. Ongoing projects are delayed and learning materials end up gathering dust on the shelves. The end result is graduates with certificates but severely lacking in the knowledge that they were supposed to acquire. This has also contributed to brain drain as bright students are able to secure study opportunities abroad and afterwards opt to stay there due to better labour relations in the host country.

Regular strikes in the education sector disrupts learning programmes and may interfere with proper training of students

Other detrimental effects to the economy include loss of revenue, reduced productivity and stagnation of both the health and education sectors due to frequent disruption of activities. The economy cannot afford to deal with recurring lapses in

Industrial action also results in loss of revenue and stagnation in the health and education sectors due to frequent disruption of activities production and payments with no corresponding output as the workers are on strike.

If the employer recognizes the trade unions, it is essential to collectively bargain with them. A national collective bargaining framework should have structures to avoid industrial action including reviewing, negotiating and implementing collective bargaining agreements. Aloofness in implementation of collective bargaining agreements will only serve to further disillusion the workforce that is hitherto termed as 'able and enterprising[4].'

A national collective bargaining framework should have structures to avoid industrial action

[4] An Investment guide to Kenya: Opportunities and Conditions, UNCTAD 2012

Chapter Three:

Revenue Performance and Outlook for 2015/16 and the Medium Term

In Brief

Following the rebasing of the GDP, it is apparent that the tax effort is not as high as previous thought. This may require a critical review of tax incidence and burden to determine the flexibility and opportunities for expanding the tax base without changing the tax rates. Income tax contributes the largest proportion of ordinary revenue followed by Value Added Tax (VAT), excise duty, "and import duty. AIA is also an important source of financing but it has routinely underperformed. Medium term revenue forecasts are predicated on stability of year-on-year growth of tax revenue components, limited change in the effective tax rates over the medium term, and some discretionary changes to the tax structure.

3.1. Review of Revenue Performance and Composition

Total revenue includes income taxes (individual and corporate income taxes), taxes on imports (import duty and import declaration fees), excise tax on certain domestic and imported goods, value added tax (VAT) on domestic and imported goods, Appropriations in Aid (AIA), and tax incomes from fees, licences among others (often called "other taxes"). Prior to the revision of GDP, total revenue comprised 23% in 1990s, 20% in early 2000 (2000-2004), and a robust 22% since then. However, given the revised GDP numbers, the proportion of total revenue to GDP is about 18% from 2009 to 2013. This indicates that the tax effort is not as high as previously thought. It may require a critical review of tax incidence and burden to determine the flexibility and opportunities for expanding the tax base without changing the tax rates (there is window to exploit the 4% of nominal GDP shortfall in revenue in the context of the Medium Term Plan and Vision 2030).

Prior to the revision of GDP, total revenue comprised 22% of GDP. However, with the revised GDP numbers, the proportion is approximately 18% of GDP

A review of revenue trends in the past decade shows that income tax contributes the largest proportion of ordinary revenue followed by Value Added Tax (VAT), excise duty, "and import duty in some years (Chart 1). In the period 2008/09 to 2013/14, among the key tax heads, income tax constituted

Income tax and VAT contribute the largest proportion of ordinary revenue about 41% of total ordinary revenue, VAT comprised 24%, while excise duty and import duty contributed 12% and 7%, respectively. According to Chart 1 income tax shows more robust upward rise in absolute terms since mid-1990s compared with excise and import duty whose contribution to ordinary revenue is flat.

The other component of revenue is Appropriations in Aid (AIA). At about 8 % of total revenue, AIA is an important source of financing for some institutions such as universities and some government agencies. But, how dependable is AIA as a dependable revenue source? Chart 1 shows the growth rates of total revenue (AIA) and ordinary revenue which excludes AIA. The deviation between the two growth trends is on account of sharp yearly variations in AIA. Owing to definitional problems, irregular or weak reporting of AIA revenues by ministries, the values of AIA are quite erratic. In 2012/13 financial year, Ksh. 71.155 billion was collected as AIA, but only about Ksh. 55.428 88 billion was collected in 2013/14: a decline by Ksh. 15.727 billion in one year.

Appropriations in aid, though an important source of financing, faces challenges accruing from definitional problems, irregular or weak reporting by ministries

Figure 23: Components of Revenue

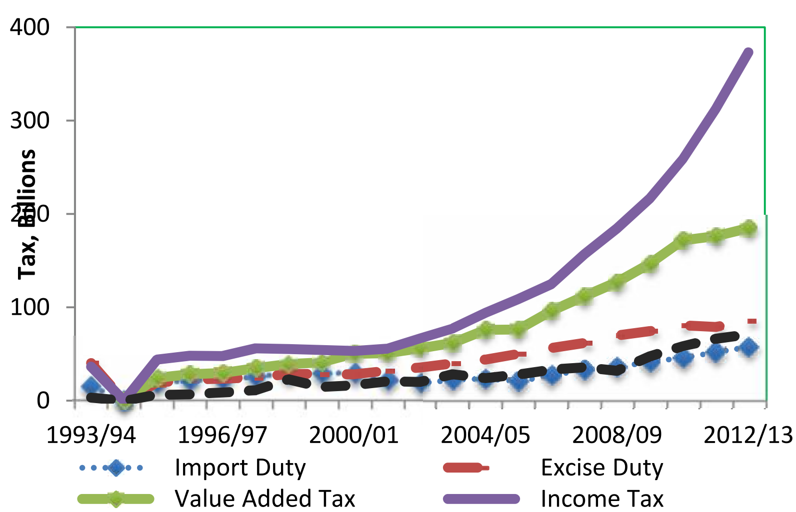


Chart – growth trend of various revenue components

Average revenue growth sharply rose from 3% in 2000 to 16% annually in 2003/04 to 2007/08, tapering a bit to 15% after 2008/09 to 2013/14 (Table 1). Table 1 further shows that income tax has maintained a robust growth rate of 19% since 2003, relative to the second fastest growing major tax head VAT. VATs 2010-2012 decline is captured by the average rate of growth of the tax head between 2008/09 and 2013/14. Indeed, VAT grew by a marginal 3 percent in 2011/12, and 5 percent in 2012/13 before surging to 26% after the repeal of the old and cumbersome VAT Act (Cap. 476).

