REPUBLIC OF KENYA

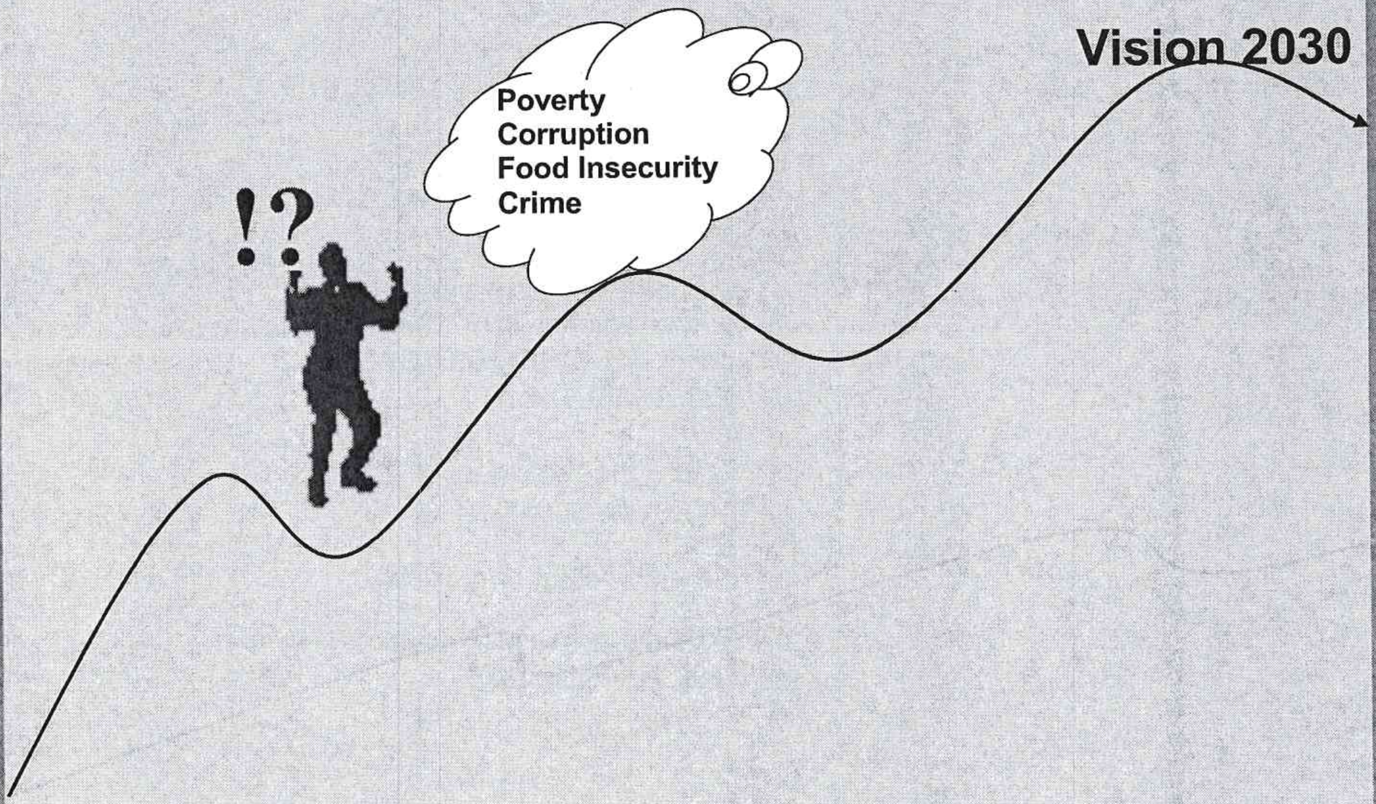
HARAMBEE

PARLIAMENTARY SERVICE COMMISSION

Parliamentary Budget Office

Keeping the Promise

Budget Options for 2014/15 and the Medium Term



February 2014 (Edition No. 5)

Preamble

In 2008, the government of Kenya officially launched the Vision 2030 national development blueprint whose aim was to transform Kenya into a newly industrializing, middle income country providing high quality life to all its citizens by the year 2030. The vision is anchored on three pillars, namely; political, social and economic. The Political Pillar aims at realising a democratic political system founded in issue based politics and respect for the rule of law; the Social Pillar aims at building a just and cohesive society with social equity and the economic pillar seeks to improve prosperity of all Kenyans and achieve an economic growth rate of 10% per annum. However, while significant strides have been made towards achieving the various flagship projects under Vision 2030, some targets have fallen short, notably the achievement of economic prosperity for all Kenyans and in particular, achievement of the 10 percent economic growth rate by 2012, sustained to 2030.

In 2010, the country passed a new constitution which changed the country's political system from a centralized governance system to a devolved system of government. It was expected that this measure would address concerns of skewed economic development and rebalance growth by bringing services closer to the people and enabling counties to pursue diverse economic development strategies for an all-inclusive economic growth.

