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Stimulating Economic Growth for Prosperity

Budget Options for 2018/19 and the Medium Term

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Preamble

The year 2017 was quite an eventful one for the economy, characterized by intense political activity which culminated in two elections between August and October. As a result of the prolonged uncertainty, businesses failed to thrive and there was a marked decline in private sector activity; worsened by the declining availability of credit to the private sector. In addition, the country endured the effects of a prolonged drought which led to food and water scarcity. The focus for 2018 should therefore be to set the country back on a positive growth trajectory targeted at creating jobs, reducing poverty and generally improving the quality of life for all Kenyans.

The theme for the ninth edition of the Budget Options is, ***"stimulating economic growth for prosperity".*** This entails policy directions and strategic initiatives for the government to consider that will best address the prevailing challenges in the economy and transform livelihoods in line with the government's economic transformation agenda. The 'Big Four' Plan is one direction that if implemented in an environment that is conducive for fostering economic growth, will lead to a reduction in poverty and general improvement in various aspects of wellbeing such as food, shelter and health.

This Budget Options reviews the state of the economy, analysing the country's productive capacity and how this can be scaled up as well as the dynamics of fiscal policy and how this can be streamlined in order to limit borrowing while ensuring value for money. The document also reviews the place of the interest rate capping law in the economy including the perceived benefits and challenges and addresses the imbalances in the external sector. In addition, the Budget Options proposes measures to enhance equity and efficiency in allocation of resources as well as options for achieving higher revenue growth.

The purpose of the Budget Options is to engage, enhance and enrich discourse on the economy and development matters; proposing viable options in policy making to inform the next medium-term budget.

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The core team comprised of Millicent Ojiambo- Makina, Josephat Motonu, Edison Odhiambo, Chacha Machage, Julie Mwithiga and Amran Mursal. The team acknowledges the valuable contributions and hardwork from each of the three departments which led to the successful development of this publication. In particular, the team would like to acknowledge contribution from Fredrick Muthengi and Danson Mkonu who assisted in carrying out research, data preparation and analysis as well as final editing of the document.

List of Acronyms and Abbreviations

AIA	Appropriation in Aid
BROP	Budget Review and Outlook Paper
BPS	Budget Policy Statement
DEV.	Development Expenditure
DTAs	Double Taxation Agreements
EPZ	Export Processing Zone
FDI	Foreign Direct Investments
GDP	Gross Development Product
GFS	Government Financial Statistics Manual
ICT	Information Communication Technology
KNBS	Kenya National Bureau of Statistics
MTEF	Medium Term Expenditure Framework
MTP	Medium Term Plan
PAYE	Pay As You Earn
PBB	Programme Based Budgeting
PBO	Parliamentary Budget Office
PBOM	Parliamentary Budget Office Model
PMI	Purchasing Managers' Index
PPP	Public Private Partnership
QEBR	Quarterly Economic and Budgetary Review
Rec.	Recurrent Expenditure
REP	Rural Electrification Programme
SDGs	Sustainable Development Goals
TFP	Total Factor Productivity
VAT	Value Added Tax

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Chapter One

The State of Kenya's Economy

A. The Real Economy: Can Kenya Scale up its Productive Capacity?

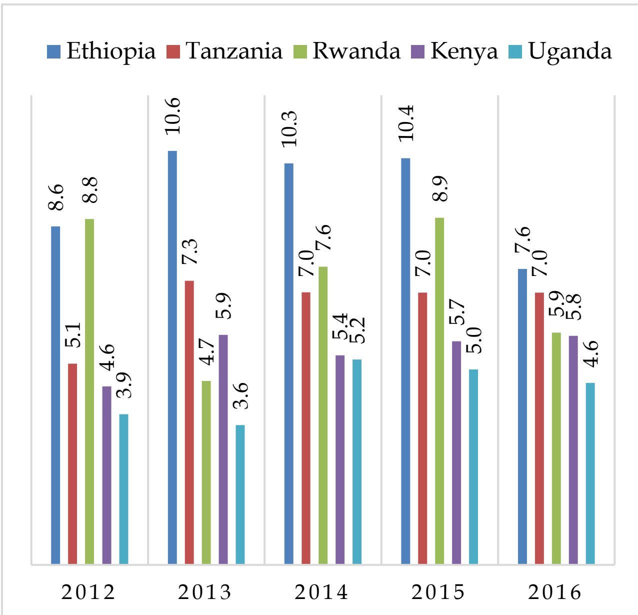
1. **Kenya's potential output[1]is notably low, suggesting significant challenges and inefficiencies in supply and productivity of capital and labour.** A country's productive capacity typically depends on the quantity and productivity of labour, capital stock as well as the state of technology and innovation. Since independence, new capacity generated by the economy has failed to reach critical mass to enable the country evolve from a factor driven economy to one more highly sophisticated with efficient and innovative methods of production as its hallmark. On the contrary, after a good start at independence, the country's industrial and manufacturing sector started faltering in the 1980s and progressively worsened with key industries such as Rivatex, Kicomi and Pan paper mills eventually closing down. In recent times, the government has made attempts to improve productive capacity primarily through bridging the gap on the country's huge infrastructure deficit. Significant investments have been made in revamping the road networks, ports and rail in order to facilitate access to hitherto inaccessible areas, open new trade routes, ease transportation costs and generally reduce cost of doing business. Electricity and energy costs are another major constraint and the government has also committed to various energy-related projects such as geothermal development in order to increase electricity generation capacity and hopefully lower costs. However, despite these investments, economic growth remains muted, raising concerns on whether the country is investing in the right infrastructure, whether the infrastructure is strategically located and whether there is complementary investment in other sectors of the economy such as Agriculture and Manufacturing that will then have knock on effects on the returns from improved infrastructure.

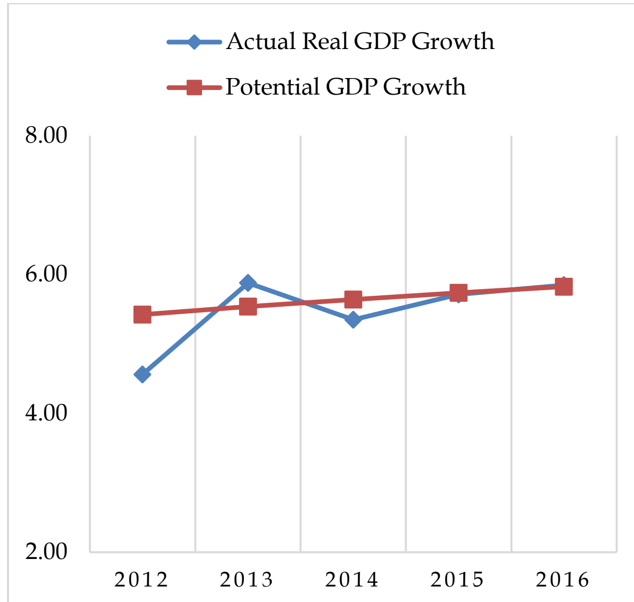
2. **In terms of global competitiveness[2], Kenya is ranked 91 out of 137 countries in the Global Competitiveness Index for 2017-2018;an improvement in ranking though its status as the largest economy in the East African region is slowly waning.** Rwanda is the trailblazer of the East African region having registered higher growth than Kenya over the last five years (Fig. 1) and is also ranked 58 in terms of global competitiveness; 33 ranks ahead of Kenya. It is worth noting also that though Tanzania and Uganda are ranked lower than Kenya at position 113 and 114 respectively, they are on record as being the only countries in Sub-Saharan Africa - alongside Ethiopia –to have improved their performance consistently since 2010. As such, whereas their ranking may be lower, their trajectory in terms of improving global competitiveness is better than Kenya's. In the wider Eastern Africa region, Ethiopia's economy has been rapidly expanding and was able to register a double-digit growth in three consecutive years (Figure 1). According to IMF, Ethiopia is leading in terms of GDP, at 87.3 Billion USD in 2017 compared to Kenya's 85.9 Billion USD even though Kenya has higher per capita GDP due to a lower population. Ethiopia has also been commended for having a favorable industrial policy in the region, attracting more Foreign Direct Investments (FDI). One of the reasons for Ethiopia's attractiveness as a key destination for FDI is the cost of labour. Indeed, among countries within the Eastern Africa region, Kenya has the highest monthly minimum wage, estimated at USD 331 as at2015[3]. The minimum wage setting process is complex as it is disintegrated according to sectors within

[1]Potential Output/GDP refers to the production capacity of the economy when it has fully utilized its resources
[2]Measures national competitiveness through set of institutions, policies and factors that determine productivity
[3] Monthly Minimum wage Kenya (USD 331), Ethiopia (USD 77), Tanzania (USD 149), Uganda (USD 6) – Bhohat,H et al (2015) Minimum wages in Sub-Saharan Africa

which is a further breakdown according to geographical areas and occupational distinctions. This, coupled with high electricity tariffs, is perhaps why Kenya has not been able to attract more investors.

Figure 1: Economic Growth for selected countries in EA Figure 2: Kenya's Actual vs Potential GDP Growth





Source: World Bank **Source: KNBS, PBO**

3. **Kenya's low productive potential can be attributed to low innovation and poor use of technology - or use of outdated technology - as indicated by an incredibly low Total Factor Productivity (Fig 4).** Over the past decade, Total Factor Productivity (TFP) has contributed negatively to growth indicating significant inefficiencies in production of final goods and services as well as weak technological progress and innovation. However, it is worth noting that this is gradually improving as public and private enterprises continue to leverage technology in their production processes. Consideration of TFP in formulation of macroeconomic policies and management is vital for sustainable economic growth in the long-run. Institutions such as the National Productivity Centre whose outputs ultimately center on improving the country's TFP should account for their resource allocation through tangible verifiable outputs that are geared towards enhancing the country's productive capacity. There is need also to prioritize research and development for innovation. It is noted that despite the existence of various research institutions such as NACOSTI, ILRI, KARI, KEFRI, ICIPE, and Kenya Numerical Machining Complex among others, the country still lags in terms of innovation and adoption of advanced methods of production. Going forward, resource allocation to research institutions should be pegged on productivity and specific outputs.

4. **Capital has been the main driver of economic growth but has not been able to sustain growth in the longer-term**. Various studies[4] on Kenya's long-term productivity have found that economic growth was driven by capital accumulation and Total Factor Productivity (TFP) in the 1970s; factor accumulation (physical capital, human capital, labour) in the 1980s and 1990s whereas early 2000s growth was explained by TFP and capital accumulation. The contribution of capital to economic growth appears to have declined in recent years; marred by use of obsolete machinery in production processes, low adoption of technology and lack of innovation to more advanced methods of production.

5. **The contribution of public investment to economic growth is declining due to low returns on the huge capital investments.** There are two broad reasons for this; firstly, is the choice of capital projects including their location. Development projects should be chosen based on their ability to 'crowd-in' other sectors of the economy such as industry and exports in order to facilitate economic expansion. A road can be beautifully done but if it is not linked to an existing resource base, then it may yield little if any returns on investment[5]. Secondly, is the issue of poor execution of development projects. Most development projects implemented by Ministries, Departments and Agencies (MDAs) face delays in implementation and are implemented over a longer period than intended, with higher costs than was necessary. As such, return on investment is yielded at a slow pace.

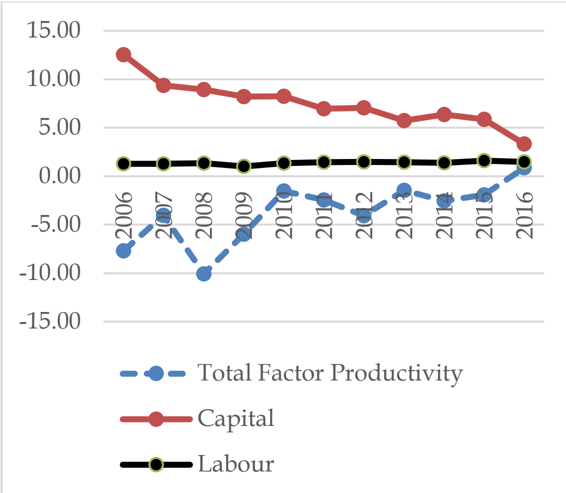
6. **On the other hand, the contribution of labour to economic growth has stagnated over the past decade.** Low labour productivity has been attributed to various challenges such as poor skills set of the workforce, non-conducive work environment among other poor labour management practices, poor work attitude[6] and ethics, lack of motivation as well as low adoption of productivity enhancing tools. The level of capital intensity, wages, training of workers, level of education, level of technology and technology capabilities have been found to significantly affect labour productivity. This is further worsened by inherent weaknesses in the enablers of development such as poor state and unreliability of energy and transport infrastructure.

[4]Kalio, A, et al (2012), Analysis of Economic Growth in Kenya: Growth Accounting and Total Factor Productivity; Kumar, S and Pacheco, G(2010), What determines long-run growth in Kenya?; IMF country report (2009),Kenya: Selected Issues and Statistical Appendix

[5]Over the last two decades, Pakistan invested billions in infrastructure – airports, roads, railways - which sadly remain underutilized and have failed to trigger the much-anticipated economic boom.