Income tax growth rate is robust at 19%; VAT has also increased significantly from 5% growth rate in 2012/13 to 26% after repeal of the old VAT Act (Cap 476)

With regard to variability of growth rate of tax heads, the reported sample standard deviations clearly show the income tax as the most stable during 2008/09 to 2013/14, followed by import duty. As the backbone of revenues in Kenya, income tax growth is the least erratic and is likely to remain so. In spite of marked volatility about 2003 partly due to tariff and administrative changes in the customs after 2003 (introduction of the Simba system), this tax head later stabilizes after 2007/08.

The most stable tax heads are income tax as well as import duty

As expected, VAT, excise duties, are modestly volatile but "other taxes" and AIA are quite unstable. Year on year, the growth of both VAT and excise tax has been on a downward trend since 2006/07 financial year, though a recovery in excise duty is noted from 2011/12, and that of VAT in 2013/14. The stability in income tax collections and recent recovery of the local component of VAT after the enactment of the VAT Act, represents a good chance of self-reliance on domestic revenues. Despite the modest recovery of the import duties, continued review of tax enforcement systems at the customs and the inevitable effects of trade facilitation will likely reduce the size

Stability in income tax collections and recovery of VAT represent a good chance of self reliance on domestic revenues and contribution of import duties in the long term. The slow performance of excise tax could indicate structural changes in the excise tax bases (e.g. changes in consumption of alcohol and cigarettes).

Table 5: Average growth performance of revenues, July 1994 - June 2014

	1994/95-1997/98	98/99-2002/03	2003/04-2007/08	2008/09-2013/14
Total Revenue	**13%**	**3%**	**16%**	**15%**
Ordinary Revenue	**13%**	**3%**	**16%**	**15%**
Import Duty	**10%**	**-5%**	**13%**	**13%**
Excise Duty	**9%**	**8%**	**12%**	**9%**
Value Added Tax	**13%**	**10%**	**15%**	**13%**
Income Tax	**9%**	**4%**	**19%**	**19%**
Other Taxes	**36%**	**-10%**	**23%**	**15%**
A-in-A	**22%**	**20%**	**14%**	**10%**

Source: PBO

3.2. Review of 2013/14 revenue collections

Despite the underperformance of revenues by Ksh. 106 billion in the previous financial year, the government projected to collect Ksh. 1.127 trillion in total revenues in 2013/14, comprising of Ksh. 1.038 billion in ordinary revenues and Ksh. 88.5 billion in AIA. These amounts included a target of Ksh. 13.5 billion of the Railway Development Levy.

Despite revenue underperformance in the previous financial year, the government still projected revenue collection that was 33% higher than the actual revenue growth in 2012/13

Using available revenue data, the approved revenue estimates for 2013/14 were 33 % higher than the 2012/13 actual collections despite the fact that average revenue growth from 2003/04 to 2012/13 is 14%. Nearly all tax heads had a forecast growth of more than 20%, which is quite an ambitious target given past performance and forecast macroeconomic factors.

Table 6: Revenue outturn, 2013/14

	Preliminary revenue outturn 2013/14*	Printed Budget 2013/14	Underperformance
Total Revenue	974,417	1,127,460	**-153,043**
Ordinary Revenue	918,989	1,038,981	**-119,992**
Import Duty	67,555	97,458	**-29,903**
Excise Duty	102,029	100,080	**1,949**
Value Added Tax	232,630	229,008	**3,622**
Income Tax	449,590	455,914	**-6,324**
Other Taxes	67,185	156,519	**-89,334**
A-in-A	55,428	88,479	**-33,051**

Source: QBERs, National Treasury; PBO computations

Table 5 shows that the revenue forecasts were out-of-step (forecast error) from the true revenue realization in 2013/14 by 15.7 %. Other taxes, comprising a consolidation of a host of property taxes, investment revenue and license fee collections were Ksh. 89 billion below the actual collections reported of Ksh 67 billion. The perennial underperformer AIA was Ksh. 33 billion below the approved forecasts. But, this underperformance is actually due to major forecast errors. For example, total revenues were expected to grow by 32% in 2013/14 when actually the real average growth rate is 15% since 2008/09. Similarly, "other revenues" were expected to double in 2013/14, even though these revenues are historically very volatile. Nevertheless, a forecast of about 100% was way above the highest average growth rate (36%) in two decades recorded in mid-1990s (Table 1).

Revenue underperformed in 2013/14 on account of major forecast errors

Nevertheless, the Railway Development Levy exceeded the full year target of Ksh. 13.5 billion by about Ksh. 6 billion. A review of expected full performance in May 2014 showed a quite tight forecast performance. Using March 2014 revenue realization, and expected information on revenue collections for the period

Railway Development Levy exceeded the targed revenue collection by Ksh. 7.5 billion

April to June, the forecast revenue realization for end-June 2014 was estimated between Ksh. 979 and Ksh. 988 billion, which was not very far off from the Ksh. 974 billion revenue realization reported by National Treasury.

The main driver of revenue growth in financial year 2013/14 is VAT

The main driver of revenue in that financial year was VAT: following the enactment of the VAT Act, the VAT collections shot up significantly. Import VAT exceeded target following improved risk assessment of import cargo and reduction in items under the zero-rated and exempt category. But, the perennial underperformer was still AIA. Some of the shortfalls in AIA, surprisingly, are attributed to underreporting by some institutions such as universities.

3.3. Medium Term Revenue Forecasts

3.3.1. Preliminary Revenues, 2014/15: Main drivers

The government projects total revenue to reach 1.181 trillion in 2014/15, with ordinary revenue amounting to Ksh. 1.087 trillion. Above trend analysis shows that the end-of-period revenue forecast errors are lower if the growth of given revenue components is stable. For instance, growth of income tax and import duty are stable and their shares in GDP are predictable using historical information, thus the end-of-financial year forecasts are likely more robust compared to AIA and "other revenues".