So far, implementation of the two "promises" has encountered various challenges. The country has not been able to achieve a 10 percent growth rate as envisioned in the national development blueprint. Furthermore, implementation to devolved system of government is also facing numerous challenges. There are concerns that key achievements under the two policy measures may take a long time before they are realized. It is therefore important for all of us[1] to take deliberate measures to ensure that it is possible to enhance the economic prosperity of all Kenyans. This edition of the Budget Options explores the various deliberate measures that are available and that can be considered in order to deliver on our promise to the people.

[1] Kenyans must embrace hard work and an environment that does not embrace confrontation

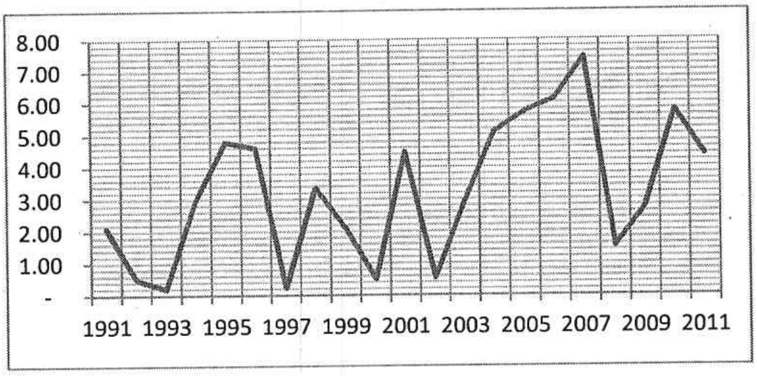
Acknowledgements

This Edition of the Budget Options was prepared by a core team comprising of Millicent Ojiambo, Benjamin Ng'imor and Josephat Motonu; under the supervision of the Director, Phyllis Makau together with Martin Masinde (Senior Deputy Director) and Robert Nyaga (Chief Fiscal Analyst). The team also acknowledges insightful contributions from Lucy Makara, Joseph Ndirangu, Gichohi Mwaniki, Fredrick Muthengi, Joash Kosiba and Danson Mkonu.

TABLE OF CONTENTS

Chapter One: An Economy in Transition: Outlook, Prospects and Opportunities

Figure 1: Kenya's economic growth 1991 - 2011



Data Source: Economic Survey (Various)

Year 2013 marked the first general elections since the 2007/08 post-election violence and this made the situation even more precarious, presenting serious downside risks to the economy. Furthermore, the economy faced numerous other challenges such as rising cases of insecurity, financing and budgeting problems during the transition to devolved government, expenditure pressures stemming from cost of the devolved governments as well as rising wage demands in the civil service especially from teachers and doctors; persistent unemployment and rising cost of living. However, the economy was able to navigate these challenges and post a reasonable level of growth though below target.

The economy proved resilient in 2013, navigating numerous challenges to record a reasonable level of growth

Inflation in single digits but outlook remains uncertain...

Inflation in 2013, though rising, remained fairly stable and closed the year at single digit

Growth in 2013 was largely driven by a stable macroeconomic environment. Inflation, though steadily rising through the year especially between the months of May and September, remained at single digit, closing the year at 7.2 percent compared to 3.7 percent in January 2013.

Table 1: Production In '000 of Tonnes

	2012	2013	Deviation
Maize	3,603	3,000	-17
Wheat	442	342	-23
Sorghum	175	160	-9
Other	274	244	-11
Grand Total	**4,494**	**3,746**	**-17**

Source: FAO

Fuel driven inflation also remains a concern especially due to political instability in oil producing countries. Fuel is the second biggest contributor to overall inflation in Kenya and oil price volatility could easily push inflation to double digits.

Increase in fuel prices is also a threat to inflation levels

The Exchange Rate has stabilized but downside risks persist...

The exchange rate remained stable against major world currencies throughout 2013, fluctuating between Kshs. 84 and Kshs. 87 to the dollar. This can be attributed to loan disbursements under the IMF's Extended Credit Facility, which boosted Kenya's foreign reserves, as well as an increase in Diaspora remittances. The foreign exchange reserve position has been maintained above the statutory 4 months of import cover, albeit marginally, thereby cushioning the Kenya Shilling exchange rate. However, the risks to the exchange rate in 2014 include oil price volatility as well as increased importation of goods. Kenya's import bill remains high, driven by fuel importation as well as high import demands for capital goods. This is likely to worsen the current account deficit and exert pressure on the Kenya Shilling.

The Kenya shilling exchange rate against major world currencies remained stable for the better part of 2013 but faces threats from oil price volatility and increased importation of goods

Furthermore, Kenya's cost of doing business remains unacceptably high with the country being ranked position 129 out of 189 countries in the Doing Business 2014 rankings. This is a drop by 7 positions from the Doing Business 2013 Rankings. If Kenya is to achieve private sector led growth, there is need to create a proper investment climate and simplify the cost of doing business. This includes simplifying tax laws, reducing the number of licences required to start a business and the time taken to obtain the requisite documents.