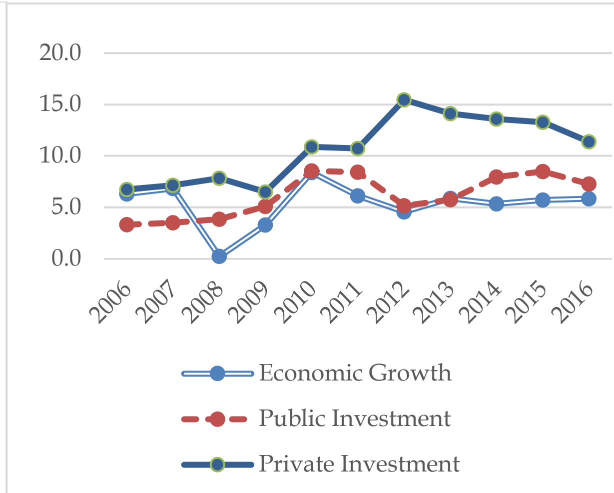
[6] Lack of commitment and sense of urgency and efficiency

Figure 2: Contribution to Real Growth (%)



Source: KNBS, PBO

Figure 3: Investment as a share of real GDP



Source: Economic Survey (Various Issues)

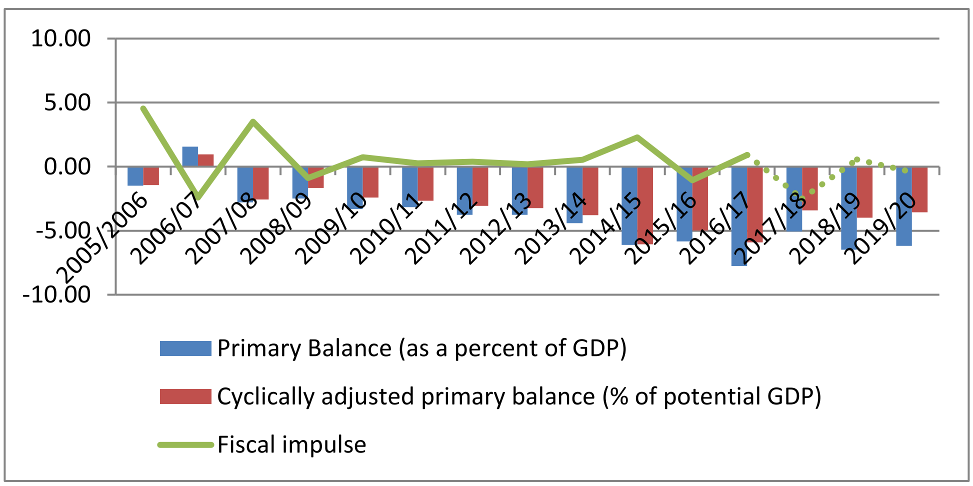
7. **Scaling up the productive capacity through improved labour productivity will require** policies geared first and foremost, towards improvement of quality of education. The education system should be aligned in such a way that it encourages innovation, talent development, entrepreneurship and practical technical skills thereby inculcating a productivity mindset amongst students- not just to focus on letter grade exams. The new school curriculum is geared to address these challenges and it is upon the government to ensure that the policies outlined therein are competently implemented. In addition, investment in latest technology among other productivity enhancing tools may enhance productivity of workers. Other interventions include improving labour management practices through providing a conducive work environment, rewarding effort among other labour concerns so as to improve work attitude and ethics.

8. **Scaling up the productive capacity through enhanced capital accumulation will require** investment in latest machinery and equipment for production processes in addition to enhancing the capacity of human capital through continuous training and development in use of the productivity enhancing tools. To this extent, the government should focus on policies that allow the private sector to thrive. This is because the private sector tends to capitalize more on innovation and enhanced efficiency in production processes rendering it more efficient in use of resources than the public sector. Such policies may include a debt strategy that borrows less from the domestic market in order to enhance availability of affordable credit, especially for SMEs. This will enhance investment-led growth and job creation. Furthermore, there is need for enhanced investment in sectors such as Trade & Industry for setting up of more EPZ and industrial parks; Irrigation projects and construction of dams to ensure adequate water supply among other key infrastructure projects. This may require increasing the ratio of development spending to total expenditure to a minimum of 40 percent. Policies to attract Foreign Direct Investment will also attract more capital. The government can consider provision of **Tax incentives** such as through lowering the corporate tax rate (in a non-discriminative manner) for new companies that are setting their production units in the country.

B. Restructuring Fiscal Policy: Slow Progress for Fiscal Consolidation

9. **Even though the government has continuously indicated that it is pursuing fiscal consolidation (targeting lower budget deficits and reasonable debt accumulation), the underlying fiscal position continues to be expansionary.** Over the last eight years, for the most part, fiscal policy has been expansionary as indicated by an expanding cyclically adjusted (primary) balance[7] (Fig. 5). In 2009/10, the government launched a fiscal stimulus plan to revamp the economy after a period of depressed growth in the aftermath of the post-election violence in 2007/08, the global economic crisis as well as (the ever present) drought. The objective of the stimulus was to set the country back on a positive growth trajectory through targeting sectors that were perceived as likely to yield maximum benefit in terms of stimulating growth and development. After two years of implementation, the stimulus package was wound up. However, a near flattening of the fiscal impulse at a positive level since 2009/10 (fig 5) denotes no significant change in fiscal policy, implying that though the stimulus was wound up, the government continued to pursue an expansionary fiscal stance. A likely contraction of fiscal policy was observed in financial year 2015/16 but was promptly foregone for an expansionary position in 2016/17 as the government continued to increase spending

Figure 4: Fiscal Policy 2005/2006-2019/2020



Source: PBO Macroeconomic Diagnostics

10. **The persistently high government expenditure is primarily due to huge infrastructure projects as well as increased administrative expenditure due to a general increase in the size of government on account of the number of administrative units created by the 2010 Constitution.** As earlier indicated, in recent years, the government has put in tremendous effort towards bridging the country's infrastructure deficit. An estimated 30 percent of Kenya's road network requires rehabilitation or reconstruction and the country's airports, ports and rail reportedly are operating beyond capacity.

[7] primary balance when the GDP is at potential; adjusted for changes in the business cycle

11. The government is in the process of implementing key flagship projects particularly in the Roads, Rail and Energy sectors as contained in the country's economic blueprint which will bridge the deficit but which require significant capital outlays. Furthermore, the advent of county governments and county assemblies following a change in the constitutional dispensation has considerably increased the size of government whose operations are mostly funded from the national coffers. Though the government has previously made attempts to streamline expenditure particularly on non-core items, government spending continues to be high, particularly on operations and maintenance. Indeed, over the past seven years, government spending has increased by an estimated 20 percent (including county allocations) even as revenues increased by a lower rate of 13 percent. As such, the government has had to resort to borrowing in order to meet the expenditure needs[8].

12. **There have been attempts in particular through legislative oversight, to provide clear and credible limits of fiscal policy but this has not been adhered to.** For instance, during the review of the Budget Policy Statement for financial year 2017, the legislature resolved that the fiscal deficit be maintained at 6 percent so as to ensure the fiscal policy framework pursues a deliberate convergence path towards the East African Community Monetary Union protocol's fiscal target of 3 percent level of fiscal deficit by FY 2020/21. However, this seemed to be an uphill task during the budget finalization and the mediation process on sharing of revenue between the two levels of government that followed. The expenditure pressures were so significant even as revenue underperformed such that the targeted deficit level could not be adhered to; and is estimated to rise to ~8.9 percent[9] by the close of the financial year 2017/18. Given the continuing expenditure pressures as government continues to implement subsidies such as free secondary education, hospital insurance coverage, free maternal healthcare, cash transfers among others as well as the unclear fiscal policy direction of the country -heavy spending and borrowing amidst claims of fiscal consolidation –it seems unlikely that the deficit will converge to 6 percent.

13. **Over time, given the increased spending amidst revenue shortfalls, an increasing share of revenue is being used to fund recurrent expenditure pressures with development expenditure mostly being funded through borrowing.** Currently, the expenditure needs of government outstrip by far the country's domestic revenue capacity, thereby necessitating borrowing (local and external) as well as transfer of some costs to the private sector through public private partnerships. A review of past expenditure indicates that while GoK development spending has increased by 25 percent over the past decade, recurrent spending has increased by 15 percent. This does not include money transferred to county governments. Given that revenue is growing at a much slower pace and taking into account the county government transfers, an increasing share of revenue collected by government is used to fund recurrent expenditure including money sent to county government. This has resulted in limited fiscal space which then leads to increased borrowing to finance required government outlays in development expenditure.

14. **Given the necessity of borrowing in the development agenda but also keeping in mind the underlying inherent risks, projects funded through borrowing must be designed to yield returns.**

[8] The recurrent expenditure has grown faster than the development expenditure hence the increase in public debt cannot be explained by the huge investment in infrastructure alone

[9] Deficit (cash basis, incl.grants)

Many development projects typically experience delays in implementation. It is not uncommon for development spending to be reduced significantly through a supplementary budget which then lengthens the duration and consequently the cost of the project. Indeed, some projects have accrued penalties due to breach of contract whereas some others such as those requiring counterpart funding from government did not kick off at the expected time due to delayed funding. There is urgent need therefore, to establish a systematic process of project appraisal and implementation so as to ensure there is prioritization and phasing of projects. Indeed, no new projects should be initiated after the Budget Policy Statement has been approved by Parliament.

15. **Though a useful stabilizing instrument during periods of depressed economic growth, expansionary fiscal policy should not be implemented in perpetuity otherwise it may become counterproductive.** Expansionary fiscal policy will cause an increase in budget deficit which requires higher revenues and often ends up in increased borrowing. Furthermore, it may cause crowding out of the private sector. Increased borrowing reduces private consumption and investment. As a result, aggregate demand then increases very slowly or not at all. Furthermore, it is also argued that government spending is more inefficient than private spending therefore there will be a decline in economic welfare. It is also true that in the long run, aggregate supply is inelastic therefore an increase in aggregate demand will only cause inflation to rise. Eventually, budget deficit will become too large, thereby increasing debt to unsustainable levels.

To restructure fiscal policy, the following are the options:

Strategy	Basis	Impact
Reduce planned expenditure	The country's budget has grown substantially over the past years with each subsequent budget termed as the 'largest ever'. To stem this 'incremental budgeting', one of the simple measures the government can consider is to cap expenditure at previous year level, adjusted for inflation. In this regard, the 2018/19 budget should not exceed **Ksh. 2.2 trillion (2017/18 budget excluding one off payments[10])**. All government expenditure must be reorganized to fit within this plan.	Approximate savings **Ksh. 200 billion**
Reduced fiscal deficit	Peg the fiscal deficit at 6 percent in the 2018/19 budget as earlier resolved by the legislature during the approval of the 2017 Budget Policy Statement.	Deficit should reduce by approximately **Ksh. 32 billion**; reducing likelihood of borrowing
Reduced actual government spending (or just stick to the planned expenditure)	Consider fully costed, quantifiable, policy driven rationalization measures that will reduce the budget by **Ksh. 32 billion.**	Fiscal Deficit maintained at **6 percent;** measures in outer years to reduce deficit to **3 percent**
Limit borrowing	Stick to the approved borrowing plan as	Create fiscal space for

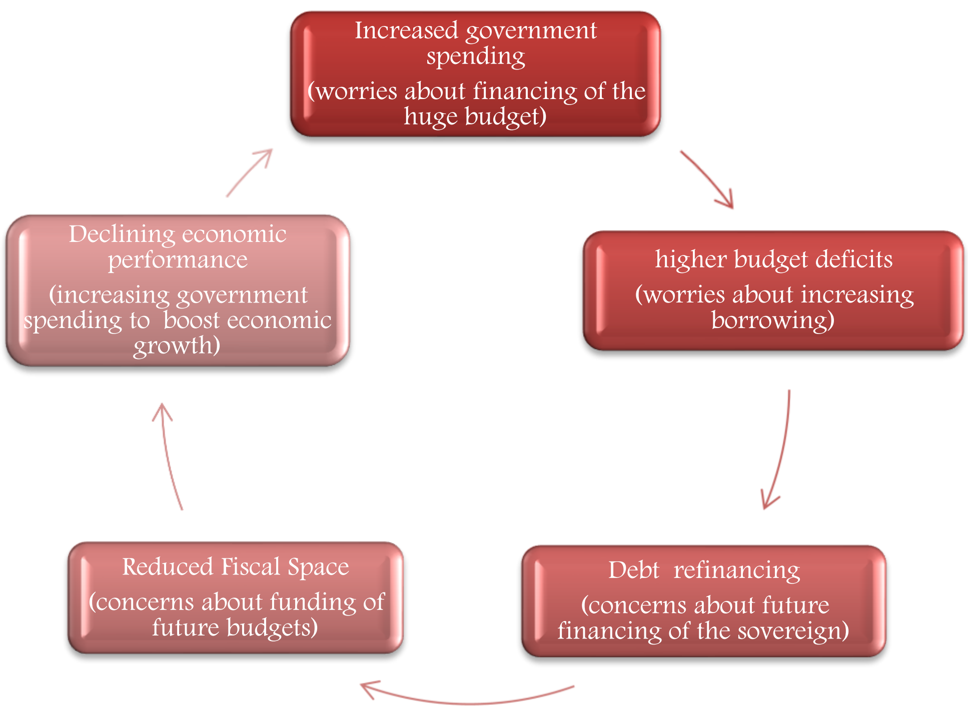
[10] One off payments comprise money spent on elections, Maize subsidies, Collective Bargaining Agreements for Teachers and medical practitioners etc

	outlined in the medium-term debt management strategy paper as well as the set thresholds and limits. Do not go beyond these measures	budget
Increase revenue generation	Fiscal consolidation is best achieved through enhanced revenue generation rather than expenditure cuts. Measures to enhance revenue generation are highlighted in chapter three of this document.	Create fiscal space for budget
Freeze Public Sector Employment	The public-sector wage bill has grown significantly over the past years; a freeze in employment and allowing natural attrition to take place will slow down the wage growth. Employment should focus only on essential services such as in Security, Health and Education	Reduce government spending and focus on other economic generating activities
Re-prioritization of Projects	No new projects should be considered unless previous ones are completed. In addition, the Budget Estimates should be accompanied by a detailed report on completed, on-going and future projects	Slow down debt accumulation while ensuring returns on investment

C. Risks inherent in Debt: Enforcing Medium Term Debt Management Options

16. **Kenya's fiscal deficit has been on an expansion path from 4.1% of Gross Domestic Product (GDP) in 2010/11, to 8.9% in 2016/17 leading to increased borrowing and higher debt accumulation.** As earlier indicated, the expanding fiscal deficit can be attributed to large infrastructure spending by government in order to boost economic growth and development. However, revenues have not grown at the same pace leading to increasing borrowing to meet the high expenditure pressures. This has resulted to higher debt levels, with an annualized debt growth rate of 18% for the past 10 years, pushing nominal debt to Kshs. 4.41 trillion or 57% (of the Kshs. 7.711 trillion GDP) by June 2017(QEBR, 2017).