Government projects revenue collection of Ksh. 1.181 trillion in 2014/15 with ordinary rvenue amounting to Ksh. 1.087 trillion

The forecast of June 2015 revenue outturn is premised on several factors, among them: stabilisation of VAT enforcement and therefore performance of VAT following the enactment of the new VAT Act in 2013; enforcement of revenue enhancing measures in the Finance Act, 2014 especially enforcement of the

Performance of VAT, enforcement of Capital Gains Tax, reduction of tax avoidance and transfer pricing will drive the 2015 revenue forecast

Capital Gains Tax; and reduction of tax avoidance and transfer pricing. Key macroeconomic factors include the expected 5-6% real GDP growth rate in 2014/15 financial year combined with a modest inflationary creep.

Using above information, income tax is forecast to reach Ksh. 530 billion, and import duty 74.5 billion (see the baseline scenario, Table 3). The other tax components are quite volatile, but VAT could exceed Ksh. 241.3 billion by end June, Excise duty Ksh. 103.4 billion, "other taxes" Ksh. 77.2 billion, and AIA, Ksh. 46.8 billion. Total revenue is therefore estimated to reach Ksh. 1073.3 billion, falling short of Treasury estimate by about Ksh. 83.2 billion due to underestimation of AIA. Ordinary revenue is estimated to reach Ksh. 1,026.4 billion, relative to Ksh. 1,086.4 billion in the printed estimates.

Total revenue is estimated to reach Ks. 1073.3 billion, falling short of Treasury estimate by approximately Ksh. 83.2 billion

3.3.2. Medium term forecasts

Medium term forecasts are predicated on stability of year-on-year growth of tax revenue components, limited change in the effective tax rates over the medium term, and some discretionary changes to the tax structure (modest improvements in tax progressivity, and scrapping of burdensome licensing fees). Other policy considerations in the medium term may include improving equity of taxes, progressivity (reduce per capita effective tax rates) and enhanced oversight of collection and accounting of tax revenues. Owing to the unpredictability of AIA and ongoing effort by the government to convert some AIAs to exchequer revenues, we forecast that these revenues will remain at their nominal forecast 2014/15 levels in the medium term.

Medium term revenue forecasts are based on stability in growth of tax revenue, limited change in effective tax rates and enhanced oversight in collection and accounting of tax revenues

The forecast medium term revenue scenarios are as follows:

- Baseline scenario: continuance of most recent tax performance, combined with changes in the tax base.

Baseline revenue scenario is based on recent tax performance combined with changes in the tax base; alternative projections include an optimistic and a pessimistic scenario

- Alternative scenarios: includes a more optimistic scenario where revenue grows strongly in nominal terms, and a less optimistic scenario which incorporates underperformance of various drivers of the tax bases and removal of distortionary license and administrative fees (which drastically reduces "other revenues in the forecast period).

In the baseline scenario, income tax will exceed Ksh. 624.9 billion in 2015/16 if the recent robust performance is maintained (Table 6, baseline scenario). VAT is projected to reach Ksh. 298.3 billion, excise tax, Ksh. 112.6 billion, and import duty, Ksh. 82.1 billion. Ordinary revenues under this scenario will reach Ksh. 1.206 trillion in 2015/16, rising to Ksh. 1.389 trillion in 2016/17. Total revenue includes the Railway Development Levy (Ksh. 24.9 billion in 2015/16) and the rather unpredictable ministerial and agency fees.

In the baseline scenario, revenue is expected to grow based on recent performance with income and VAT leading growth

Under the less encouraging economic conditions, income tax is forecast to rise from about Ksh. 530 billion in 2014/15 to Ksh. 565.6 billion in 2015/16 owing to negative shocks on wage employment and possible payroll tax incentives (Table 6, alternative scenario 1). In correspondence with the baseline scenario, both excise and import duties grow moderately to Ksh. 104.8 billion and Ksh. 82 billion in 2015/16, respectively. VAT is estimated to reach about Ksh. 250 billion in 2015/16. Total revenues in this scenario reach Ksh. 1.134 trillion and ordinary revenues, Ksh. 1.070 trillion. With the suggested

In the pessimistic scenario, negative shocks on wage employment and possible payroll tax incentives will lead to slow growth in revenue removal of some license and administrative fees (worth about Ksh. 10 billion), the category called "other taxes" will fall from Ksh. 77 billion forecast by end-June 2015 to Ksh. 67.1 billion in 2015/16 financial year.

Based on historical revenue growth rates, ordinary revenue is lkely to increase from Ksh. 1.063 billion in 2014/15 to Ksh. 1.324 billion in 2015/16

If revenues performed at historical high growth rates, then we would see a boom in ordinary revenue collections from Ksh. 1.063 billion in 2014/15 to Ksh. 1.324 billion in 2015/16. Income tax exceeds the Ksh. 638.7 billion in 2015/16 if the recent robust performance is maintained (Table 6, Alternative scenario 2). VAT is projected to reach Ksh. 298.3 billion, excise tax, Ksh. 120.9 billion, and import duty, Ksh. 85.9 billion.

Table 7: Alternative medium term revenue forecasts

	Baseline Scenario				
	2013/14*	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Total Revenue	**974,417**	**1,132,135**	**1,296,078**	**1,485,440**	**1,704,330**
Ordinary Revenue	**918,989**	**1,048,560**	**1,206,614**	**1,389,575**	**1,601,493**
Import Duty	67,555	74,495	82,147	90,586	99,891
Excise Duty	102,029	103,414	112,606	122,614	133,513
Value Added Tax	232,630	263,412	298,267	337,734	382,424
Income Tax	449,590	530,076	624,970	736,853	868,765
Other Taxes	67,185	77,164	88,624	101,787	116,905
AIA	55,428	61,478	64,552	67,779	71,168
RDL	19,600	22,097	24,912	28,086	31,664
	Alternative Scenario 1				
	2013/14*	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Total Revenue	**974,417**	**1,087,901**	**1,134,243**	**1,204,456**	**1,280,326**
Ordinary Revenue	**918,989**	**1,026,423**	**1,069,950**	**1,136,989**	**1,209,281**
Import Duty	67,555	74,495	82,147	90,586	99,891
Excise Duty	102,029	103,414	104,817	106,239	107,681
Value Added Tax	232,630	241,276	250,243	259,543	269,189
Income Tax	449,590	530,076	565,600	603,506	643,951
Other Taxes	67,185	77,164	67,142	77,115	88,568
AIA	55,428	61,478	64,293	67,467	71,045
RDL	19600	19,600	22,097	24,912	28,086