Kenya's cost of doing business remains high and is an impediment to private sector led growth

Fiscal Consolidation[2]

A review of the 2013/14 Budget Framework as contained in the Budget Policy Statement for 2013/14 indicates that the envisaged fiscal consolidation appears to be off track. The deficit including grants contained in the BPS 2013 framework has always been revised upwards. This is illustrated in the table below:

Fiscal consolidation appears to be off track as the deficit including grants is always revised upwards in the budget framework

Table 3: Balance (Cash basis including grants) projections

	2010 /11	2011 /12	2012/13		2013/14		2014/15	
	Prov.	*Prov.*	BPS '13	Budget (revised)	BPS '12	BPS '13	BPS '12	BPS '13
Balance (Cash basis including grants)	-4.8	-5.7	-6.5	-6.8	-4.3	-4.7	-3.5	-4.0

Data: BPS (Various)

From table 3 above, there appears to be a tendency by the government to indicate a lower deficit at BPS level while an increase appears in either the budget or the subsequent Budget

2 Fiscal consolidation is a policy or policies aimed at reducing government deficits and accumulation of debt. It entails deliberate efforts to ensure the country is living within its means through increasing revenues and reducing non-core expenditures

Economic Outlook – Opportunities and Risks

In brief

In the baseline scenario, Kenya's economy is projected to grow at an average of 5.3 percent over the medium term. Opportunities which are likely to drive economic growth include a fairly stable political environment, robust regional demand in Sub-Saharan Africa and a stable macroeconomic environment. However, there are downside risks which may adversely affect economic growth in 2014. These include taxation and budgetary challenges in the county governments, insecurity threats and a weak global outlook.

Economic growth projections for the Medium Term

In 2013/14, the economy is projected to grow at 4.9 percent and further rise to 5.4 percent in 2014/15 and 5.5 percent in 2015/16. This scenario is based on increased investment in infrastructure and implementation of flagship projects such as the standard gauge railway. Furthermore, vast economic opportunities lie in the petroleum and mining extractive industries and are likely to attract investors. County economic activities are also likely to drive growth including specific investment and economic exploits in each county. It is also expected that a stable political and macroeconomic environment will persist and the stable interest rates will support credit access to the private sector thereby promoting private investment. Thus there are better prospects for economic growth if the concerns of insecurity and corruption are addressed.

The economy is poised to grow at 4.9 percent in 2013/14, rising to 5.0 percent in 2014/15 and 5.1 percent in 2015/16

Kenya's Opportunities for Economic Growth

Kenya managed to maintained a stable political environment despite continuum terrorism threats

1. **Stable political environment**

   Having held successful general elections in 2013, the country has maintained a somewhat stable political environment despite continuing terrorism threats.

economy will grow by 5 percent in 2013 and 6 percent in 2014; and the UN forecasting a growth of 4.0 percent in 2013 and 4.7 percent in 2014. This is despite weak political environment in some countries, poor weather as well as subdued global economic growth. Africa remains the dominant destination for Kenya's exports, accounting for 48.5 percent of the total Kenyan exports and a growth of 31.1 percent (KNBS, 2012). On the other hand, the EAC is projected to grow robustly, at 6.3 percent in 2013 and 6.7 percent in 2014.

Sub-Saharan economic growth, and specifically the EAC, remains robust, portending significant benefits to Kenya's economy through increased regional trade

A positive economic outlook for Sub Saharan Africa therefore implies more robust demand and a ready market within the continent for Kenya's export products.

3. Stable Macroeconomic environment

Inflation remained in single digits throughout 2013, and the Kenya Shilling exchange rate against all major currencies has been fairly stable. The low rates of inflation, stable interest rates and exchange rate was assured through appropriate monetary policies, especially stable CBR rates. The policy rate has remained at 8.5 percent for the better part of 2013, signalling the banks to lower credit costs. However, despite the effort by the CBK to bring down interest rates through its policy signal, bank interest rates still remain high.

The Central Bank retained the policy rate at 8.5 but the banks have respond poorly and bank interest rates remain high

4. **Booming Petroleum and Mining Sector**

Kenya has traditionally relied on agriculture to drive its economy but now vast economic opportunities lie in the petroleum and mining sector since the discovery of oil in Turkana and gas deposits in northern Kenya, titanium at the Coast and large deposits of coal in Kitui County. This has attracted a number of investors in the regions and if properly exploited, the country is poised to be a mineral resource powerhouse.

The discovery of mineral resources in Kenya is an opportunity for the country to reduce reliance on agriculture

Downside risks to the outlook

1. **Challenges in implementation of the new system of government**

The transition to devolved government has been plagued with a number of fiscal challenges in its implementation phase. The county governments came into existence in the middle of the budget cycle resulting in poorly prepared and rushed budgets, most of which were not anchored on development strategies, and which entailed huge deficits, raising questions on sustainability. In the coming financial year, county budgets should be anchored on the county development plans and financing of the county budgets clearly to the estimated resources/ revenue available to the county.