Figure 5: How we accumulate Debt: the link between government spending, Debt and Economic Growth

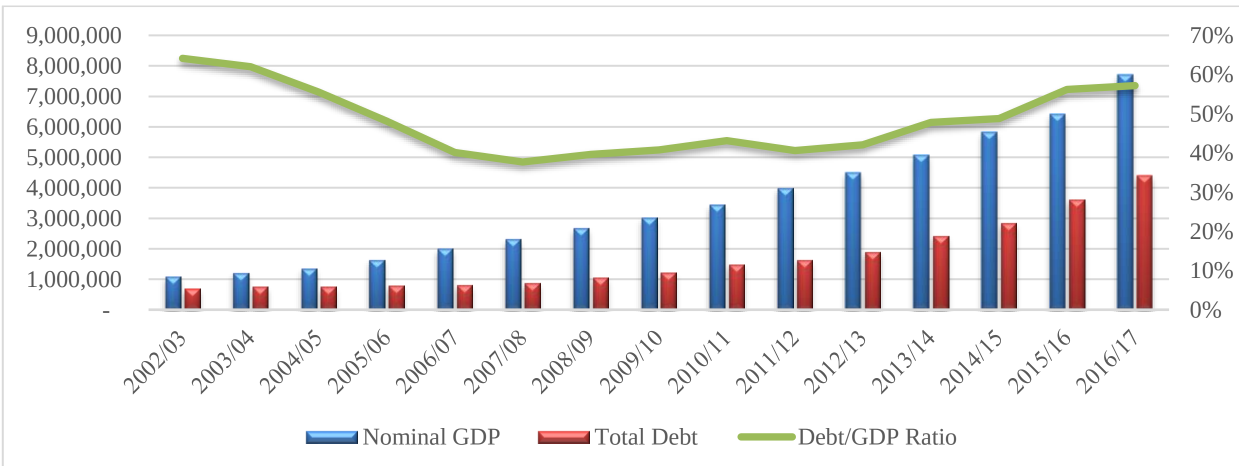


Source: PBO

17. **Kenya's Present value of Debt/GDP ratio is approximately *48.7* percent, well below the 74 percent threshold in the Debt Sustainability Framework but the speed of accumulation of new debt could render the debt path unsustainable.** This is indicated by the widening budget deficits as a result of sustained expansionary fiscal policy and rising ratios of debt to GDP ratios. According to the PFM Act the limit for debt is in net present value terms is 50 percent. This means that total public debt is close to breaching the legal debt limit unless a review is made to reelin the limit to the DSA framework limits. Further, the growth rate of debt stockmay soon reach levels that will require fiscal adjustments, including expenditure cuts, to stabilize the debt-

to-GDP ratio. The debt service to revenue ratio threshold has been breached according to the MTDS and is expected to remain so until 2019[11]. In financial year 2018/19, debt related payments (interest payments and redemptions) are expected to rise to 42% of total revenue (See figure 7). This means that adverse revenue shocks could strain Kenya's ability to repay its debt obligations increasing the risk of debt refinancing or debt rescheduling, or major expenditure reduction.

Figure 6: Trends of nominal GDP, Stock of Debt & Debt/GDP Ratio

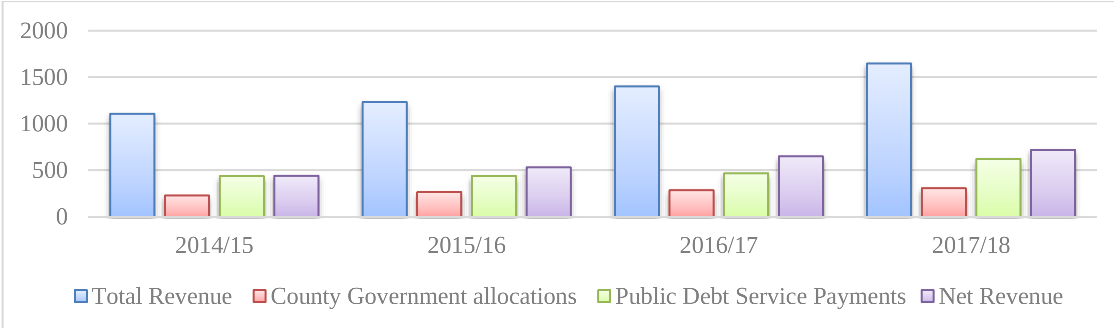


Source: National Treasury

18. **Though the MTDS indicates that debt sustainability over the medium term will be based on fiscal consolidation, it is unlikely that this will be achieved through expenditure rationalization given that the fiscal stance remains expansionary.** The government is in the process of implementing key policies that center on enhancing manufacturing, affordable housing, healthcare, and food security. Manufacturing is likely to help create sustainable jobs, through increased export earnings as well as value addition. While manufacturing will largely be private sector led, health care, housing and food security will require significant funding and subsidies from the government. These expenditure pressures are likely to stand in the way of any expenditure reductions and debt management commitments required to contain growth of stock of debt over the MTEF. The government faces quite inflexible budget, with much of recurrent and development expenditure not amenable to major cuts. For example, the wage bill reduction is unlikely due to strong labour unions, pension, debt repayment is mandatory, while development spending is required to sustain economic growth. With limited fiscal space, the government may need to reduce debt accumulation through curbing some forms of discretionary spending such operations and maintenance, travel, hospitality and training expenses.

[11] The Medium Term Debt Strategy - 2017/18 -2019/20, indicates that the Debt to Service Ratio for 2017 is 34.1percent, against a threshold of 30 percent, and is expected to remain so up to 2019 when the ratio will fall to 31.6 percent

Figure 7: Public Debt Service Payment versus National Revenue



Source: BROP 2017 & Supplementary Budget Estimates

Proposed Medium Term Debt Management Options:

19. So what are the options? How do we keep debt within sustainable levels for promotion of sustainable economic growth? This can be achieved through long term fiscal consolidation comprising targeted expenditure reduction; paced reduction in debt accumulation; adherence to primary deficit limits; and enhancing public sector debt management. In particular, the following options are important to help keep Kenya's debt in a sustainable path:
    - - **Ensure implementation of credible expenditure rationalization and revenue expansion policies to ensure attainment of the EAC target of 3% of GDP primary deficit**. Recent commitments and policy statements on how to achieve this target appear to have been disregarded due to expenditure pressures. A clear framework for either fast economic growth which helps reduce the deficit ratios or a combination of expenditure reduction and revenue growth should be implemented. Due to growth reducing effects of expenditure cuts or tax rate increases, it is important to carefully target these policies. For instance, high return public development spending should be ring fenced.

    - Address emerging Refinancing risk sustainably: Governments debt financing and refinancing choices are constrained partly by the interest rate controls and international bond market conditions. The choice between external commercial financing relative to domestic borrowing should be weighed carefully. Relative to domestic debt, commercial debt finance carries inherent exchange rate, interest rate risks, and refinancing risk. Alternatively, domestic borrowing will tend to displace private borrowing in the current interest rate control regime. As a general rule, external commercial borrowing should meet at least two conditions: one, where loan terms are far favourable relative to local borrowing and the terms are fixed over the term of loan; and, two, to refinance a maturing loan where exchange rate risk is high. In other scenarios, the government should use domestic borrowing cautiously so as not to lock out the private sector from the loan market.

Box 1: Kenya's Debt Risk Profile

Contingent Liabilities[12] continue to pose a significant risk to the country's already vulnerable debt position. The National Government has various debt guarantees offered to state owned (fully or partially) enterprises which are currently estimated at Kshs. 135.8 billion, just Kshs. 64 billion short of the Kshs. 200 billion threshold[13]. The use of guarantees has evolved over time in Kenya from providing guarantee to development programs with projected stream of returns to rescue of key players in strategic sectors. The resultant effect of contingent risk arising from guarantee payments is that, should the risk materialize, then it becomes an extra-burden on already limited financial resources and does not optimize national resource utility. Currently, Kshs. 1.1 billion is incurred defaulted guaranteed debts by KBC, TARDA and EAPC.

The country continues to face significant risks from interest rates, though this applies mostly to external debt. Domestic interest payables, while still accounting for 75 percent of interest payments, has a lower risk profile as a result of the interest rate capping law that has enabled the government borrow domestically cheaply and with rates within predetermined risk bands. External debt interest payables on the other hand, owing to use of commercial loans such as Debut International Sovereign Bond ($2.75 billion), Standard Charted Syndicated Loan, and massive financing from Chinese institutions[14], has a riskier profile owing to higher interest rate terms, changes in international financial capital flow, and perception of credit rating institutions.

Exposure to risk from exchange rate fluctuations primarily depends on the level of external debt. As at June 2017, this category of debt accounted for 51% of the total debt portfolio indicating that up to 51% of Kenya's debt is susceptible to exchange rate fluctuations from US dollar, Euro, British pound and the Yen. Fluctuation in exchange rates also exacerbates the interest rate risk from external debt. This reiterates the need to have a stable exchange rate regime to curtail on short term exchange rate risks that can cause deviations from annually planned fiscal framework.

[12]According to GFSM, 2014, these are obligations that do not arise unless a particular discrete event(s) occur. These range from Interest rate risks, exchange rate risks on existing debt and debt guarantees etc.

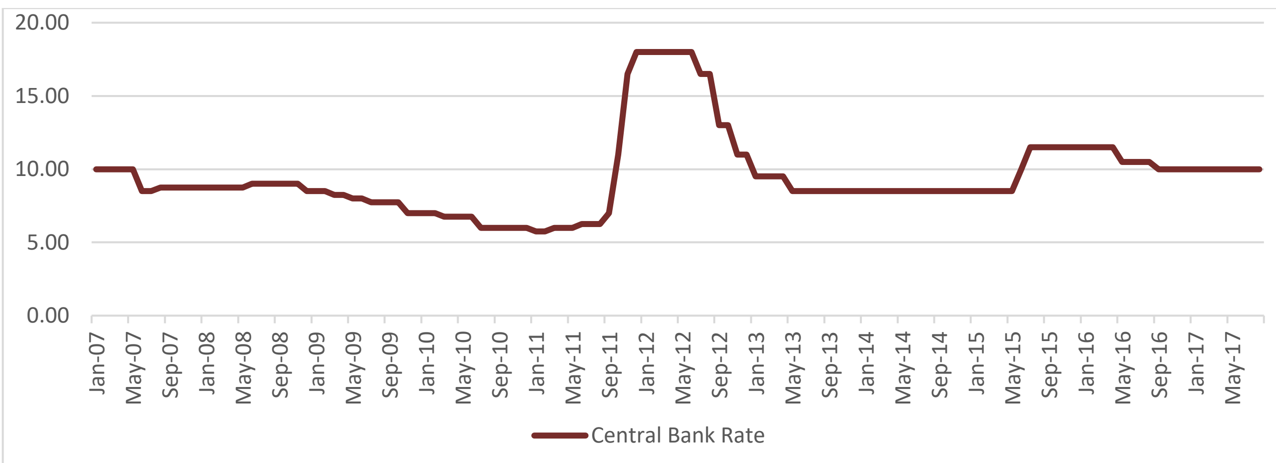
13 In accordance to National Assembly resolution dated 17th June, 2011, setting limit at Kshs.s. 200 billion

[14]Interest on loans from Exim Bank of China will reach Kshs.s. 23.4 billion and China Development Bank, Kshs.s. 3.4 billion, by FY 2019/20. With maturing debt at Kshs.s. 30.7 billion and Kshs.s. 16 billion, respectively.

D. Which way for Monetary Policy in an Interest Rate Capping Regime?

20. **Though the government has been pursuing a fairly expansionary monetary policy stance as indicated by the lowering of the Central Bank Rate (CBR) to encourage credit growth to the private sector, decline in private sector credit growth continues to persist.** In early 2016, the Central Bank Rate stood at 11.5 percent; a level that had first been arrived at in July 2015. Then, the high CBR level was in order to anchor inflation expectations following elevated risks to the inflation outlook which were mainly attributed to pressures on the exchange rate on account of a strengthening dollar and a widening current account deficit. With time, as the shilling stabilized and the inflation outlook seemed promising, the Central Bank concluded that there was some room for easing of monetary policy and therefore lowered the CBR by 100 basis points to 10.5 percent in May 2016. This was further reduced by 50 basis points to 10 percent in September 2016 in order to stimulate private sector credit expansion following the capping of interest rates. However, credit to the private sector has continuously been on the decline for the better part of 2017.

Figure 8: CBR Movement From 2007-2017

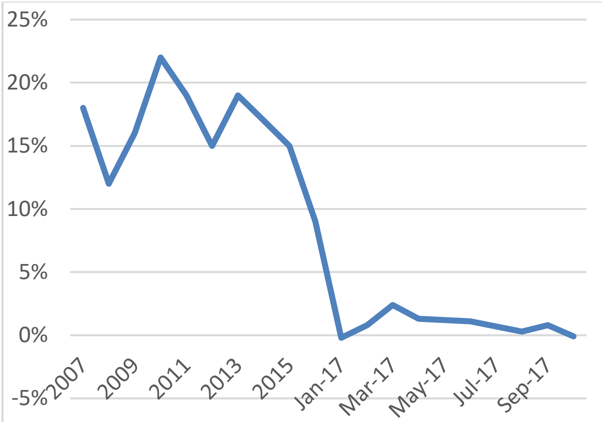


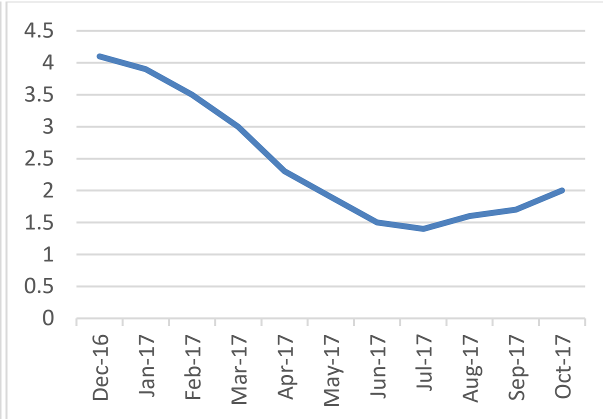
Source: CBK

21. **The monetary policy stance for 2017 was aimed at containing the annual growth in money supply to 10.5 percent by June and 12.3 percent by December 2017 with credit to private sector expected to pick up to 6.2 percent by June 2017 and 7.1 percent by December.**[15] However, money supply has declined significantly since 2016 following the capping of the interest rates. Indeed, by June 2017, growth in money supply had slowed down to 1.1 percent and declined even further to – 0.8 percent in October. This is far from the targeted 12.3 percent annual growth in money supply. Conversely, the tide seems to be turning, albeit slowly, for private sector credit growth which had also slowed down to 1.4 percent growth in July but has since rebounded to an estimated 2 percent as at October 2017. These dynamics are attributed to the capping of interest rates which influenced banks to tighten their credit terms in line with the interest rate caps, as well as buying more Treasury securities and reducing overall risk exposure.