	Alternative Scenario 2				
	2013/14*	**2014/15**	**2015/16**	**2016/17**	**2017/18**
Total Revenue	**974,417**	**1,146,741**	**1,416,229**	**1,632,781**	**1,884,518**
Ordinary Revenue	**918,989**	**1,063,720**	**1,324,350**	**1,531,088**	**1,771,948**
Import Duty	67,555	76,161	85,864	96,803	109,135
Excise Duty	102,029	111,098	120,973	131,726	143,434
Value Added Tax	232,630	263,412	298,267	337,734	382,424
Income Tax	449,590	535,885	638,744	761,346	907,480
Other Taxes	67,185	77,164	88,624	101,787	116,905
AIA	75,028	83,022	91,878	101,693	112,570
RDL	19,600	19,600	22,097	24,912	28,086

Source: PBO; RDL: Railway Development Levy

Chapter Four:

Expenditure Options for 2015/2016 and the Medium Term

In Brief

The country is at a critical stage where the youth cannot find jobs that match their skills; the pressure for additional spending especially in the social sector is high, yet substantial resources are being raised and allocated through the regular budget year in year out. The country will be part of the statistics for not achieving a number of the Millennium Development goals. The 2015/2016 annual budget and the medium term budget should be an opportunity for the government to rationalize its priorities and maximize on efficiency rather than increasing the allocation of resources to various projects and programmes.

4.1. Meeting the Vision 2030 targets versus equity and fiscal sustainability

The government's strategy for the medium term has been to improve efficiency and productivity in the economy thereby accelerating sustainable inclusive growth, creating employment and securing the livelihoods of Kenyans. For this to happen, there is need to maintain a stable macroeconomic environment, institute structural and governance reforms, improve security, invest in energy & transport infrastructure, as well as quality healthcare and education; and ensure food security.

Sustainable, inclusive economic growth will require a stable macroeconomic environment, governance reforms, investment in energy and transport infrastructure as well as quality healthcare and education

Ensuring macroeconomic stability is crucial to create a conducive environment for private sector investment to thrive. To achieve this, the government should recognize that available resources are limited and hence the need to efficiently allocate them to priority areas. This will go a long way in expanding economic activity geared towards increasing employment creation and reducing poverty. This can be achieved through targeting a realistic and strong revenue front and containing the growth in expenditure. It will also involve shifting expenditures from recurrent to capital and eliminating duplicative and unproductive expenditures.

Efficient allocation of resources can be achieved through targeting a realistic and strong revenue front; and reducing expenditure growth especially in unproductive expenditures

For the economy to develop, pertinent issues that hinder growth should be addressed. These include:

a) developing a realistic and credible budget framework whose implementation is feasible,
b) improving efficiency and effectiveness in public resource utilization and budget implementation,
c) entrench programme based budgeting at both levels of government and
d) address corruption through reforming the procurement systems to reduce corruption and obtaining better value for money, and adoption of a centralized procurement system for selected goods and services
e) Enhance savings by reducing expenditures on non-core functions and activities like frontline service. This may include outsourcing of some of these functions as opposed to the current practice of hiring staff.
f) Rationalize public entities and agencies to save money and improve accountability
g) Reviewing public spending to weed out poorly performing programmes, low priority activities and inefficient policies.
h) Leveraging ICT in most of the processes to reduce huge administrative costs and reduce revenue leakages in resource mobilization

There is need for a credible budget framework, efficiency in utilization of resources, enhance national savings, address corruption and leverage ICT in most processes to create a conducive environment for economic growth

4.2. Expenditure Policy Options for 2015/2016: Doing more with less

Fiscal policy for 2015/16 should aim at constraining expenditure to reduce the primary balance

The 2015/2016 and the medium term offers an opportunity for a fiscal policy that aims at supporting rapid economic growth by constraining the growth of the expenditure so as to lower the primary balance. Targeting to reduce the primary balance will ensure less dependence on borrowing to fund the expenditure, thus allow private sector led growth.

The policy options for 2015/2016 and the medium term are based on a strong and feasible revenue target and prudent use of expenditures to have the highest impact on inclusive economic growth. It is expected that revenue target for 2015/2016 will amount to Ksh 1.2 trillion and further increase to Ksh 1.5 trillion in 2017/2018. The focus will be to maximize efficiency and effectiveness in the utilization of the minimal resources while ensuring better delivery of services.

Focus in the 2015/16 budget should be to maximize efficiency in use of minimal resources

The following basic assumptions have guided the three options given in table 8 below:

a) That the Economic growth needs to be mainly driven by the private sector
b) That Pillar one of the Government policy has reiterated that there is need to restraint expenditure while re-orientating expenditure from consumption type of expenditure to development type of expenditures
c) That the outer two years of the medium term will be mainly fiscal consolidation.

Table 8 provides scenarios underpinning the fiscal framework for 2015/2016 and the medium term.

Assumptions for the budget outlook include private sector driven growth, reorientation of expenditure to development and fiscal consolidation in the medium term

The first option targets to reduce the primary deficit from -5.4% of GDP in 2014/2015 to -3.5% of GDP in 2015/2016 through moderate contraction of expenditures thus allowing the budget deficit to reduce to -5.9% of GDP from -8% of GDP in 2014/2015. The second option targets to reduce the primary deficit to -2.9% of GDP through extensive contraction of expenditures thus letting the budget deficit to further reduce to

In the first fiscal framework scenario, primary deficit is reduced through rationalizing recurrent expenditure; second scenario allows development expenditure to grow and third scenario entails increased expenditures

-6% of GDP. The third option will see the primary balance increase to -5.6% of GDP with the expenditures slightly contracted and the budget deficit increasing to -8.1% of GDP.