The challenges facing transition to devolved government are an impediment to growth

Other pertinent issues which will need to be addressed include:

i. Low absorption of funds occasioned by delays in county budget approvals.

ii. Large recurrent spending associated with inherited public workforce from the national government as well as the local authorities.

There is need to address challenges such as low absorption of funds and large recurrent spending

3. Expenditure Pressures and misalignment of expenditure

The country faces the twin problem of rising expenditure pressure at the national and county levels of government and misalignment of resources through duplication of roles and expenditure. At the national level, rising expenditure is driven by massive infrastructure spending and the public wage bill. At the county level, high wage bill together with additional recruitment by counties presents significant fiscal challenges. In particular, concern has been raised over the rising wage bill which stood at Kshs. 457.5 billion in 2012/13 and is likely to go higher in view of pressures emanating from both the national and county governments. Thus it appears that most of the funds are chasing consumption based expenditure as opposed to investment related expenditure. This will not only stifle growth but is also likely to drive up inflation as the increased expenditure drives up cost of goods.

Rising expenditure pressures due to county governments, infrastructure spending and the public wage bill are an impediment to growth

4. Weak global economic outlook

Despite projections of improvement in the global economic outlook, the situation is not rosy and downside risks still persist which may curtail the projected growth especially in the Euro Area. Constrained growth in Europe would impact negatively on Kenya in terms of decreasing external demand for Kenya's exports particularly horticulture and decreased Foreign Direct Investment. This may also adversely affect tourism.

Though the global economic outlook is showing signs of improvement, downside risks remain and these may affect the country in terms of decreasing demand for Kenya's exports

Chapter Two: Fiscal Performance and Outlook

Revenues

Collection of revenue as a proportion of the country's economic growth has modestly increased over the last decade from 21% of GDP to 23% of GDP. Over the period, Income tax and Value Added Tax (VAT) have contributed the largest proportion of revenue. In the last 10 years, all tax heads have increased with the largest growth coming from the income tax and the VAT heads. The two heads contribute about 63% of the total revenues annually. The government projects to collect Ksh 1.0 trillion in 2013/2014 with income tax accounting for 40% of it.

Revenue collection has increased over the years with Income Tax and VAT as the largest contributors to revenue

The government introduced a new tax, the railway development levy, which will support the construction of the single gauge railway line. The levy will be funded by a 1.5% tax on all home-bound imports (for Kenyan domestic market). Latest revenue figures show that KRA had collected Ksh. 10 billion of the railway development levy from July-December 2013, clearly surpassing the Ksh. 6.8 billion target. One of the reasons for performance is that the levy had little common exclusions or waivers and was applied on all imports.

The government introduced the railway development levy and latest KRA figures indicate a collection of Kshs. 10 billion surpassing the Ksh. 6.8 billion target

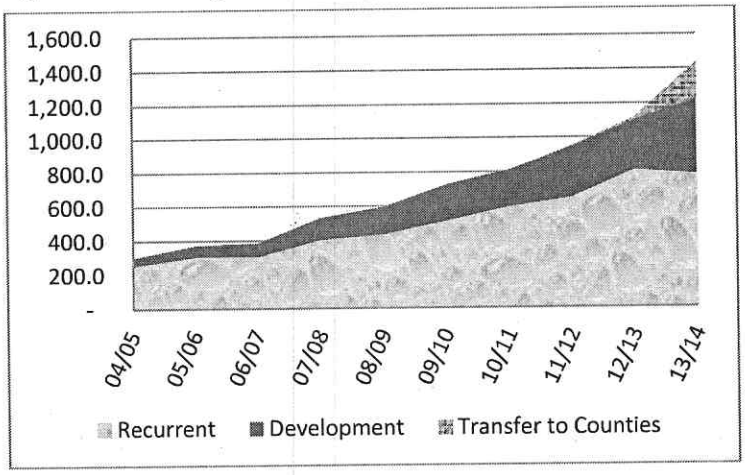
Figure 5 below indicates the average contribution to revenue from the six major revenue heads.

projected to drop to Ksh. 780.6 billion in 2013/2014 owing to the transfer of some functions to the county governments.

Development expenditure rose tremendously over the period from Ksh. 45.6 billion in 2003/2004 to Ksh 298.9 billion in 2012/2013 and its projected to further increase to Ksh. 444.1 billion in 2013/2014. This increased spending has been attributed mainly to the investment in physical infrastructure. Figure 6 below shows the systematic growth of government expenditure from 2004/2005 to 2013/2014.