[15] Monetary Policy Statement, 2016, Central Bank of Kenya

Figure 9: Growth in money supply (% change)Figure 10: Growth in private sector credit (annual% growth)

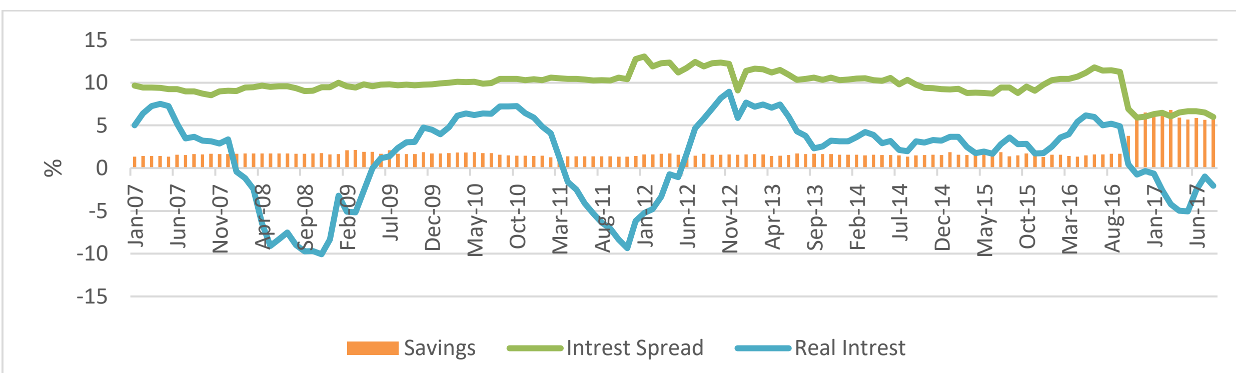




Source: CBK

22. **The move to cap interest rates was occasioned by failure by banks to regulate the high interest rates charged on commercial loans and wide interest rate spreads.** Though the lending rates remained quite high, savings rate averaged below 2 percent. Real interest rate spread (interest rate adjusted for inflation) remained on average above 3 percent. The Banking (Amendment) Act, 2016 has significantly reduced the interest rate spread to single digits (as shown in the figure below). This has made commercial loans more affordable but ironically, *less* accessible. Similarly, the savings rate has increased from 1.56 percent to 5.94 percent and the deposit rate slightly above 7%.

Figure 11: Interest Rate Spread, 2007 -2017



Source: CBK

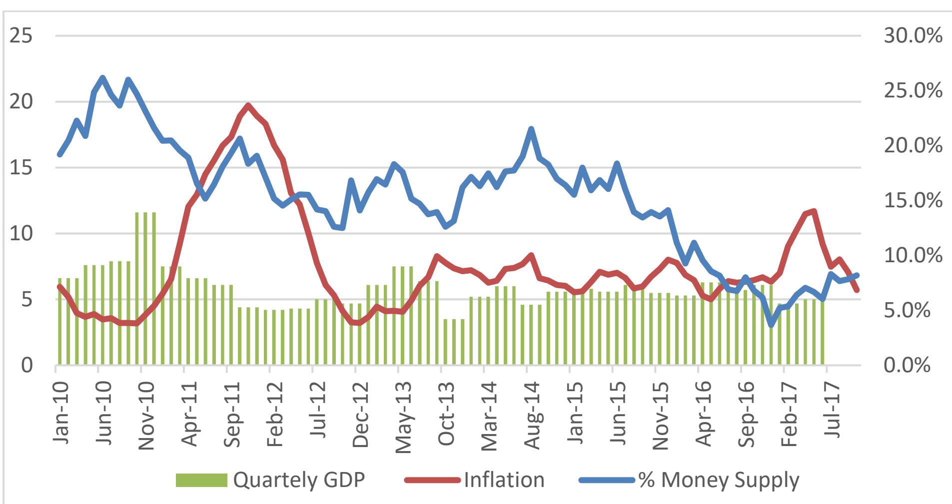
23. **The contraction of credit to the private sector since September 2016 has affected agriculture, manufacturing and business Services sectors: a development that is likely to impede economic development and poverty alleviation given the number of people who earn their livelihoods from the three sectors.** According to data from the Central Bank, growth of credit to the agriculture sector has significantly contracted over the past one year and was estimated at -2.0 percent as at September 2017. Credit to the manufacturing sector as well as business services also experienced contracted growth

but this has gradually improved with credit to the manufacturing sector expanding by 6.1 percent by September 2017. A survey by KNBS in 2017 on Micro, Small and Medium Establishments (MSMEs) revealed that most SMEs fail due to inadequate operating funds and access to credit. Provision of credit to the private sector and the SMEs holds great potential to improving livelihoods primarily through creation of jobs.

24. **The high appetite for borrowing by government is exacerbating the situation as banks prefer to lend to government whose loans are considered "risk free.'** The cap on lending rates has afforded government easy access to funds to finance its large budget deficit. Thus, the combination of interest rate caps and government large spending appetite has influenced banks to invest in government securities consequently reducing credit to individuals and businesses.

25. **Though there are concerns that interest rate capping may have hampered mechanisms of the CBR, it may have also led to a leaner and more competitive banking sector.** The capping of interest rates may have given the necessary impetus for banks to streamline their operations through staff reduction and further automation thereby leading to a leaner and more productive workforce. Nevertheless, the interest rate controls, which are legally anchored to the CBR by design, have affected the flexibility of the key monetary policy tool, the CBR itself. Notably, regular changes to the CBR, even if necessary, would occasion simultaneously changes to deposit rates and lending rates, leading to volatility and instability in the financial markets.

Figure 12: Money Supply vs. GDP Growth& Inflation



Source: CBK

Policy Options:

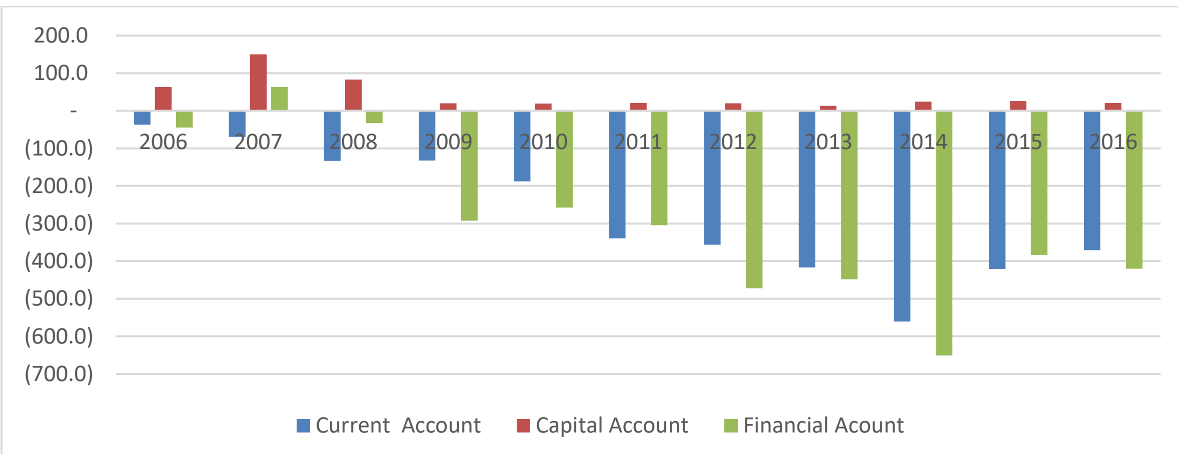
1. **Limit fiscal deficit and domestic borrowing** – this will encourage banks to increase credit to the private sector thereby stimulating private sector activity and promoting economic growth and development. As noted above, external commercial should not unduly replace domestic borrowing. Thus, the broader policy goal should be to target a smaller fiscal balance.

2. **Restructure the interest rate capping law** – this law may require further streamlining to ensure that the profitability of banks is not compromised and to improve Monetary Policy flexibility. A review of the interest rate regulation framework should ensure that the design of any controls is completely delinked from the CBR, which is essentially a monetary policy rate of the CBK.

E. Restoring Balance in the External Sector

26. **Though the current account deficit appears to have improved in 2015 and 2016 following nine years of sustained expansion, it is likely to worsen in 2017 (Fig 14).** The improvement in the current account balance in 2016 was because of decline in merchandise imports as well as increased net inflows. From 2015 to 2016, net inflows increased by 32.7 percent occasioned by improved foreign earnings from tourism supported by conference tourism as well as increase in remittance inflows. By the end of 2016, remittance inflows stood at USD 160.9 million (CBK). Going forward, the likely deterioration of the current account deficit is due to lackluster performance of the export sector even as imports increase.

Figure 13: Balance of payments

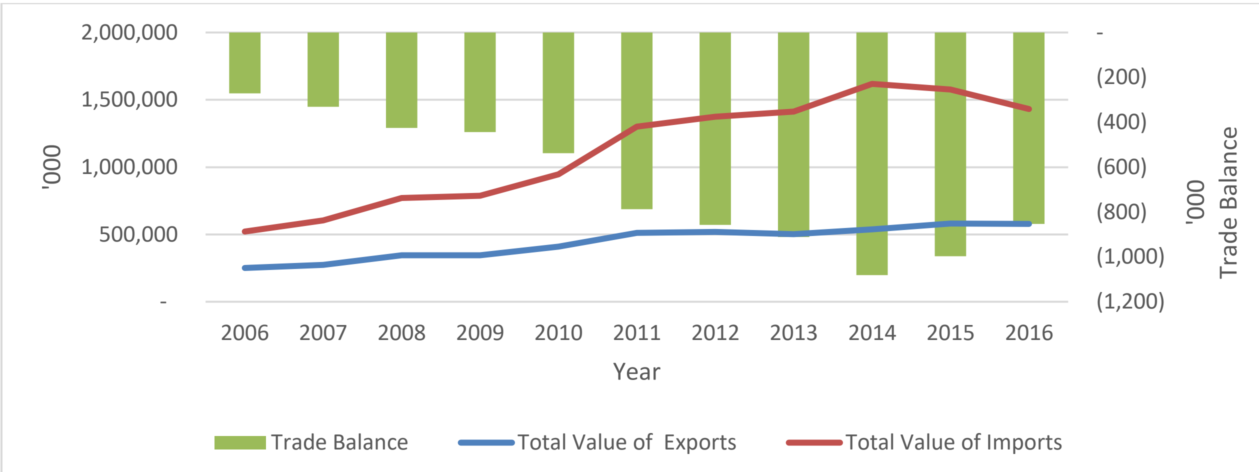


Source: KNBS

27. **Exports grew at a slow pace over the past decade before experiencing stagnation and eventually a gradual decline whereas imports have steadily declined over the past three years.** In the last decade, the trade balance of the country averaged 13 percent with the country's exports having grown on average by 9 percent while imports grew at an average rate of 11 percent before experiencing a slowdown. Domestic exports declined from Kshs. 581 billion in 2015 to Kshs. 578.1 billion in 2016. This is attributed to a decrease in re-exports of Kenya's petroleum products as well as manufactured goods that may have been occasioned by increased cheap imports of manufactured goods from china within East Africa. On the other hand, imports have declined over the past three years, from Kshs. 1.6 trillion in 2014 to Kshs. 1.43 trillion in 2016. The decline was attributed to lower global oil prices as well as reduced transport equipment acquisitions. Despite the decline however, it is worth noting that there has been a steady rise in non-food industrial supplies as well as food items relative to total expenditure on imports. The increase in importation of food items can be attributed to the prevailing drought

conditions for the better part of 2016 and 2017.Going forward, the import bill may face upward pressure due to global rise of crude oil as well as likely increased importation of machinery and equipment as key infrastructure projects continue to be implemented.

Figure 14: Trade Balance



Source: KNBS

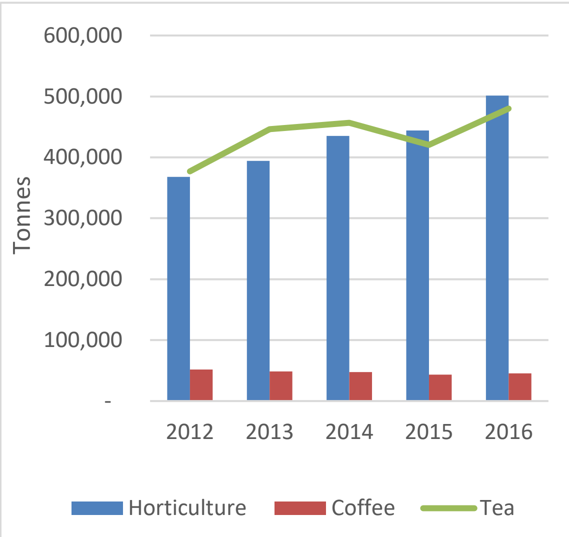
28. **A review of the recent trend of exports shows a decline in both value and volume terms.** Kenya seems to be losing grip on its East African export market as available data indicates a decline in Kenya's exports to the region. Exports to Uganda decreased by Kshs. 6 billion in 2016 compared to 2015 whereas exports to Rwanda decreased to Kshs. 17.5 billion in 2016 from Kshs. 18 billion in the previous year. In volume terms, it is noted that there is a steady decline in the volume of the main export products, namely, coffee, tea and horticulture in the course of 2017. Though this is attributed to unfavorable weather conditions, it is noted that the decline in volume of Kenyan exports to Europe by 3 percent in 2016 is partly due to the European Union placing Kenya's exports on their watch list due to quality concerns. This is a concern as it compromises the image of the country as a key exporter and may generate a lack of confidence in Kenyan products going forward.

29. It is also indicated that weak global demand and fall in prices led to temporary closure of local firms and a decline in exportation of Soda Ash and Fluorspar. It is important therefore, for the country to expand its export base and diversify goods as well as value addition in order to be protected from such vulnerabilities.