Table 8: Proposed Expenditure Options for 2015/16 - 2017/18

	2013/14	2014/15	2015/16			2016/17	2017/18
	Prel.	Rev. Budget	Option 1	Option 2	Option 3		
Revenues + Grants	**1,001.3**	**1,212.7**	**1,349.5**	**1,349.5**	**1,349.5**	**1,544.8**	**1,763.7**
% of GDP	*19.8%*	*21.2%*	*20.7%*	*20.7%*	*20.7%*	*20%*	*20.2%*
Revenues	974.4	1,164.0	1,296.1	1,296.1	1,296.1	1,485.4	1,704.3
% of GDP	*19.3%*	*20.4%*	*19.9%*	*19.9%*	*19.9%*	*20%*	*20.2%*
Grants	26.9	48.7	53.4	53.4	53.4	59.8	64.8
Expenditure	**1,300.7**	**1,668.9**	**1,731.1**	**1,681.1**	**1,878.8**	**1,867.2**	**2,063.8**
% of GDP	*25.7%*	*29.2%*	*26.5%*	*25.8%*	*28.8%*	*25.1%*	*24.4%*
Recurrent	788.0	900.1	926.1	907.9	984.9	948.2	1,019.2
% of GDP	*15.6%*	*15.7%*	*14.2%*	*13.9%*	*15.1%*	*12.8%*	*12.1%*
o/w CFS (interest & pensions)	165.0	183.8	210.0	203.0	220.4	216.8	244.8
Salaries & wages (civil service)	281.2	306.0	315.2	312.1	327.6	324.6	345.6
Development	319.3	539.5	543.3	511.5	632.2	630.3	725.9
% of GDP	*6.3%*	*9.4%*	*8.3%*	*7.8%*	*9.7%*	*8.5%*	*8.6%*
o/w domestically financed	198.5	293.9	245.8	234.0	314.5	335.5	435.0
foreign financed	118.6	235.1	284.5	264.5	304.5	280.4	275.9
County Transfers	193.4	229.3	261.7	261.7	261.7	288.8	318.7
Budget Deficit	**(299.4)**	**(456.2)**	**(381.6)**	**(331.6)**	**(529.3)**	**(322.0)**	**(294.7)**
% of GDP	*-5.9%*	*-8.0%*	*-5.9%*	*-5.1%*	*-8.1%*	*-4.3%*	*-3.5%*
Financing	**299.4**	**456.2**	**381.5**	**331.5**	**530.7**	**321.9**	**294.4**
Net External Financing	106.5	335.2	249.3	229.3	269.3	219.5	207.2
% of GDP	*2.1%*	*5.9%*	*3.8%*	*3.5%*	*4.1%*	*3.0%*	*2.5%*
Net Domestic Borrowing	192.9	121.0	132.2	102.2	261.4	102.4	87.2
% of GDP	*3.8%*	*2.1%*	*2.0%*	*1.6%*	*4.0%*	*1.4%*	*1.0%*
Primary Deficit	**(164.6)**	**(309.0)**	**(229.1)**	**(186.1)**	**(366.4)**	**(171.4)**	**(134.0)**
% of GDP	*-3.3%*	*-5.4%*	*-3.5%*	*-2.9%*	*-5.6%*	*-2.3%*	*-1.6%*
Nominal GDP	**4,985.1**	**5,719.1**	**6520.5**	**6520.5**	**6520.5**	**7430.2**	**8448.2**

Source: Projections by PBO

In the medium term, the primary deficit is set to reduce to -2.3% of GDP in 2016/2017 and -1.6% of GDP in 2017/2018. To attain this, the expenditures are to reduce to 25.1% and 24.4% of GDP in 2016/2017 and 2017/2018 respectively. The reduction in expenditure will predominantly be on recurrent expenditure while development expenditure is set to rise from 8.5% of GDP in 2015/2016 to 8.6% of GDP in 2017/2018.

Option 1: Reducing the primary deficit to -3.5% of GDP

Under this option, the overall expenditure will be reduced from 29.2% of GDP in 2014/2015 to 26.5% of GDP. To attain this, capital expenditure will have to be set 8.3% of GDP while recurrent expenditure be capped at 14.2% of GDP. This will result in the budget deficit coming down to -5.9% of GDP. The external borrowing then should be limited to 3.8% of GDP and net domestic borrowing at 2.0% of GDP. This will have externalities that can lead to reduction as interest rates on Treasury bills and Treasury bonds come down. For this to be achieved, the following policies need to be adopted:

Reducing primary deficit to -4.5 percent of GDP will entail reduction in expenditure and limiting borrowing

i. **Freeze wages adjustments**

A large proportion of the recurrent expenditure goes for payment of salaries and wages for public servants in civil service, parastatals and other independent & oversight institutions. Annually, the government wage bill increases due to annual wage increments and wage adjustments from either Collective Bargaining Agreements (CBA) or recruitment of additional personnel. The government needs to adopt a policy to curb any wage adjustments in 2015/2016 and direct the SRC to undertake an extensive job evaluation exercise whose recommendations will be implemented in the next fiscal year.

Reduction of expenditure and limitation of borrowing can be achieved through freezing wage adjustments, stopping hiring of additional staff by both levels of government and outsourcing of non-core services

Hiring of additional staff by both national and county governments should be curbed as the government awaits the findings from the civil service rationalization programme. The freeze should also be enforced on parastatals and independent & oversight institutions. For non-core functions in each entity, the government should consider outsourcing of these services as opposed to hiring staff.

i. **Implementation of parastatal reforms**

The government mandated a taskforce to propose reforms on parastatals with the aim of realigning them to the current system of government, improve their efficiency and effectiveness, rationalize areas of overlapping mandated and enhance their ability to meet their core regulatory and development mandates.

Streamlining operations of parastatals will improve their service delivery and create savings in future

The report of the taskforce highlighted a number of concerns including their impact to the wage bill, the declining performance in some parastatals and the consulted effort to further increase the number of parastatals. The government needs to fully adopt the recommendations from the report and realign the parastatals to improve on their service delivery and create savings in expenditure.

Efforts should be made to reduce recurrent operation costs of MDAs which have digitized their operations

ii. **Rationalize recurrent expenditures for MDAs that have adopted e-citizen system of delivery of services**

The government has adopted Information Technology in a number of government operations by different government agencies. It has also introduced one-stop-shop (Huduma) centers across major town in the country to offer centralized government services. It is however noted that the said agencies still have substantial amount of funds under their recurrent budget despite the digitization. Government should reduce the recurrent operation costs of these MDAs and also rope in additional ministries whose functions can either be digitized or implemented by the Huduma centers.