Development expenditure has increased mainly due to investment in physical infrastructure

Figure 6: Growth of government expenditure 2004/05 to 2013/14*



Source: QEBR various

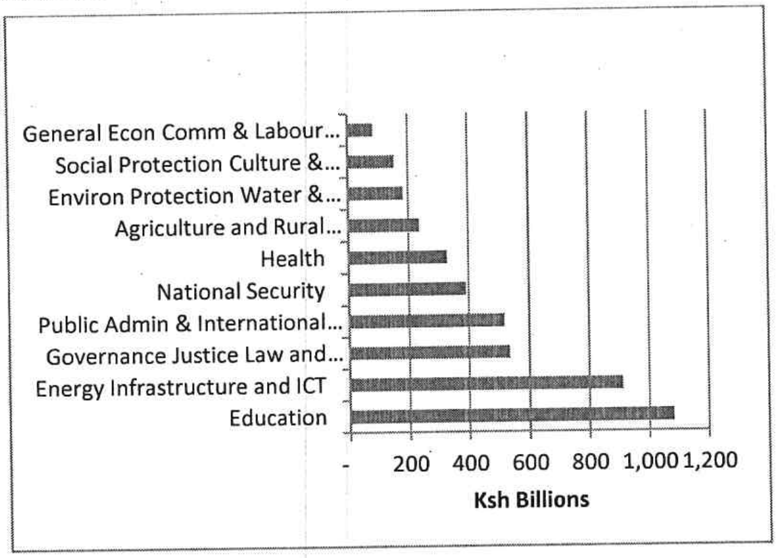
*projected figures

Graph showing government recurrent and development expenditure from 2004/05 to 2013/14

The government's discretionary spending has increased fourfold over the last ten years from Ksh 299.1 billion in 2004/2005 to Ksh 1.1 trillion in 2012/2013 and it is projected to further increase to Ksh 1.3 trillion in 2013/2014. The mandatory expenditures have doubled over the same period from Ksh 132 billion in 2004/2005 to Ksh 346 billion in 2012/2013 with a proposed increase to Ksh 380 billion in 2013/2014. The allocations for mandatory expenditure mainly consists of

Government's discretionary spending has increased fourfold whereas the mandatory expenditures have doubled over the last ten years

Figure 8: Cumulative spending on MTEF sectors: 2005/2006 to 2012/2013



Source: BPS various

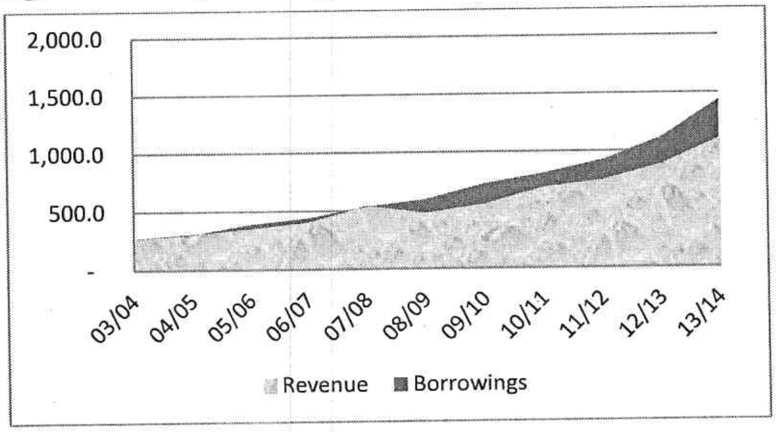
Graph showing cumulative sectoral spending 2005/06 – 2012/13

Financing of the Expenditures

The government expenditures are financed by both revenues and borrowings. The proportion of the budget financed through borrowing has risen since 2008/2009 as seen in figure 6 below. This trend can be attributed to either a large fiscal deficit or insufficient revenue mobilization.

Proportion of government spending financed through borrowing has been increasing since 2008/09

Figure 9: Financing of the budget



Source: QEBR various

Public Debt

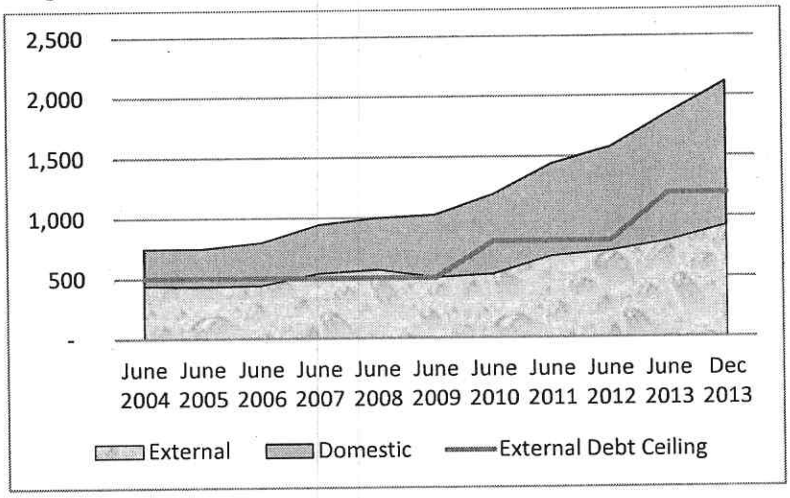
In Brief

The stock of public debt has increased in the last decade with domestic debt at 55% of total debt and external debt at 45% of total debt. External debt is largely on concessional terms but the commercial component has been increasing. Domestically, the government has focused on long term borrowing.