30. On the other hand, there has been an increase of exports to Asia with export earnings having increased by 7.4 percent to earn the country Kshs. 140.5 billion in 2016. Similarly, there has been an upward trend in volume of exports to North America namely USA and Canada. Export earnings to USA have risen by on average of 14 percent

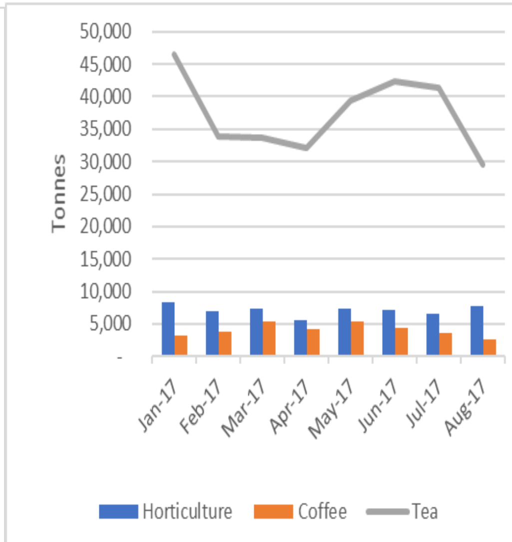
while exports to Canada have risen by 46 percent in the last five years as shown in the figure below. This could be partly explained by the expansion of Export Processing Zones (EPZ) being supported by Africa Growth Opportunity Act (AGOA).

Figure 15: Quantities of Principle Domestic Exports



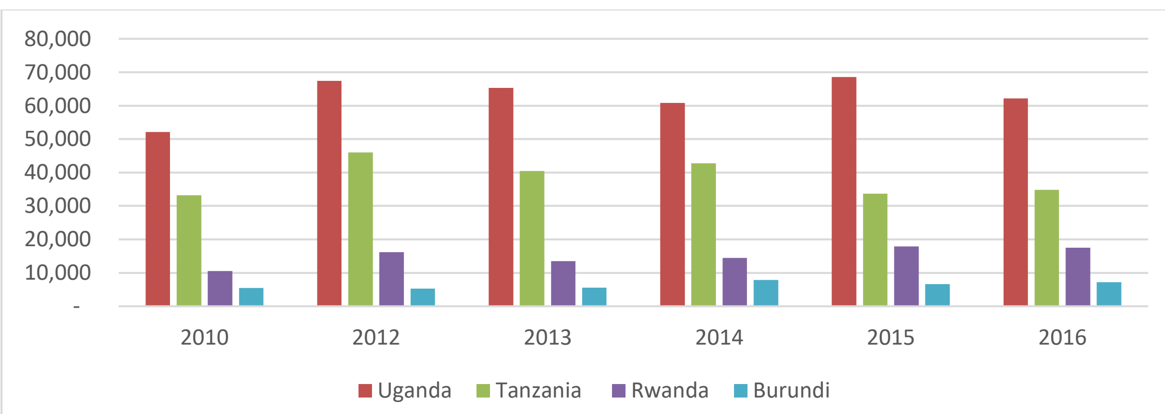
Source: KNBS

Figure 16: Monthly quantities Jan-Aug, 2017



Source: KNBS

Figure 17: Value of Kenya's Exports within East Africa



Source: KNBS

31. **On the other hand, though the capital account is at a surplus, it has been on a declining trend and this may adversely affect the country's balance of payment position.** The decline in the capital account is occasioned by a decrease in Foreign Direct Investments (FDIs) as well as increased foreign interest payments. Net financial inflows increased to

Kshs.420 billion from Kshs. 384 million in 2015 because of short term capital inflows occasioned by ongoing foreign financing for government infrastructure projects. The financing of the country's capital account primarily through loans is not reliable as this is money that has to be repaid. A sustainable improvement in the current account balance will typically require higher national savings which will ultimately lead to higher investment levels and therefore boost growth levels in the country.

Policy Options

i. **Revamp the manufacturing industry:** In order for Kenyan goods to compete successfully in the international arena, there is need to bring down the cost of production by lowering the electricity tariffs as well as increase value addition to the products produced especially agricultural products. As indicated in the Budget Watch 2017, the focus should be on increasing exports in value as well as volume terms through diversification of the export base as well as value addition to export products; improved competitiveness

ii. **Support Private Credit growth:** The government should formulate policies that are geared towards supporting private sector credit. With increase in access to credit, companies may be more innovative hence invest in the latest technology which are energy efficient as well as increase efficiency in the production of goods and services.

iii. **Institutional and governance reforms to attract Foreign Direct Investment:** this entails measures to reduce cost of doing business in the country such as energy and transportation costs as well as easing licensing processes to make it easy for businesses to set up in Kenya. Some reforms such as easing construction costs and reliability of electricity supply, enhanced tax compliance systems. Further reforms can be done still on energy reforms and improving process of registering a business and obtaining licenses.

iv. **Linking infrastructure development with exports:** Any strategy of upscaling infrastructure development must be geared towards supporting export of goods and services.

F. Medium term economic growth prospects

a. Review of Economic Performance

32. **The Kenyan economy has surmounted significant difficulties in the course of the year which contributed to a downward revision of the growth outlook to 4.8 percent for the year 2017.** Growth in the first two quarters of 2017 was estimated at 4.7 percent and 5.0 percent respectively and is forecasted to average 4.8 percent for the rest of the year. The key impediments to economic growth stemmed primarily from an unfavorable business environment. This was fueled by heightened political uncertainty on account of a prolonged and hotly contested election. During this period, private sector activity declined significantly due to subdued demand and a lower willingness to spend. Consumers were generally unwilling to make major expenditure decisions in a period of uncertainty, as were the manufacturers and other players who may have postponed investment decisions. Reduced credit access as a result of the capping of interest rates also hampered performance of businesses as banks became more cautious lenders.

33. **Subdued economic growth resulted in revenue underperformance leading to widening budget deficits and poor budget implementation**. The realism of revenue projections are typically based on the soundness of the macroeconomic fundamentals, and more importantly, the economic growth realized. The revenue projections for 2017 were based on a rather optimistic[16] growth projection of 5.9 percent. As such, the budget has not been implemented as envisaged and the country may have to resort to borrowing to plug the deficits.

Medium term economic growth prospects

I. Baseline Scenario

Assuming no significant change in policy, Economic growth is projected at 5.0 percent in 2018, picking to 5.6 in 2019 and 5.9 in 2020. In fiscal years, this translates to 4.4 percent growth for financial year 2017/18, 5.5 percent in 2018/19 and 5.8 percent in 2019/20.

34. **Fiscal Policy Outlook:** Government expenditure will follow the usual expansionary pace as has been the case since 2009/10. Expenditure will increase as the government continues to provide subsidies such as Free Secondary Education, Free Maternal healthcare and enhancing social safety nets in addition to implementing key flagship projects including the "Big Four" agenda. Government investment is estimated at approximately 7.4 percent of GDP for 2017/18 given the pledges by the government to continue with key public projects in roads, rail and energy generation. Given that

[16] This was an election year and the drought effects could not allow achievement of the targeted revenue

growth of revenue is likely to remain subdued, the increased government expenditure will be matched by a widening of the budget deficit and likely continued debt accumulation.

35. **Monetary Policy Outlook:** Private sector growth is likely to remain subdued given the current interest rate capping regime that has led banks to be more cautious lenders. For the better part of 2017, Private sector activity declined due to heightened political uncertainty as well as reduced credit access. According to the Stanbic purchasing managers Index (PMI), private sector activity declined significantly in the course of 2017 not only due to subdued demand and a lower willingness to spend/invest by consumers and manufacturers, but also due to significant financial constraints. Going forward, private sector activity is likely to improve as the business environment recovers from a tense political period.
36. **Real Sector Outlook:** Agriculture is slowly recovering given the improved weather outlook and is likely to perform modestly in 2018, though not extraordinarily so. This is because investment in agriculture mostly remains 'business as usual' with no real or clear strategy to enhance agricultural productivity.
37. **Inflation** is likely to remain within single digits given reduced volatility from food prices. However, downside risks from food prices still remain especially with the winding up of the maize flour subsidy and the likely underperformance of the agriculture sector. Other risks will most likely emanate from fuel and raw material prices which have slowly been edging upwards. High prices of raw materials are also likely to increase the import bill thereby worsening the trade balance even further.
38. **External Sector Outlook:** The trade deficit is likely to continue expanding on account of stagnating exports and increasing imports. Reported increases in Kenya's exports are mostly due to increase of exports in value terms, not volume terms. Structural competitiveness or quality of exports is still wanting and Kenya's export market share in sub-Saharan Africa has been declining. On the other hand, given continued huge government investment projects, imports are likely to continue increasing.

II. Alternative Scenario

i. Increasing credit access to the private sector

39. According to the Purchasing Managers Index for December 2018, business conditions have improved remarkably and private sector activity is once more on expansionary territory. However, this development is likely to be marred by the reduced access to credit by the private sector. The policymakers can consider two options to remedy this. Firstly, is for the government to put in check its growing appetite for borrowing. This will free up credit which can then be made available to the private sector. Secondly, the government can consider reviewing the banking (amendment) act to accommodate some of the concerns raised by banks and other stakeholders. Using the PMI index as a proxy for private investment, it is assumed that increased credit access to the private sector will lead to a 3-5 percentage expansion in private sector activity.

ii. Rationalizing Government Expenditure

40. The implementation of key government projects under the "Big Four" Agenda will require significant capital outlays. Unless the government is somehow able to increase the country's, domestic revenue raising capacity, focus should be on rationalizing expenditure from non-core and non-productive expenditure towards government investments. Indicative budget figures as provided in the draft budget policy statement estimate total expenditure at Kshs. 2.49 trillion up from Kshs. 2.32 trillion in 2017/18. Of this, recurrent expenditure is estimated at Kshs. 1.5 trillion and development expenditure at Kshs. 658 billion. Assuming the government will be able to meet its proposed revenue collection, the proposal is to peg recurrent expenditure at the 2017/18 level of Kshs. 1.4 triillion, allowing only for small changes due to inflation. The Kshs. 100 billion savings should then be re-oriented to development expenditure to cater for the mega projects while reducing dependency on borrowing.

41. Assuming efficiency in use of resources and that the budget is implemented as envisaged with no midyear revisions, pursuing the indicated alternative policy direction will yield economic growth of 6.3 percent, rising to 6.5 percent over the medium term. This will lead to enhanced revenue collection and further stimulate demand leading to more sustainable growth. The benefits from policies to improve agriculture and manufacturing are likely to be more long term and will depend on how effectively they're implemented. Impact on growth will be more apparent in the medium term.

Chapter Two:

Enhancing Equity and Efficiency in Allocation of Resources

A. Government Budgeting process and enhanced delivery of services

A credible Budget Process for efficient mobilization and allocation of available resources

42. The budget is the most important document through which the government delivers its National Development agenda. It is a key economic policy tool that provides the means through which the government affirms its priorities and how it intends to deliver services to its people.
43. According to public finance scholars ***"A credible budget is both technically sound and faithful to political directions; takes a medium-term perspective in early decision making and setting a hard budget constraint".*** Kenya has in the recent past instituted various reforms in order to create a budget system that can deliver a credible budget. These reforms, coupled with the changes in the legal framework, have resulted to a lengthy budget process that takes more than nine months. Moreover, the production of various budget documents involves complex structures and outlay of the estimates.
44. Article 221 of the Constitution states that the Cabinet Secretary responsible for Finance shall table in the National Assembly, the Estimates of Revenue and Expenditure of the National Government for the next financial year. The Public Finance Management Act of 2012 (PFM)- in an effort to streamline the process of preparing the estimates and enable timely decision making on priorities as well as adherence to the constitutional deadline for submission- provides for further guidance on activities that must take place before the estimates are submitted. In addition, PFM Act provides for early engagement with the legislature through the submission of Budget Review and Outlook Paper (BROP)and the Budget Policy Statement (BPS) among other documents. Whereas these documents are critical for early engagement with various stakeholders and in particular for enhancing participation and inclusiveness in the budget, **the documents are complex and sometimes do not enhance prioritization and efficiency in the budget process.**

Linking the National Priorities to the Budget Making Process: The Case of the Medium-Term Expenditure Framework Approach

45. The Kenyan government in 2000 adopted the Medium-Term Expenditure Framework (MTEF)[17]. The key principles of a credible MTEF include;
    a) Achieving fiscal discipline i.e. ensuring one lives within their own means and making the ceilings binding;
    b) Achieving allocative efficiency which means a process of ensuring that resources are allocated to agreed strategic priorities with clear performance targets both between and within sectors; and
    c) Achieving predictability through the development of consistent and realistic resources while ensuring there are no across the board expenditure cuts in the course of the financial year.

[17]MTEF is a comprehensive process of budgeting that allows for preparation of the budget within a medium-term perspective and provides a framework for evaluating and allocating available resources to agreed policy priorities and national development objectives.

The implementation of MTEF in the last ten years has created institutions such the sector working groups and the public hearing forums. However, there are weaknesses in the MTEF especially as relates to

a) Prioritization of programs, the process of costing and inclusion of new programs in the budget
b) The inability to make trade-offs due to the design and composition in terms of MDAs that make up a sectoral working group.
c) The weak linkage between the strategic National agenda as outlined in government strategy papers and the annual and medium-term budget.
d) Across the board expenditure cuts with widening differences between future ceilings and the annual budgets.

Thus, there may be need to re-launch the MTEF to avoid a mechanical preparation and inclusion of the medium-term allocation, priorities in the budget documents.

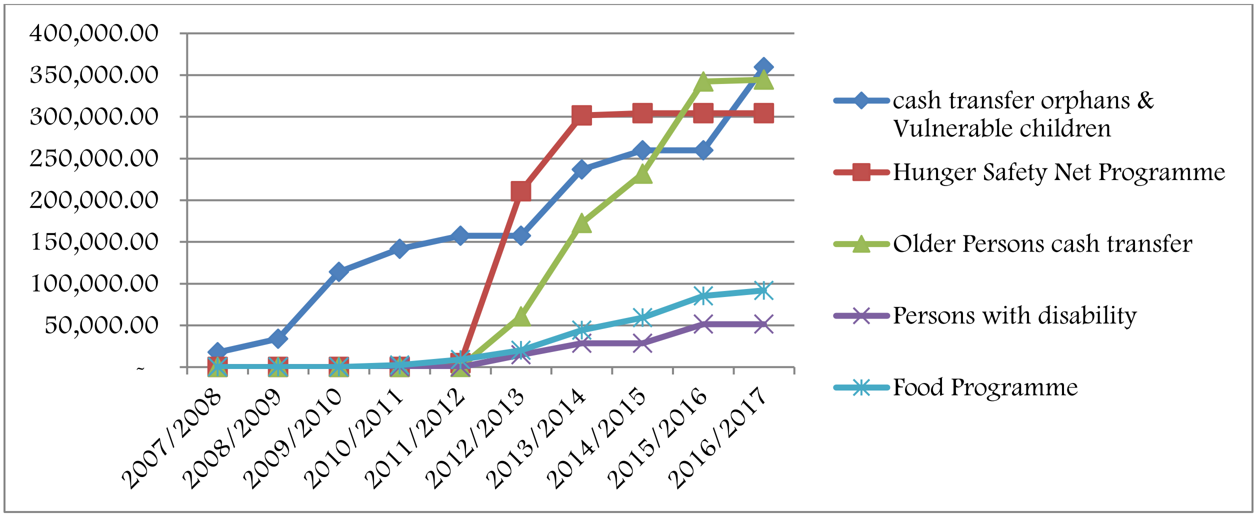
"The MTEF has also not achieved its objective and therefore budgeting in Kenya remains incremental. How useful and the two outer years in the current MTEF budgeting?"