To improve Kenya's prospects as an investment destination, consider digitizing issuing of work permits, licenses, land titles, PIN numbers and power quotations

Further, the services for investors including issuing of business permits, work permits, licenses, land titles, PIN numbers, power quotations and environmental impact assessments among other should also be digitalized and centralized in a similar manner to the Huduma Centers. This will improve the country's rating as an investment destination and reduce instances of corruption.

iii. Limit new capital projects to Vision 2030 projects only

The government should continue implementing all ongoing projects but limit the addition of new projects to only those indicated in the 2nd MTP of the Vision 2030. Development expenditure is the prime consumer of borrowed funds and to reduce the primary deficit, there is need for prudence in the use of borrowed funds. Funding should only be directed to projects identified in the country's blueprint that will enhance economic growth.

Exercise prudence in management of borrowed funds by directing such funds to only those projects identified in the country's economic blueprint

Option 2: Reducing the primary deficit to -2.9% of GDP

Under this option, the overall expenditure will reduce to 25.8% of GDP from 30% of GDP in 2014/15. To attain this, the capital expenditure will have to be limited 7.8% of GDP while recurrent expenditure capped at 13.9% of GDP. The budget deficit will be reduced to -5.1% of GDP, in view of this, the government will only need to borrow Ksh 331.6 billion. The external loans should be capped at 3.5% of GDP while domestic borrowing at 1.6% of GDP indicating more resources will be availed to the private sector. This will lead to further reduction as interest rates on Treasury bills and Treasury bonds. For this to be achieved, the policies highlighted in option one should be implemented. In addition to them, the following policies should also be considered:

Reducing primary deficit to -3.7 percent of GDP will require limiting capital expenditure at 8.6 percent of GDP and recurrent expenditure at 13.1 percent of GDP

i. Rationalize recurrent expenditure for devolved functions

There have been instances of duplication of roles by the national and county governments especially on functions that are shared among the two levels of government. The healthcare and agriculture sectors have been largely devolved but the national government still holds significant number of staff and a huge amount of resources. Further, the role of the national government in the roads and energy sectors has also been faulted especially on the role of KURA, KeRRA and REA. The national government should reduce its role in devolved functions allowing the county governments to undertake their functions. The recurrent budget for health and agriculture should be reduced and the necessary legislations to realign the function of the roads and energy sectors enacted and implemented in 2015/2016.

Funds at the national level allocated towards devolved functions such as healthcare and agriculture should be rationalized to avoid duplication of roles

ii. Limit new capital projects to energy and transport sectors only

The government should continue investing in on-going capital projects but curtail all new projects to only those of energy generation, energy transmission, standard gauge railway (SGR) and commuter railway development. Since capital expenditure is largely funded by borrowed funds, contracting it will effectively reduced the primary deficit. The elimination of other new projects will ensure saving of some of government counterpart funds.

New capital projects should be limited to energy and transport sectors with counterpart funding to reduce reliance on borrowing

Option 3: Increasing the primary deficit to -5.6% of GDP

Under this option, the overall expenditure will slightly reduce to 28.8% of GDP from 29.2% of 2014/15. To attain this, the capital expenditure will have to be 9.7% of GDP while recurrent expenditure increased to 15.1% of GDP from 14.2% of GDP in 2014/2015. The budget deficit will increase to -8.1% of GDP indicating the government will have to source for Ksh 529.3 billion to fund the deficit. The external borrowing will be limited at 4.1% of GDP while the domestic borrowing will increase to 4% of GDP from 2.1% of GDP in 2014/2015. This high borrowing will reduce the amount of credit available to the private sector maintaining the current constrained private sector growth and increase the interest rates for Treasury Bills and Treasury Bonds.

Maintaining the primary deficit at -6 percent of GDP will require substantial expenditure which will be funded from borrowing thereby constraining private sector growth

The third option doesn't include policies to reduce the expenditure. The increase in wages and salaries caters for both annual wage drift and allowance for wage adjustments. The recurrent and capital expenditures are also allowed to grow normally. This will push the expenditures for 2015/16 to Ksh 1.9 trillion.

The second option is the best in terms of achieving more with less as it proposes the largest reduction on the primary balance and ensures rationalization of government expenditures with decreased dependence on borrowing

The best scenario that will ensure prudent macroeconomic stability is the **second option** since it proposes the largest reduction on the primary balance. This ensures that the government rationalizes its expenditures to work within the available revenues with decreased dependence on borrowed funds. Implementation of the second option will allow the government and private sector to get a share of the limited domestic credit available without altering the country's macroeconomic stability.

Sectoral Ceilings for 2015/2016

Implementation of the second option will ensure that expenditure is channeled towards essential sectors of the economy capable of promoting sustainable growth. Under this option, funding for Energy, Infrastructure and ICT sector will increase from 4.5% of GDP in 2014/2015 to 6% of GDP targeting growth in the energy and transport subsectors. Thus investment will focus on energy generation and transmission; as well as the standard gauge railway and commuter railway. Transfers to counties will be maintained at 4% of GDP. The allocations for the 'public administration and international relations' and the 'governance and security' sectors will be maintained at 3.4% and 3.9% of GDP respectively. The Judiciary and Parliament will also be maintained at 0.3% and 0.4% of GDP respectively.

Expenditure should focus on funding for investment projects in the energy and transport sectors

All other sectors will see a reduction in funding. Social sector spending will reduce from 6.6% to 6.5% of GDP. These reductions will predominantly be in the health sector. The economic sector will reduce from 2.2% to 2.1% of GDP with reduction predominantly on the agriculture sector.