Increased borrowing overtime has led to an increase in the stock of public debt. As at December 2013, the stock of debt stood at Ksh 2.1 trillion compared to Ksh 749 billion in June 2004. The debt has a near equal split comprising of 45% external debt and 55% domestic debt. The trend in public debt over the last decade is as indicated in figure 8 below.

The stock of public debt has increased over the last ten years and has a nearly equal split with external debt comprising 45% and domestic debt comprising 55% of total debt

Figure 11: Stock of public debt 2004 - 2013



Source: Monthly debt bulletin various

The bulk of external debt is from multilateral creditors

The external debt as at December 2013 amounts to Ksh 922 billion. Bulk of the external debt was from multilateral creditors which accounted for 61 percent while bilateral creditors and commercial creditors accounted for 31 percent and 8 percent respectively. The government has most of its external debt in

Fiscal Framework for the Medium Term

(PBO projections)

In Brief

Revenue is projected to amount to Kshs. 966.8 billion in 2013/14 and rise to Kshs. 1.1 trillion in 2014/15 with income tax and VAT as the more significant tax heads. On the other hand, government expenditure for the both the national government and county governments is estimated at Kshs 1.3 trillion in 2013/14 and 1.5 trillion in 2014/15.

Baseline Revenue Projections

The revenue forecasts are pegged on the attainment of the macroeconomic targets and improved tax administration. Tax is influenced by the GDP and other macroeconomic indicators like inflation and stability of the exchange rate. Baseline revenue forecast are based on the following assumptions:

Revenue forecasts is based on assumption of GDP growth between 5 – 7%, stable inflationary pressures, slow growth of import duty and improved VAT performance

i. Modest growth of GDP over the medium term of between 5% and 7%.
ii. Stable inflationary pressures in 2014 of about 7%.
iii. Slow growth of ordinary import duty with the introduction of the railway levy fund to finance the construction of the single gauge railway line reflecting some substitution effect.
iv. Improved VAT performance by 14% with the implementation of the VAT Act 2013.

Based on above assumptions, the total revenue is projected to rise from Ksh 966.8 billion in 2013/2014 to Ksh 1.1 trillion in 2014/2015 which is 23.5% of GDP. In the medium term, total revenue will grow to Ksh 1.2 trillion and Ksh 1.4 trillion in 2015/2016 and 2016/2017 respectively.

Revenue is projected to amount to Kshs. 966.8 billion in 2013/14 and Kshs. 1.1 trillion in 2014/15

VAT	5.7%	5.6%	5.7%	5.8%	5.8%	5.8%
Investment income	0.4%	0.4%	0.4%	0.3%	0.3%	0.3%
Other Revenue	1.5%	1.5%	1.5%	1.5%	1.6%	1.6%
Railway Development Levy	0.0%	0.0%	0.5%	0.4%	0.4%	0.4%
Ministerial & Departmental Fees	1.8%	1.6%	1.5%	1.4%	1.3%	1.2%

Source: PBO

*PBO Estimates

Baseline Expenditure Projections

The 2014/2015 budget forecast is pegged on the proposed revenue performance and the continued implementation of devolution. The budget should aim at ensuring inclusive economic growth that is targeted on poverty reduction and improvement of the well-being of Kenyans. The baseline forecast is based on the following assumptions:

Expenditure projections are based on targeted minimal domestic borrowing, absorption capacities of spending agencies, continued government investment and successful acquisition of the sovereign bond

i. Targeting to fund the entire budget with minimal domestic borrowings.
ii. High absorption capacities of spending agencies especially for development funds.
iii. Continued implementation of the government's development agenda by investment in proposed infrastructure projects like the standard gauge railway.
iv. Successful acquisition of the Ksh 87 billion sovereign bond in 2013/2014.

Expenditure for both national and county governments is estimated at Kshs. 1.3 trillion in 2013/14 and Kshs. 1.5 trillion in 2014/15

Based on the above assumption the total expenditure and net lending (comprising National Government and County Governments) is projected to rise from Ksh 1.1 trillion in 2012/2013 to Ksh 1.3 trillion in 2013/2014. The 2014/2015 expenditures are projected to be Ksh 1.5 trillion which is about

Efficiency in Expenditure and Increasing Opportunities

In Brief

Resource mobilization and absorption capacities of spending agencies will determine performance of government expenditure policies. Options which may enable the country to position itself for efficient budgetary performance include creating a budget surplus in the medium term through leveraging ICT, restructuring parastatals, eradicating ghost workers, improving programme based budgeting, review of the Public Procurement and Disposal Act and linking National and County Development Strategies.