46. The Vision 2030 and the two MTP's were identified and pronounced by government as one of the basis from which the budgets for annual and the medium term are expected to be prepared. However, due to resource constraints and new expenditure pressures a number of priority programmes may be delayed and some may never be implemented.
47. The government further introduced Program Based Budgeting (PBB) which allows for decision on what to finance to be based on performance targets. The PFM Act, provided for implementation of programme based budgets to commence on 2013/14 financial year whereas that of counties in 2014/15 financial year. The National Government has been preparing the budget on a programme basis and even the appropriation bill is now by programme. However, decision making is still being done at line item level as evidenced by decisions to adjust the budget which are communicated at item level and hence making the budget incremental. In addition, PBB only works where the performance indicators are smart and are the basis for adjustments in the budget. **To strengthen PBB there will be need to address the issues related to programme design and identification of performance targets.**

B. Social protection: - Cash Transfers

48. Since 2007/08 to 2016/17, the number of beneficiaries for cash transfer Programme in Kenya has been increasing. The orphans and vulnerable children have the highest number of beneficiaries at 359,576, the older persons with 344,378 beneficiaries and the hunger safety net Programme with 304,236 beneficiaries as shown in figure 19.

Figure 18: Beneficiaries of the cash transfer programme



Source: State Department for Social Protection

49. It is believed that regular cash transfer has created positive effects on poor households as they spend their money on food, clothes, school fees, medical bills and paying debts and other long-term wellbeing of beneficiaries such as starting a small scale business to complement the household income. The allocation for the cash transfers has been on an increasing trend from 2012/13, apart from the financial year 2015/16 when there was a decrease in allocation.

50. Despite the increases in cash transfer and the Kenyan economic growth about 17 million people (45.6%) live below the poverty line of KSh. 134 per day while 19% live in extreme poverty, according to a World Bank report -2015. These are the people who need cash transfers to meet some basic needs. The people in extreme poverty also suffer the most when the country experiences emergencies such as floods, drought and economic recession. Children in poor households have a high probability of experiencing stunted growth; they don't get good quality education, unemployment, long term illness, and disability and reduced family income.

51. The Constitution of Kenya and Vision 2030 aim at long term improvement of livelihood for all citizens. Kenya is also a signatory to various regional, international declarations and agreements for social protection of the vulnerable. However, in some programmes such as support to orphans due to HIV/AIDs has not helped the households to improve their standard of living and move from extreme poverty. Some of the weaknesses in the program and the options available include:

(a) Increasing dependency of households on the programme

In most households where there are persons benefiting from cash transfers, there are other members of the family who end up using the funds for buying food, paying school fees, paying debt and other basic family requirements. This makes the household to depend on the cash transfers that may disadvantage the intended person.

(b) In other programme the community feels that targeting is not well done with many eligible people not benefiting from the transfers.

The options for better management of social transfers may include;

- The cash transfers can be made conditional in that the recipient fulfills certain condition such as ensuring the children attend school and/or health facilities for immunization on regular basis. In effect making it a two – pronged approach in combating poverty in that there is investment in human capital to improve health and ensure there is no transmission of poverty from one generation to the next. This is likely to minimize culture of dependency increase investment and households' income in the long run so that the household can move from poverty and no longer require social assistance support and make it more possible for beneficiaries to access information (World Bank 2011).

- Review the structure of the operations with a view to transfer some powers from those who deliver the benefits to those who receive them. This can be done by development of a comprehensive and practical community participatory framework for beneficiaries and the community to make them aware of the available benefit in order to enable the program increase its value and relevance in reducing social and economic inequalities. Also a more comprehensive approach should be used such that all citizens who are eligible benefit.

- Establishments of social protection national monitoring framework to prevent fragmentation of social protection interventions, create coherence in targeting and delivery mechanism including auditing by various institutions such as National Gender and Equality Commission. This can be done by a review on the targeting, coordination and implementation guidelines especially with the increased allocation of the resources over the years.

C. Public Private Partnership (PPP) as an avenue of filling infrastructure resource gap in Kenya

52. The government, as part of the Vision 2030 flagship projects, has in the recent past embarked on mega infrastructure capital projects. These projects usually require investment of large amounts of resources and they have long term maturation and provide services often seen as indispensable to a society. However, the government has challenges on raising resources for capital spending. Additionally, the development

budget is always subject to cuts due to the austerity measures the National Treasury adopts whenever there are challenges of budget implementation. There are therefore limited resources for the government to implement most of infrastructure projects critical for the attainment of vision 2030.

53. According to World Bank report in collaboration with the Africa development bank and other agencies (Infrastructure county diagnostic report, 2010), Kenya requires a sustained expenditure of about USD 4 billion a year for economic growth and development. In this regard, it is worth noting that the amount required is so huge that makes funding of these projects be done at the opportunity cost of providing other social amenities. Therefore, the existence of a legal framework for Public Private Partnership arrangement in the country looks likely to provide impetus towards accomplishing these projects.

Table 1: Estimated Infrastructure Projects in Kenya

	Sector	Amount in USD. Millions
1.	Energy(Power and others)	19,808
2.	Ports, Roads, Railway and Airports	21,954
3.	Water and Sanitation	4,567
4.	Tourism	2,050
5.	ICT	7,850
6.	Devolved Government	2,000
7.	Housing and Public Works	3,901
8.	Lamu Transport Corridor	3,723
	Total Needs	62,176
	Available GoK	25,000
	Funding Gap	**37,000**

Source: The National Treasury

Transport Infrastructure

54. Investment in Infrastructure is one of the main pre-conditions for enabling the country to accelerate the pace of development and achieve SDGs. Over the years, a huge sum of money has been invested in roads, rail, maritime and air transport and more resources have been planned for the sub sectors in FY 2018/2019 and the Medium Term as shown in the table 8.

Table 2: Projected Allocations to infrastructure for FY 2018/2019 and the Medium Term (Kshs. Billions)

	2017/2018 Approved	Projected 2018/2019	Projected 2019/2020	Projected 2020/2021[18]
Road Transport	126.4	142.7	154.9	141.3
Rail Transport	94.6	94.9	96.9	95.5
Maritime Transport	14.9	16.7	16.7	16.1
Air Transport	2.1	2.1	2.1	2.1
Total		**256.4**	**270.6**	**255.0**

Source: The National Treasury

55. The transport infrastructure components of roads, rail, air and maritime has a projected resource allocation of Kshs. 256 billion, Kshs. 270.4 billion and Kshs. 255 billion in 2018/2019, 2019/2020 and 2020/2021 respectively. This cumulatively translates to Kshs. 782 billion in 2018/2019 and the medium term. The opportunity cost of funding these projects will be on other socio-economic needs which also require urgent attention. The government may offload these resources to critical sectors as it pursues Public Private Partnership for infrastructure projects in the transport sub-sector.

Affordable low cost housing

56. Kenya is facing shortage of affordable housing which directly and indirectly contributes to development of slums and poorly serviced informal settlements in near the urban areas that contributes to ill health and making the poor susceptible to many diseases. The housing crisis also contributes to insecurity in informal settlements amongst other social ills in the country. According to the State Department for Housing, Kenya requires an annual provision of 250,000 housing units but only 50,000 are produced majorly by the Private Sector. This implies that Kenya faces a deficit of 200,000 housing units annually and with the ever increasing rural-urban migration and natural growth, the deficit will rise rapidly if left unchecked. The demand for houses mainly determined by the income levels, house prices and size of the family is higher for low income levels while at the same time, there is a glut in the high end markets segment on housing which the poor cannot access.

57. According to market players, low cost housing built with use of low cost technologies may cost not more than Kshs. 1 million per unit. Therefore for the government to provide 200, 000 housing units per year, it will require Kshs. 200 billion which translates to Kshs.1 trillion over five years. The cost can therefore best be met through PPP, the ongoing PPP projects however have started addressing the housing needs of the

[18] PBO Projection

Police Service and student accommodation, and the same can be extended to such low cost housing for the majority of Kenyans.

58. Some of the options the government may pursue to achieve adequate housing though PPP may include:-
- Provision of loan facilities with longer repayment periods.
- Planning for urban expansion with provision of adequate infrastructure and standards for low cost housing

Provision of affordable energy to catalyze development in rural areas

59. Studies done on social economic effects of rural electrification show that even if there is no recorded change in household income (resulting from activities implemented at the households level), at community level there are investments. These investments include new machines, technologies to increase productivity of agriculture and other enterprises and reduce morbidity.

60. There have been policies and programs set up by the government to increase rural electrification include Rural Electrification whose aim is closing the gap on social-economic disparities by:-
- Provision of easier, affordable and faster electricity connection.
- Increased agricultural and industrial productivity
- Reduced rural-urban migration
- Creating more jobs and improving the overall quality of life in rural areas.

61. However, for greater impact of interventions in the energy sector especially through Rural Electrification Program (REP) to create jobs, there is need for cross-sectoral integration of programmes such as provision of affordable energy in the rural areas be complemented with development of road networks, to enhance movement of factors of production and outputs.

62. Further, capacity building of the target communities on uses of electricity would promote the development of industries such as cottage industries. Improved rural electrification will improve security through installation of high mast flood lights and build investors' confidence. Other accompanying programs should be initiated to enhance economic change such as modernization of agriculture, value addition of products and services. However, Kenya's supply of electricity is still not able to meet the demand for both industrial and domestic use as evidence by constant rationing of power especially in rural areas. Moreover the cost of rural electrification has remained high with limited distribution capacity. With increased power generation though PPPs, more power supply is likely to create more demand, increase efficiency in production which will eventually spur economic growth and development. The government may also give incentives to domestic consumers to exploit the solar energy by allowing duty free

importation of solar appliances while at the same time exploiting the other renewable sources of energy to enable the country move away on the dependence of hydro power.

63. Generally, For Kenya's PPP programme to be successful there is need to borrow from international best practices in countries such as Malaysia, Singapore, and Indonesia, among others. In these countries, there is a wide range of investment incentives which were given to companies awarded contracts in PPP. Kenya's PPP programme has just started and its success shall be defined by how best it incorporates these practices into their PPP programmes. Some of the surest way of attracting PPPs will be giving tax incentives, friendly interest regime and strict adherence to the rule of law among others. The following table gives array of policy options for the PPP.

Table 3: Policy options for PPP

Challenge	Description	Options
Lack of Capacity and slow implementation of projects	A large number of Public Institutions seem not to appreciate PPP arrangement as an avenue of funding mega capital projects.	Simplify and FastTrack the process to enable faster processing of the projects to enable Kenya reap from the benefits of PPP. Capacity building programmes should be enhanced both to the Ministries, Departments and Agencies on one hand and the Political class to enable PPP have visibility and enhanced PPP capabilities and broaden their knowledge. It should also be extended to the private sector. Discuss the rationale behind the guidelines/regulations so that decision makers can become more enlightened in applying the rules.
Financing Challenges and minimal local Private sector participation	Due to large gestation period, they are not the most preferred options for banks due to Asset-Liability mismatch	Develop the bond market Insurance and pensions funds should be permitted to be invested in infrastructure with safeguards for economic prosperity Establish an infrastructure debt fund which can also include funds from the foreign exchange reserves.
Weak Monitoring and Evaluation in Kenya	There is little emphasis on the use of M&E in project management.	Emphasize on the use of M&E in the project cycle. Carry out Value for Money audit in all the PPPs
Lack of involvement by the locals in high technology projects	Minimal local private sector participation: The government usually competes with the private sector in the quest for financing resources which could have aided the private sector in mobilizing the resources towards such projects. This may mean that the private sector is deprived of the financing channels.	There is need to ensure that there is technology transfer from the execution of these projects by putting in place mechanisms for local participation. They should also include management contracts that ensure the transfer of skills to the local staff by partnering with local firms to enable them grow and further stimulate economic development in the country for prosperity.

Chapter Three:

Growth of Tax Revenue to Spur Government Development Initiatives

Recent Revenue Performance

64. Total Revenue comprising of ordinary taxes, investment income, fees and charges, and AIA, rose by 11.9% to reach Kshs. 1.4 trillion in 2016/17.Still, this growth was lower than the 13.31% five-year average growth rate of revenue.As shown in Table 4, the weak points in revenue collection include the inexplicable slowdown in income taxes, excise duties, and other taxes (investment revenue, IDF fees, and other types of fees and charges). Indeed, the modest 13.14% growth in total revenue in 2016/17 masks striking slowdown of tax revenue (ordinary revenue). Overall, ordinary revenue that excludes AIA (university fees collections and RML) grew by 11% in 2016/17 relative to 14% in 2015/16. It is notable that VAT had some recovery associated with implementation of withholding VAT (10%) as amendment for supplies to designated tax payers such as government departments. Despite a strong performance of excise duties in 2015/16, the administrative dividends following the enactment of the Excise Duty Act seem to have dissipated.

65. By contributing 44% of total revenues, income tax head is the single most important source of government funding. Consequently, any slowdown in the collection of corporate and personal taxes tends to hurt overall revenue collection. It is notable that income taxes continue to decelerate relative to the strong performance seen in 2013/14. Equally, this tax head seems to grow at a lower rate than nominal GDP, indicating possible depletion of the tax base associated with tax avoidance (transfer pricing issues), tax evasion and and weak performance of major companies. At least 10 publicly listed companies in various sectors including retail, manufacturing and commercial and allied sectors have reported losses in the recent past.