Spending in the other sectors as a proportion of GDP will reduce to curb excessive government expenditure and reduce the primary deficit

Table 9: Ceilings for key expenditure items 2013/14 - 2015/16 (as percentage of GDP)

	2013/2014	2014/2015	2015/2016	2016/17	2017/18
Transfer to Counties	3.8%	4.0%	4.0%	3.9%	3.6%
Energy Infrastructure and ICT Sector	4.2%	4.5%	5.7%	5.1%	4.4%
o/w Energy	1.5%	1.3%	1.5%	1.1%	1.1%
Transport Infrastructure	2.5%	3.0%	4.0%	3.8%	3.2%
Other	0.2%	0.2%	0.2%	0.2%	0.2%
Social Sector	7.3%	6.6%	5.8%	5.3%	4.7%
o/w Education	5.9%	5.4%	4.8%	4.3%	3.8%
Health	1.0%	0.8%	0.7%	0.6%	0.6%
Social Protection Culture and Recreation	0.4%	0.4%	0.4%	0.3%	0.3%
Governance and Security Sector	4.3%	3.9%	3.4%	3.4%	3.5%
o/w Defense & NIS	1.8%	1.6%	1.4%	1.3%	1.3%
Internal Security	2.0%	1.7%	1.6%	1.6%	1.6%
Judiciary	0.3%	0.3%	0.3%	0.2%	0.2%
IEBC	0.1%	0.1%	0.0%	0.1%	0.3%
Other	0.2%	0.2%	0.2%	0.2%	0.2%
Public Administration Sector	3.6%	3.4%	2.9%	2.7%	2.3%
o/w Parliament	0.4%	0.4%	0.4%	0.3%	0.3%
Economic Sector	2.7%	2.2%	1.9%	1.8%	1.8%
o/w Agriculture	0.8%	0.6%	0.9%	0.8%	0.8%
GDP	**5,051.6**	**5,719.1**	**6,520.5**	**7,430**	**8,848**

Source: PBO

Supplement: Cash Transfers

"The Welfare State: which is the way forward for Kenya?"

Article 43(1)(c) of Kenya's Constitution guarantees food security to all Kenyans. The cash transfer program is one of the strategies the country uses to fulfill this Constitutional requirement. About 46% of the Kenya's population lives below the poverty line. The country continues to grapple with serious socio- political and economical problems associated with poverty, unemployment and food insecurity. These problems have forced the government of Kenya to review its policies and strategies on social protection for the most vulnerable members of the society i.e. the orphans and vulnerable children, the elderly, people living with disabilities and the urban poor.

The Government of Kenya implements an unconditional cash transfer (UCT) programme called the National Safety Net Programme (NSNP) in which monthly cash payments is made to the targeted beneficiaries (the most poor and vulnerable members of the society). Within NSNP components the Kenya Government wholly funds the Cash Transfers to the Older Persons (CTOP) and Persons with Severe Disabilities (CT-PWSD) while various major development partners who include World Bank, UNICEF, DFID supports the Cash Transfers to Orphans and Vulnerable Children (CT-OVC).

The Ministry of Labour, Social Security and Services (MLSSS) and the National Drought Management Authority (NDMA) which is under the Ministry of Devolution and Planning, implement the NSNP programme which has five main components namely:

- Cash Transfers to Orphans and Vulnerable Children;
- Cash Transfer to the Older Persons;
- Cash Transfer to Persons with Severe Disabilities;
- Urban Food Subsidy; and
- Hunger Safety Net

It is important to highlight that the Hunger Safety Net Programme (HSNP) is unconditional social protection programme that delivers regular cash transfers to targeted poorest and vulnerable households in four counties of Turkana, Mandera, Marsabit and Wajir.

In the second Medium Term Plan (2013-2017), the Ministry of Labour and Social Security envisage to roll out a consolidated social protection fund for vulnerable groups as one of its priorities. In fact, 73% (Kshs. 14.38 Billion) of the ministerial budget for 2014/15 was allocated to the National Safety Net Programme.

The table below indicates the sectoral resource requirement and the resource allocation over the medium term for the programme.

Table 1: Analysis of Resource Requirement versus Allocation for the National Safety Programme (In Billions Kshs.)

Baseline Estimates	Resource Requirements			Resource Allocation		
2014/15	2015/16	2016/17	2017/18	2015/16	2016/17	2017/18
14,371	20,850	29,974	41,626	14,371	14,464	15,559

Source: 2014 Sector Reports, National Treasury

During the pre-budget (2015/16) public consultations conducted in 14 counties by the Budget and Appropriations Committee in October, 2014, members of the public raised concerns on the impact of the cash transfer programs, particularly on whether the public gets value for money and whether the intended beneficiaries benefit. From the aforementioned hearings it quite clear that the members of the public are dissatisfied in how the cash transfer program is been implemented. They questioned the criteria of identifying beneficiaries citing lack of transparency in the entire process.

The Kenya Government implements unconditional cash transfer (UCT) programme which was introduced as a pilot project in the year 2004 and at the beginning of the programme, donors played a dominant role in terms of availing financial resources. However, evidence from the budgetary reports indicates that the share of Government financial resources for the implementation of the cash transfer programmes has gradually been increasing every year as shown in table 1 below.

Table 2: National Government Budgetary Allocations for Unconditional Cash Transfer Programs (Kshs Billions)

	2009/10	**2010/11**	**2011/12**	**2012/13**	**2013/14**	**2014/15**
UCT-OVC	2.4	2.8	3.8	4.1	7.5	7.4
UCT - 0P	0.4	0.5	1.0	1.0	3.0	5.3
UCT – PLWSD	-	-	-	0.4	0.8	0.8
Urban Food Subsidy	-	-	0.2	0.2	0.3	0.4
Total Allocation	**2.8**	**3.5**	**5.7**	**6.1**	**12.1**	**14.1**

Source: Estimates of Expenditures (Various)

There is currently much discussion across the globe about whether conditions for the cash transfer are necessary. It is therefore necessary to review whether the Cash Transfer programs in Kenya need to be conditioned or not.

What is the difference between conditional and unconditional cash transfers?

Unconditional Cash Transfer (UCT) programs aim to reduce poverty by providing welfare programs without any conditions upon the receivers' actions while Conditional Cash Transfers (CCT) are programs where the Government (or a charity) only transfers the money to persons who meet certain criteria. For a CCT program, the benefits are conditioned on certain behaviours usually related to investment in nutrition, health and education.

Conditional Cash Transfer (CCT)

In recent years, conditional cash transfer (CCT) programs have been introduced for a wide array of different purposes. Applied, for instance, to education and child health in poor countries, they have been hailed as being among the most significant innovations in promoting investment in human capital among the poor.

Nancy Birdsall, president of the Center for Global Development was thus quoted in the New York Times as saying, "I think these programs are as close as you can come to a magic bullet in development. They are creating an incentive for families to invest in their own children's futures. Every decade or so, we see something that can really make a difference, and this is one of those things" (Dugger, 2004).