The performance of government expenditure policies will depend on the resource mobilization and absorption capacities of spending agencies. The country's budget is funded by taxpayers' monies and borrowings. Prudent spending of these minimal resources will ensure the country catapults to the envisaged middle income country as per the Vision 2030. The following policy options may be considered to assist in positioning the country for significant economic growth:

Efficient expenditure of minimal resources that the country collects will promote growth

i. Creating a budget surplus in the Medium Term

The country has maintained perennial fiscal deficits for the last 10 years due to increased expenditure. It is noted that even though the revenue collection has been improving over the period, government's appetite for spending has been increasing with the rise in collection. The recurring fiscal deficit has forced the government to resort to borrowing from external and domestic sources. Domestic borrowing tends to crowd out private investment, bids up interest rates and presents a significant burden to the taxpayers through debt repayment. The government should strive to reduce dependency on borrowing in the next financial year and strive to achieve a budget surplus in the medium term.

The government should target to reduce dependency on borrowing and achieve a budget surplus in the medium term improve the turnaround time in service delivery by government entities.

iii. Restructuring of Parastatals

To ensure there is value for money, the National Assembly should also closely scrutinize all legislations that propose formation of new parastatals with the aim of either embedding the proposed functions to an existing government ministry or entity.

Embed proposed parastatals to existing government ministries/ entities to reduce duplication of functions

iv. Eradicating ghost workers

The need for a comprehensive audit of personnel in government is critical to ascertain the optimum number of staff required by the government. This will help in eradicating ghost workers thus saving the government colossal amounts of taxpayers' money. A number of counties have already undertaken headcounts of the staff they inherited from the government and defunct local authorities, revealing that a large number of people on their payroll are not physically working. With an ongoing audit of the National Government human resource by the Ministry of Planning and Devolution indicates that uptoKsh 70 million is lost monthly in eight ministries. The government should undertake a comprehensive human resource audit on all government ministries and state agencies.

There is need to carry out a comprehensive audit of personnel to ascertain the optimal number of staff required by the government

v. Improving the Programme Based Budgeting

The programme based budget (PBB) is a format of budgeting that links budget allocations and performance indicators. The push to have the budget prepared on programme level has been very useful in making reporting clear on whether resources are aligned to strategic priorities. However, it is worth noting that most of the budget documents are focused on presenting

Programme Based Budgeting is useful in highlighting whether expenditures are aligned to strategic priorities as well as evaluating performance

c) Rethinking the implementation of turnover tax;

d) Revamping the Value Added Tax (VAT) collections through enactment of the VAT Bill;

e) Reintroduction of taxation of capital gains; and

f) Taxation of the real estate sector

Most of the proposals are at various stages of consideration. With regard to the capital gains tax, the Cabinet Secretary for the National Treasury promised in his Budget Statement for 2013/14 that the government would review the capital gain tax under the Income Tax Act with a view of formulating modalities for its effective enforcement. This tax can help incorporate new taxpayers and improve the equity or fairness of tax system. However, it is critical to assess its revenue potential, its impact on the real estate growth, and effect on the stock market activity. International best practices show that initial tax rates for capital gains should be modest and simple, with greater emphasis on voluntary compliance to minimize administrative costs.

Government committed to review the Capital Gains Tax in 2013/14. It is critical to assess its revenue potential, impact on real estate growth and effect on stock market activity

The recently enacted VAT Act reduces the number of exempt and zero-rated items. For example, only a limited class of public institutions will benefit from tax waivers and exclusions. Further review of remaining tax legislations is required to reduce and streamline tax waivers and exclusions in line with the Constitution. Reduction of tax waivers and exclusions could help improve equitable sharing of tax burden including possible reduction of tax rates on account of expansion of the tax base.

After enacting the VAT act, review of other tax legislations is important to streamline tax waivers and exclusions in line with the Constitution

For 2014/2015 and the medium term, tax authorities and policy makers may wish to further reform the tax system by among others:

i. Harnessing revenues outside exchequer revenues

There are multiple levies, charges and fees collected by state corporations which are inadequately scrutinized by Parliament. The levies include the Universal Service Fund (Communication Commission of Kenya), Rural Electrification Levy (Rural Electrification Authority). All the revenues collected by public agencies should be included in the revenue estimates so as to clearly understand the total tax burden on Kenyans. Indeed, compartmentalization of these taxes, levies, fees and charges tends to underestimate the true tax burden on tax payers and cost to businesses. This should be corrected through consolidation of some of the charges, fees and licenses and improved reporting throughout the budget process.

All revenues harnessed by public agencies in form of taxes, levies, fees and charges should be included in the revenue estimates

ii. Stepping-up oversight of revenue accounts

The 'Finance Planning & Trade' and 'Budget' Committees' investigation on the discrepancy in the revenue accounts for 2007/08, brought out concerns on the validity and reliability of revenue accounts and reports. Whereas KRA collects revenue on behalf of government, the National Treasury is the designated receiver of most of ordinary revenue. The National Treasury is further responsible for reporting of revenue collections and performance to oversight authorities. But, the fact that differences occasionally occur over the actual revenue collected per accounting period points to weaknesses in revenue collection, reconciliation and reporting framework. To redress this problem, especially to improve the process of receipts, reconciliation, reporting, and accounting of revenue, it is suggested that the following systems be put in place:

Measures should be taken to improve the revenue collection, reconciliation and reporting framework

- Allow KRA to report periodically revenue collections concurrently to Treasury and relevant oversight authorities including Parliament; and

Chapter Three: Keeping the Promise

The Parliamentary Budget Office Macro Model (PBOM) has been used to run simulations using "what if" scenarios, in order to determine, hypothetically, the mix of policy measures that the government may need to put more emphasis on in order to achieve the targeted 10 percent growth rate in the next financial year and the medium term; as well as reduce poverty and increase employment levels.