66. Revenue collection has not kept pace with government expenditure demands, leading to rising fiscal deficits and borrowing. Still, tax revenue and AIA remain the mainstay for funding government expenditure alongside grants and debt. In 2015/16 total revenues contributed 69% of resources needed to pay for the Kshs. 1.782 trillion budget. The rest of the money was raised through domestic borrowing, external concessional loans, commercial borrowing, and bilateral grants. The following year, 2016/17, the proportion declined to 66% as a result of fiscal expansion. The resulting deficit in 2016/17 was paid for through additional borrowing comprising of Kshs. 186.3 billion commercial borrowing, Kshs. 309.8 billion domestic borrowing, and concessional program and project loans. This clearly demonstrates that the falling share of revenue to total expenditure is ultimately fueling higher borrowing.

Table 4: Revenue performance Indicators

	2012/13	2013/14	2014/15	2015/16	2016/17	Average
Total Revenue	**13%**	**15%**	**14%**	**12%**	**13%**	**13%**
Ordinary Revenue	14%	18%	12%	14%	11%	14%
Import Duty	12%	17%	10%	7%	14%	12%
Excise Duty	9%	19%	14%	20%	19%	16%
Value Added Tax	5%	26%	12%	11%	17%	14%
Income Tax	19%	21%	13%	11%	10%	15%
Other Taxes	19%	-12%	9%	39%	-15%	8%
A-in-A	7%	-22%	36%	-17%	52%	11%

Source: PBO computations

Revenue outlook for 2017/18 and the medium term

67. During the approval of the 2017/18 budget, the National Treasury projected that total revenue including grants would rise by 21.7% to Kshs. 1,704 trillion by June 2018, up from Kshs. 1.400trillion in the previous year. The approved revenue estimates comprised of Kshs. 1.549 trillion of ordinary revenue and Kshs. 155.1 billion of Appropriations-in-Aid. Clearly, this revenue growth is way off the trends as shown in Table 4 above. These ambitious revenue estimates were expected to account for 78% of needed resources to pay for the Kshs. 2.298 trillion budget (Quarterly Budget and Economic Review, September 2017). This occasioned a fiscal deficit of Kshs. 523.7 billion including grants (6.3% of the GDP) which would be financed through foreign and domestic borrowing.
68. Owing to possible overestimation of revenue (21.7% projected growth relative to 13-14% average growth in recent years), the deficit for 2017/18 was smaller relative to 2016/17. From past revenue performance, the underlying fiscal deficit would have been much higher. Nevertheless, owing to expected revenue underperformance there is no doubt additional borrowing would be needed to fill any financing requirement in the absence of vast expenditure reduction. Based on past revenue performance and elasticity assumptions of revenues, the approved revenue estimates may be off the mark by at least Kshs. 58 billion based on highly optimistic revenue yield. In this regard, Kshs. 1.646 trillion is estimated as the higher revenue yield scenario. The revenue shortfall will be worse under the baseline scenario whereby total revenue are expected to reach Kshs. 1.565 trillion by June 2018, which is quite a distance from the Kshs. 1.704 trillion approved revenue estimates (Table 5 and Appendix 3). If expenditure remains unchanged, the fiscal deficit (and possible borrowing) could rise by the amount of the revenue shortfall.
69. The medium-term revenue outlook comprises three closely linked scenario, baseline, optimistic and pessimistic scenario. The estimates reflect varying combination of assumptions on key revenue drivers and tax bases. Broadly, baseline revenue growth reflects modest growth in import values and volumes, stable growth in public and

private consumption expenditure as proxied by growth government spending and overall nominal GDP, non-increase in average wage rates, and modest inflationary pressures. Administrative and tax rate dividends arising from the simplification of VAT and excise tax regime will greatly aid in stabilization of these two critical sources of tax. It is assumed that these factors will account for a fairly strong recovery to help offset electoral related revenue underperformance in the first and second quarter of 2017/18. All these assumptions are quite consistent with recent revenue performance taking into account responsiveness of revenue to output expansion.

70. Estimated 2017/18 revenue outturn is likely to reach about Kshs. 1.565 trillion under the baseline scenario reflecting a 13.31% growth rate of revenue. This amount will consist of Kshs. 1.470 trillion as ordinary revenue and Kshs. 96 billion A-i-A. Total revenue will rise to KSh. 1.784 trillion in 2018/19 and further to Kshs. 2.035 trillion in 2019/20. The ordinary revenue is projected at Kshs. 1.687 trillion and Kshs. 1.938 trillion in 2018/19 and 2019/20, respectively (Table 5). As observed above, even under the baseline scenario, budget revenue estimates are likely to be missed by at least Kshs. 58 billion. In absence of expenditure restructuring, revenue shortfall will likely increase the fiscal deficit and subsequent rise in debt financing.

Table 5: Baseline revenue forecast (Ksh. billions)

	Actuals			Forecasts		
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Total Revenue	1,237.9	1,400.6	1,565.3	1,783.9	2,035.2	2,324.0
Ordinary Revenue	1,175.5	1,305.8	1,469.6	1,687.4	1,937.7	2,225.6
Import Duty	79.2	89.9	98.4	109.5	121.9	135.7
Excise Duty	139.5	165.5	191.0	220.4	254.4	293.6
Value Added Tax	289.2	339.0	384.5	436.0	494.5	560.8
Income Tax	566.0	625.1	697.6	809.7	939.9	1,091.1
Other Taxes	101.6	86.3	98.1	111.6	126.9	144.4
AIA	62.4	94.8	95.7	96.6	97.5	98.4

Source: PBO computations

71. Assuming more robust responsiveness of revenue to nominal GDP growth, strong imports growth driven by public infrastructure (county and national government) related equipment demand, recovery of manufacturing sector and other major employers, and growth in total consumption, then it is possible to expect a stronger revenue outturn. Under this fairly optimistic scenario, total revenue rises by 17.4%, historically strong growth, to Kshs. 1.646 trillion by end 2017/18. Annex 3 presents the optimistic alternative scenario. Still, this forecast would still fall short of the ambitious budget forecast by about Kshs. 58 billion. The shortfall is partly explained by overestimation of the AIA. With only five months to go to the end of the financial year, it is unlikely that tax administration and all above economic conditions will materialize fully. Thus, a further more cautious projection is considered bearing in mind the current political and economic situation in the country.

72. The less favorable scenario further assumes inadequate recovery of revenues from businesses still under stress following poor performance in the last seven months. Further, the upheavals surrounding the protracted electioneering period may have hurt investor and business expectations. With limited time to unwind those expectations before June 2018, it is likely income tax in particular could underperform. Consumer demand equally is not robust owing to job losses in 2017 and possible falling incomes from agriculture and associated business losses. Equally government consumption for the period January- June 2018 will depend on hastened procurement systems and high absorption rates. But this is unlikely to be achieved given existing government procurement procedures and the time period remaining before new commitments are closed in May 2018. Thus, withholding VAT and import duties are likely to be affected if planned government development and recurrent spending is not met. To further support this scenario, the Quarterly Budget and Economic Review for the first quarter of 2017/18 financial year shows that revenue collection was below target by Kshs. 42.6 billion. The share of the collections for the three months to September 2017 was equivalent to 3.9% of GDP, well below 4.2% proportion of GDP collected in 2016/17.

73. Broadly, the outlook is somewhat bleak under these assumptions. Under these factors, revenue outturn in June 2018 is to grow by 9.4% to reach Kshs. 1.532 trillion, well within the rate of growth of revenue reported in the first quarter of 2017/18. In the outer years, revenue is forecast to reach Kshs. 1.738 trillion and Kshs. 1.974 trillion in 2018/19 and 2019/20, respectively. This scenario presents the government with tight fiscal choices if it were to come through. Notably, only major expenditure rationalization would help accommodate the nearly Kshs. 100 billion revenue shortfalls. Alternatively, the government would need to raise more additional borrowing at enhanced cost given prevailing debt redemption profile in the domestic markets, or consider expanded external commercial borrowing. Annex 4 presents the less optimistic view of revenue outturn for the current financial year and the medium term.

3. Options for Achieving Stable Revenue Growth

3.1 Surveillance to deter Transfer Pricing Manipulation

74. The Kenya Revenue Authority has in recent years intensified targeted assessments and investigations to uncover possible tax avoidance. Though, at least Kshs. 25 billion in tax revenue has been recovered from review of operations and tax filings of targeted firms, potential profit shifting and base erosion effects in developed countries is believed to be monumental. For this reason, continued surveillance and investigations are needed to curb ongoing and new tax avoidance schemes by multinationals. In terms of the legal regime in the country, it is worth noting that transfer pricing matters are covered by Sections 18 and 18A of the Income Tax Act as well as the transfer pricing regulations. Nevertheless, implementation and enforcement is partly impeded by limited technical capacity at the Authority and limited awareness. The Tax Procedures Act of 2015 makes

provisions for possible punishment for undertaking plans or schemes with the sole purpose of avoiding to pay legal taxes. It is necessary to bring to bear the full force of the law in order to halt tax cheating.

75. Kenya's membership in United Nations Tax Committee and the Global Forum for Tax Information Exchange should be exploited to achieve progress towards tax information tax with other jurisdictions. This should be supported by application of requisite technology to aid in monitoring and surveillance of online and e-commerce companies operating in multiple countries. Many locally owned companies are also developing complex ownership and related company structures, which in many cases could be fronts for tax avoidance.

3.2 Review the Double Taxation Agreements to avoid Double Non-taxation

76. Kenya has signed about 20 Double Taxation Agreements (DTA). Half of the DTAs have been in operation since 1970 and 1980s, the other half have been ratified in the last 3 years. With the emergence of growing reports on base erosion and profit shifting in developing countries, it is equally perplexing that the country quickly signed additional DTAs. With growing transfer pricing issues in the international taxation platforms, DTAs require greater scrutiny and awareness in the country before they are signed. Depending on the design or articles in the agreements, tax treaties have the potential of facilitating schemes aimed at minimizing tax liabilities of multinational companies operating in various tax jurisdictions, thereby undermining revenue mobilization endeavors of the fiscal authorities.

77. DTAs are major public policy that should receive adequate attention by the policy makers, Parliament and the public. For instance, DTAs govern how bilateral taxation rights between countries are exercised and also provide the basis for negotiation of bilateral or multilateral treaties between countries. In Kenya, once a DTA has been ratified, it becomes part of domestic legislation. The thrust of the issue at hand is that awareness among members of the public is limited and equally review and ratification by Parliament is inadequate. This problem should be resolved through intense legislative and public participation in the ratification of any new DTA.

3.2 Consider progressive taxes due to income inequalities

78. Kenya is considered relatively unequal with a Gini Coefficient (measure of income inequality) of 0.45 to 0.47 according to various studies (KNBS and *Society for International Development, 2013*[19]*)*.The more equal societies include Sweden with a Gini Coefficient below 0.3. Urban centers are more unequal than rural areas. While Nairobi accounts for a big proportion of the value of consumption of goods and services

[19] "*Exploring Kenya's Inequality: Pulling Apart or Pulling Together*?" Kenya National Bureau of Statistics and Society for International Development, 2013.

relative to other areas in Kenya, it is the most unequal with average consumption of the higher income earners at least 600 times more than that of lowest earners. Apart from inequality, overall economic wellbeing as measured by poverty rates is equally depressing. At least 40% of persons in Kenya live below the poverty line. The effect of income distribution in taxation is significant. Notably, broad taxes such as VAT may place a higher tax burden on the average income earner given most purchases are subject to VAT. The rich, mainly owners of capital and the wealthy, alternatively tend to bear a relatively smaller burden of income tax relative to workers when the structure of income distribution is not considered in tax design.

79. Since ownership of productive capital including technology is linked to inequality, economic growth may not be shared equitably, further perpetuating inequality. Growing research now shows emerging structural changes in global economies: due to economies of scale and technological advancement (mobile, telecoms, computing) output growth unevenly accrues to owners of capital and technology. Labourshare (wages) of income or output is decline due to automation processes and other technology. Potentially, these changes are likely to hurt the base for PAYE, without equitably shifting the share of income tax drawn from capital and technology. These structural changes in economies are at the center of debate on the future of taxation and labour. It is critical for the country to start designing tax policies in the light of this phenomenon. As a starting point, higher tax rates should be progressively applied to rising incomes as is the case in some European countries. This will require introduction of higher rates as the quantum of profits or share of profits to PAYE exceeds a certain threshold. This will help address the rising unresponsiveness of tax revenue, particularly income taxes, to output growth.

4. Incentives design and exemption and waiver systems

80. Tax incentives in the short term represent forgone tax revenue. However, in the long term if such incentives spur economic activities, then a broader tax base could offset the forgone revenue. The repeal of the VAT legal system through the VAT Act of 2013 helped dispense with a wide array of exempt and zero-rated goods and services. The government did this to protect the tax base and to ease implementation including reducing the growing tax refund administrative burden. The Excise Duty Act of 2015 equally dropped various goods excluded from taxation. Nevertheless, the Value Added Tax law has witnessed the most incidences of policy reversals in terms of the number of exemptions and zero-rated items being re-introduced having been scrapped during the overhaul of the law in 2013. Excise Duty Act as well Miscellaneous Fees and Levies law have not been spared either.

81. Income tax laws however contain numerous exemption, waiver and incentive systems in any tax law in Kenya. These range from tax holidays, reduced tax rates, investment income tax incentives, and income tax exemptions for various international bodies, whose overall cost has not been estimated. New incentives have been provided lately including: the reduction of tax rate from 20% to 5% in respect of interest, royalties,

management and consultancy fees for non-resident persons operating in Special Economic Zone; tax exemption on dividends for Special Economic Zones firms; investment deductions; and income tax incentives for investment various towns in Kenya, among others. Incentives in the Special Economic Zones and Export Processing Zones are most perverse.

82. What is the underlying policy stance on incentives, waivers, and exemptions? Article 210 of the Constitution sets out the provisions on how tax waivers should be treated. Waivers can only be given through legislation, and the record for each waiver and reason for it be maintained and reported to the Auditor General. Such information should reach National Assembly regularly. Equally, such information should account for the cost of the waivers either in terms of forgone revenue or administrative effects and possibly broader economic effects. In this regard, economic effects may include expected economic effects of the waivers, multiplier effects of such tax waivers on broader economic activities, and consideration of potential competitive distortions occasioned by such tax waivers.