Research done in Indonesia and Mexico examined the importance of conditionality. In the Mexican Progresa program households who are beneficiaries and did not receive forms that monitor school attendance (thus received unconditional cash transfers) were compared to households that received the forms. It was shown that the conditionality had the strongest impact on children's attendance to secondary school as enrollment rates in secondary school were higher for those who received the forms.

In many countries, these CCT programs seek to both reduce poverty and encourage investments in children's education and health.

The 2009 World Bank policy research report on various countries implementing CCT found that by and large, CCT programs have had positive effects as tabulated in the table 2 below.

Table 3: Effects of Unconditional Cash Transfer Programme in Selected Countries

Country	Programme intention	Noted effect
Nicaragua	Cushioning the most vulnerable groups to meet basic human needs through provision of steady stream of income	reductions in poverty are fairly large i.e. Poverty levels fell by 5% to 9 % (2012 data)

Brazil, Cambodia, Ecuador, Mexico, and Nicaragua	Decrease in Child labour	Cambodia - the average child receiving the transfer was 10% likely to work for pay.
Pakistan	Reduction in Gender Imbalances (making cash transfers to women, as CCTs do, may also increase their bargaining power)	Increased the number of 10 to 14 year old girls in school by 11 %.
Cambodia	School enrolment rates	School drop-out rate dropped between 6^{th} and 7^{th} grades by 20 % to 30 %.
Colombia, Honduras, Mexico, and Nicaragua	Preventive health care services	The use of preventive health care services increased by between 8% and 33 %

In view of the above comparative study it is quite evident that the conditionality in cash transfer programs has a stronger impact to the beneficiaries.

The CCTs deliver both well-being benefits to recipient households and improved education and health outcomes for children in these households. They also achieve significant impacts on poverty reduction, especially poverty gap and poverty severity measure and since Kenya is domestically financing the social protection programme the tax-paying middle classes who are typically objected to the 'welfare handouts' need to be convinced that the program has impact.

Policy Options

1. Abolish the safety net programme and establish a contributory social assistance fund that will be supporting the vulnerable people in the society i.e. the orphans and vulnerable children, the elderly, people living with disabilities. This fund will operate by making a deduction from all the taxpaying individuals in the Country.

2. Make it mandatory that all citizens who have attained 65 years of age and above have free access to public hospitals and are thus covered by the National Health Insurance Fund scheme.

3. Make it mandatory that all orphans and vulnerable children who are supported by the fund are provided with the basic school items like stationery, school bags and uniforms and thus must attend school

APPENDICES

Appendix 1: Sectoral Ceilings for 2015/2016

Sector		Approved 2014/2015	Ceilings 2015/2016
Agriculture, rural and urban development	**sub-total**	**60,224**	**58,216**
	recurrent	15,957	15,874
	development	44,266	42,342
Energy, Infrastructure & ICT	**sub-total**	**256,894**	**371,347**
	recurrent	35,593	34,986
	development	221,301	336,361
National Security	**sub-total**	**90,721**	**88,942**
	recurrent	90,721	88,942
	development	-	-
Health	**sub-total**	**47,362**	**46,188**
	recurrent	26,061	25,737
	development	21,301	20,451
Education	**sub-total**	**308,351**	**311,019**
	recurrent	273,380	275,952
	development	34,971	35,067
General Economic and Commercial Affairs	**sub-total**	**16,248**	**13,946**
	recurrent	6,654	6,552
	development	9,594	7,394
Governance Justice Law and Order	**sub-total**	**130,855**	**132,367**
	recurrent	119,157	120,286
	development	11,697	12,080
Public Administration and International Relations	**sub-total**	**196,917**	**186,839**
	recurrent	94,227	93,992
	development	102,690	92,847
Social Protection, Culture and Recreation	**sub-total**	**24,053**	**23,672**
	recurrent	11,085	10,942
	development	12,968	12,730
Environment Protection, Water and Natural Resources	**sub-total**	**50,807**	**49,815**
	recurrent	14,704	14,500
	development	36,103	35,315
Total (Gross)	**total**	**1,182,432**	**1,282,351**
	recurrent	**687,540**	**687,763**
	development	**494,892**	**594,588**

Appendix 2: Progress towards achieving MDGs

Goal	Key Indicators	Baseline 1990	Current Status	Target 2015	Remarks
Eradicate Extreme Poverty and Hunger	Proportion of population below US$1 per day (%)	44.7% (1992)	42% (2013)	21.7%	Unlikely to be met
	Prevalence of underweight in under-five years of age (%)	20.1%	16.4% (2009)	16.26%	
Achieve Universal Primary Education	Net enrolment rate in primary education (%)	83%	96% (2013)	100%	Achieved
	Primary school completion rate (%)	47%	73% (2013)		
	Literacy rates of 15-24 year old, women and men	72.2%	83.5% (2009)		
Promote Gender Equality and Women Empowerment	Ratio of girls to boys in primary, secondary and tertiary education	Primary 94.9%	98% (2013)	100%	On track
		Secondary 74.9%	87% (2013)	100%	
		Tertiary 36.1%	76% (2013)	100%	
Reducing Child Mortality	Under-five mortality rate (per 1000 births)	99	71 (2013)	33	Unlikely to be met
	Infant mortality rate (per 1000 births)	64	48 (2013)	25	
Improve Maternal Mortality	Maternal Mortality ratio (per 100,000)	400	360 (2010)	147	Unlikely to be met
	Proportion of delivery by skilled health personnel (% of births)	44%	43.8% (2009)	100%	
Combat HIV/AIDS, Malaria and other diseases	HIV prevalence among 15-49 year old	2.5%	6% (2013)	6%	Achieved
	Incidence associated with malaria (%)		3% (2013)	3%	
	Incidence associated with tuberculosis (per 100,000)		283 (2010)	444	
Ensure Environmental Sustainability	Proportion of terrestrial and marine areas protected	11.5%	11.6% (2012)	10%	On track
	Proportion of population using improved drinking water source	42.7%	62% (2012)	74%	
	Proportion of population using an improved sanitation facility	24.6%	30% (2012)	81%	
Global Partnership for Development	Total debt service (% of exports of goods, services & primary income)				On track
	Internet use per 100 inhabitants		39 (2013)		
	Mobile phone subscriptions and fixed telephone lines per 100 inhabitants		71 (2013)		