83. To reduce the revenue, economic and market distortion effects of tax waivers requires careful targeting. In this regard, persons, sectors, industries, or firms targeted for waivers need to be identified carefully. A few proposals below are suggested for enhanced waiver systems owing to their potential direct and indirect positive economic effects in Kenya.

4.1 Incentives to promote green energy investment

84. In the energy front, tax incentives in the country have been used to support the endeavours towards investment and usage of green energy. For instances, the country has witnessed in the recent past, amendments to tax laws especially the Value Added Tax Act, Import Duties law and Excise Duty Act so as to induce green energy sector growth. It is worth noting that since 2012 to-date, there has been a clear policy shift in the tax system such as the import duty, VAT exemptions or zero ratings on supplies of green energy materials, accessories and equipment.

85. In addition, the country has continued to attract investment including from private sector in the green energy development. Two major green energy development projects can be identified, namely: Kshs. 80 billion Lake Turkana wind power project, and Olkaria phase 3 geothermal power project funded expected to cost Kshs. 60 billion. Other green energy projects include endeavours towards carbon trading, forestation and reforestation, among others. Since green investment has the double benefit of generating income for the country through carbon credits trading, as nascent as it may, as well as conserving the environment, it is imperative that the sector be accorded targeted tax waivers.

4.2 Incentives to support manufacturing: a key "Big Four" Agenda

86. Manufacturing sector has the potential to spur economic growth by way of direct job creation through forward and backward supply linkages. In addition, augmentation of value addition in the production chain will ensure requisite quality of manufactured goods to encourage import substitution and also to support manufactured exports so as to improve Kenya's current account balance. To support manufacturing, investment deductions on installation of plants and machinery for manufacturing firms with the capacity to create over 1,000 new jobs for citizens are strongly suggested. This will attract foreign direct investment in the manufacturing sector and stimulate growth through exports earnings and employment creation.

87. A further incentive requires provision of low interest quick-disbursing fund for organized and clustered manufacturing firms to ensure steady supply of affordable credit for investors in the manufacturing sector. Time bound and objective tax holidays such as reduced corporation income tax may also be considered to firms who demonstrate deliberate efforts towards stable job creation and expansion in manufacturing. To reduce abuse of the incentive system, the incentive system should be monitored and regulated. Part of the incentive benefits should accrue upon attainment of the performance targets associated with the tax incentive.

4.3 Incentives for assembly and use of newer cars to reduce air pollution

88. It is estimated, by the World Health Organization, that approximately 3.5 million people die globally due to outdoor air pollution caused mainly by motor vehicles exhaust fumes. Major cities in Africa, Kenya included, are urbanizing rapidly with concomitant rise in the number of motor vehicles. Imported used cars are predominant in Kenya owing to initial cost of purchase for most Kenyans. Studies have shown that conservatively over 70% of vehicles imported in Kenya are second hand. Therefore, taking the 109,781 units of vehicles imported into the country in 2015 alone implies about 80,000 vehicles imported are old and more susceptible to emitting exhaust pollutants such as incompletely combusted hydrocarbons, which are associated with diseases such as asthma and cancer among others. This menace can be addressed through policy and incentives to encourage purchase of new cars.

89. In the recent past, the Finance Act granted tax incentives to promote local assembly of motor vehicles. The incentives include the exemption from the 20% excise duty on importation of vehicle assembly parts as well as exemption on the 25% duty payable on imports. This has attracted vehicle manufacturing firms such as Volkswagen who have established a vehicle assembly plant in Thika town. Others such as Peugeot, Ford and Nissan Motors, among others are also believed to have shown interest in venturing in the local assembly.

90. Therefore, in order to encourage purchase and use of new and environmentally clean motor vehicles on the Kenyan roads, the government may consider additional tax incentives such as Value Added Tax exemption (zero-rate) for the importation of parts for the local assembly of motor vehicles and lower duty on newer, more energy efficient vehicles. Alternatively, the duty payable on imported vehicles can be raised to discourage used vehicle imports. Subject to considerations on the broader economic effects within the EAC regional markets framework, the excise duty on imported second hand vehicles can be varied in accordance with year of manufacture and vehicle efficiency parameters. This will significantly help narrow the price gap between the second hand and new vehicles, ultimately shifting the consumer choice towards the usage of new vehicles to achieve environmental wellness of the populace.

ANNEXES

Annex 1:Outstanding Debt (June – 2012 to June 2017) Kshs. Millions

DATE	Jun-10	Jun-11	Jun-12	Jun-13	Jun-14	Jun-15	Jun-16	Jun-17
DOMESTIC DEBT								
Banks								
Central Bank	50,215	39,691	47,383	39,170	65,700	63,335	99,856	55,061
Commercial Bank	351,579	384,640	411,867	524,505	617,221	730,419	927,307	1,141,889
Sub Total	401,794	424,331	459,250	563,675	682,921	793,754	1,027,163	1,196,950
Non-Banks Financial Institutions	2,956	10,013	4,103	13,083	14,925	626,690	787,970	915,316
Other Non-Bank Sources	255,518	329,878	395,477	473,797	586,481			
Sub-Total	258,474	339,891	399,580	486,880	601,406	626,690	787,970	915,316
Non-Residents								
Total Domestic	660,268	764,222	858,830	1,050,555	1,284,327	1,420,444	1,815,133	2,112,266
As % Of GDP	27	28	26	23	25	25	27	27%
As % Of Total Debt	54	51	52	56	53	50	50	48%
EXTERNAL DEBT								
Bilateral	159,687	215,035	199,950	217,970	248,636	405,562	491,864	724,823
Multilateral	348,647	436,838	451,287	507,920	593,397	680,192	794,798	841,899
Commercial Bank	20,458	25,041	50,540	58,928	234,799	276,937	432,377	712,100
Suppliers Credits / Export Credit			14,811	15,207	16,452	16,628	16,628	15,914
Total External	569,138	722,888	763,971	843,562	1,138,505	1,423,703	1,796,198	2,294,736
As a % GDP	24	26	23	19	23	25	27	30%
As a % of Total Debt	46	49	47	45	47	50	50	52%
DEBT -GRAND TOTAL	1,229,406	1,487,110	1,622,801	1,894,117	2,422,832	2,844,147	3,611,331	4,407,002
As a % GDP	51	53	50	42	48	50	55	57%
GDP	2,410,600	2,784,850	3,990,412	4,496,000	5,044,236	5,703,321	6,586,000	7,710,947

Source: National Treasury

Annex 2: Debt Guarantee from State Owned Enterprises (Kshs. Millions)

ORGANIZATION	YEAR LOAN CONTRACTED	PURPOSE OF LOAN	CREDITOR	OUTSTANDING STOCK	STATUS
KBC	1989	KBC Modernization Project	Japan	2,224	Defaulted
TARDA	1990	Tana Delta Irrigation Project	Japan	1,156	Defaulted
EAPCC	1990	Cement Plant Rehabilitation Project	Japan	1,438	Defaulted
KenGen Ltd	1995	Mombasa Diesel Generating Power Project	Japan	3,767	Ongoing
	1997	SonduMiriu Hydropower Project	Japan	3,827	Ongoing
	2004	SonduMiriu Hydropower Project II	Japan	9,534	Ongoing
	2007	SonduMiriu Hydropower Project - Sang'oro Power Plant	Japan	4,218	Ongoing
	2010	Olkarial Unit 4 & % Geothermal Power Project	Japan	55	Ongoing
	2010	Rehabilitation and Expansion of the Hydropower Plant Kindaruma	Germany	3,514	Ongoing
	2011	Rehabilitation and Upgrade of the Geothermal Plant Olkaria	Germany	4,656	Ongoing
Kenya Ports Authority	2007	Mombasa Port Modernization Project	Japan	22,099	Ongoing
Kenya Airways	2016		Various	75,260	Ongoing
Kenya Railways	2008	Kenya Railways Concession	IDA	4,044	Ongoing
Kenya Farmers Association	2005	Revival of KFA	Local Banks	Unutilized	Unutilized
National Cereals and Produce Board	2009	Importation of maize under GSM-102	USA	Unutilized	Unutilized
TOTAL	-	-	-	**135,792**	-

Source: National Treasury

Annex 3: Optimistic revenue forecast

	Actuals		Forecast			
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Total Revenue	1,237.9	1,400.6	1,645.6	1,935.5	2,278.8	2,685.4
Ordinary Revenue	1,175.5	1,305.8	1,546.1	1,831.0	2,169.1	2,570.2
Import Duty	79.2	89.9	101.8	115.2	130.5	147.7
Excise Duty	139.5	165.5	198.5	238.2	285.8	342.9
Value Added Tax	289.2	339.0	399.8	471.5	556.1	655.8
Income Tax	566.0	625.1	739.5	875.0	1,035.3	1,225.0
Other Taxes	101.6	86.3	106.3	131.0	161.4	198.9
AIA	62.4	94.8	99.5	104.5	109.7	115.2

Source: PBO computations

Annex 4: Low revenue scenario

	Actual		Forecast			
	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21
Total Revenue	1,237.9	1,400.6	1,532.5	1,738.1	1,974.1	2,245.2
Ordinary Revenue	1,175.5	1,305.8	1,436.8	1,641.5	1,876.6	2,146.8
Import Duty	79.2	89.9	96.7	107.7	119.8	133.4
Excise Duty	139.5	165.5	183.4	211.7	244.3	282.0
Value Added Tax	289.2	339.0	369.2	418.7	474.8	538.5
Income Tax	566.0	625.1	697.6	809.7	939.9	1,091.1
Other Taxes	101.6	86.3	90.0	93.8	97.7	101.9
AIA	62.4	94.8	95.7	96.6	97.5	98.4

Source: PBO computations

Trends of Total Revenue (Equitable and Conditional)Transfers to the County Governments for FY 2013/14 -2017/18 in Kshs in Billions

No.	County	FY 2013/14 Total Revenue	FY 2014/15 Total Revenue	FY2015/16 Total Revenue	FY 2016/17 Total Revenue	FY 2017/18 Total Revenue	Cumulative Revenue FY 2013/14- 2017/18*
1	Baringo	3.63	4.06	4.67	5.04	5.62	23.01
2	Bomet	3.72	4.27	4.94	5.33	5.76	24.02
3	Bungoma	6.52	7.41	8.08	8.73	9.59	40.32
4	Busia	3.68	5.41	5.72	6.17	6.39	27.36
5	Elgeyo-Marakwet	3.14	2.99	3.46	3.74	4.05	17.38
6	Embu	3.36	3.96	4.24	4.65	4.86	21.08
7	Garissa	4.70	5.24	6.37	6.81	7.63	30.75
8	Homa Bay	5.73	5.13	5.96	6.42	7.18	30.42
9	lsiolo	2.42	2.75	3.22	3.47	4.28	16.14
10	Kajiado	3.51	4.06	4.63	5.00	6.28	23.49
11	Kakamega	7.36	8.93	9.71	10.52	11.16	47.69
12	Kericho	3.61	4.04	4.77	5.14	5.69	23.25
13	Kiambu	6.26	6.75	8.25	8.92	10.76	40.94
14	Kilifi	5.82	6.63	7.83	8.46	10.85	39.60
15	Kirinyaga	2.83	3.36	3.74	4.03	4.84	18.81
16	Kisii	5.82	6.43	7.84	8.46	8.57	37.13
17	Kisumu	4.87	5.42	6.33	6.81	7.52	30.94
18	Kitui	5.83	6.64	7.54	8.14	9.49	37.64
19	Kwale	4.03	4.64	5.41	5.85	7.94	27.87
20	Laikipia	2.76	3.16	3.66	3.95	5.00	18.53
21	Lamu	1.60	1.88	2.19	2.46	2.91	11.05
22	Machakos	5.47	6.37	7.38	8.01	8.43	35.66
23	Makueni	4.72	5.52	6.24	6.74	7.55	30.77
24	Mandera	6.78	7.91	9.24	9.98	10.56	44.46
25	Marsabit	4.07	4.62	5.38	5.81	7.25	27.13
26	Meru	5.51	7.31	7.07	7.71	12.63	40.24
27	Migori	4.76	5.31	6.19	6.68	7.21	30.16
28	Mombasa	4.35	4.88	5.92	6.31	9.02	30.48
29	Murang'a	4.32	5.01	5.62	6.06	6.79	27.81
30	Nairobi City	9.90	12.95	13.63	14.61	18.45	69.54
31	Nakuru	6.96	7.54	8.95	9.60	10.40	43.45
32	Nandi	3.89	4.27	5.00	5.39	5.67	24.21
33	Narok	4.15	4.82	5.53	5.98	7.18	27.65
34	Nyamira	3.32	3.78	4.40	4.74	5.14	21.37
35	Nyandarua	3.44	3.90	4.52	4.87	5.40	22.13
36	Nyeri	4.07	4.40	5.07	5.44	5.79	24.77
37	Samburu	2.81	3.19	3.71	4.01	4.40	18.12
38	Siaya	3.97	5.01	5.30	5.70	6.05	26.04
39	Taita Taveta	2.63	2.98	3.50	3.77	4.38	17.25
40	Tana River	3.12	3.60	4.16	4.59	6.02	21.48
41	Tharaka-Nithi	2.43	3.44	3.32	3.57	4.18	16.94
42	Trans Nzoia	3.92	4.54	5.35	5.78	6.25	25.84
43	Turkana	7.89	9.24	10.75	11.63	11.01	50.52
44	Uasin Gishu	4.07	4.63	5.49	5.85	6.30	26.33
45	Vihiga	3.03	3.79	4.10	4.42	4.93	20.26
46	Wajir	5.65	6.40	7.49	8.09	8.94	36.57
47	West Pokot	3.59	3.86	4.52	4.89	5.38	22.24
	Total Transfers to County Governments	210.00	242.42	276.37	298.33	345.69	1,372.81
Revenues(Incl. Loans & Grants		**1,279**	**1,597**	**1,589**	**1,961**	**2,345**	
	% Share (to counties) of To	**16.42**	**15.18**	**17.39**	**15.21**	**14.74**	
	% Growth Rate of Transfers	-	15.44	14.01	7.94	15.88	
	Overall Inflation Rate %	5.7	6.9	6.6	6.3	-	