Simulations were carried out using PBOM to determine the mix of policy measures that could drive the country to achieve a 10 percent growth rate and decrease poverty levels

Policy Option 1: Investment in infrastructure

The Vision 2030 aspires for the country to have highly modernized infrastructure through a vast network of roads, railways, ports, airports, water and sanitation facilities and telecommunications; such that it will be impossible to refer to any region of the country as remote.

Assuming that additional Ksh. 90 billion is invested in revamping the country's infrastructure in 2014, Simulations indicate that this investment will result in an additional 2.9 percent growth, pushing the 2014/15 growth from about 5 percent in the baseline scenario to approximately 7.9 percent.This growth is also likely to be driven in part by an increase in private investments which from the simulations, is seen to increase by approximately 2 percent in 2014/15. This can be attributed to improvements in the investment climate with the modernization of infrastructure, thereby attracting private investments and boosting private businesses. There is observed an increase in private sector employment, attributable to booming business in the private sector, as well as increase in total productivity and real GDP per capita. Consequently, poverty is likely to decrease by 0.3 percent in 2013/14 and 0.6 percent in 2014/15.

An investment of Kshs. 90 billion in the country's infrastructure in 2014/15 will result will result in a 7.9 percent economic growth and reduction in poverty levels by 0.3 percent

Option 3. Alternatively, the money can be channeled towards combating insecurity through specialized training of security personnel and investment in latest technology.

Policy Option 3: Agricultural productivity

Agriculture accounts for approximately 25% of the country's total GDP and a majority of Kenyans - statistics puts it at 75% of those in the rural areas - depend on agriculture for their livelihoods. Given that the majority of Kenyans earn a living from agriculture, then in order to achieve the twin goals of long term economic growth and poverty reduction, any strategic budgetary interventions aimed at addressing poverty and improving the standard of living for most Kenyans should primarily be targeted at enhancing agricultural productivity.

Majority of Kenyans depend on agriculture for their livelihoods and strategic interventions to reduce poverty should primarily be targeted at agriculture

In 2010, the government launched the Agricultural Sector Development Strategy (ASDS) covering the period 2010 – 2020. One of the targets of the strategy is for the agricultural sector to achieve a growth rate of 7 percent per year over the next five years.

Simulations indicate that an increase in agricultural productivity by 7 percent in 2014/15 will result in an increase in GDP to 5.4 percent in 2014/15 and 5.5 percent in 2015/16. This growth will largely be driven by an increase in investment levels, especially private investments, as well as an increase in private consumption. There is a notable increase in the level of income of households in the agriculture sector, as well as an increase in ordinary revenues especially income tax. On the other hand, poverty is observed to decrease by 0.9 percent in 2014/15 and 1.8 percent in 2015/16, especially for households in the rural sector.

An increase in agricultural productivity by 7 percent in 2014/15 will increase GDP by 5.4 percent and reduce poverty by 0.9 percent

- Poverty will reduce by approximately 1.4 percent in 2014/15 and 2.8 percent in 2015/16. There is also observed a significant reduction of households in the agricultural and informal sectors and an increase in the number of households in the formal sector. This can be attributed to increased attractiveness of the formal private sector which is seen to thrive from the simulation with increased productivity of employees in the private sector by approximately 1.7 percent.

Policy Option 4: Investment in Human Capital

In order to achieve the envisaged growth, it is important to also invest in the human resource base in order to ensure that human capital is competitive enough to drive growth to double digits and sustain it through 2030 and beyond. This will be achieved through provision of quality education as well as investment in health.

Government expenditure on education has increased significantly over the past decade

i. Education

The percentage allocation to the sector has been growing in real terms over the years, from 19.8% of total government spending in 2003/04 to 22.1% of total government spending in 2011/12. Education expenditure as a percentage of GDP has also increased from 6.2% in 2003/04 to 7.2% in 2010/11, decreasing slightly to 6.6% in 2011/12. The table below shows total education expenditure as a percentage of government spending:

Table 6: % of education expenditure to GDP and total government spending 2003/04 to 2011/13 budget

Year	03/04	04/05	05/06	06/07	07/08	08/09	09/10	10/11	11/12
Total education Expenditure of GDP (%)	6.2	6.2	6.3	6.3	6.4	6.3	6.8	7.2	6.6
% of total education expenditure to govt. spending	19.8	22.0	22.2	21.3	19.0	20.4	20.6	20.0	22.1

Source: Comprehensive Public Expenditure Review 2013, Ministry of Devolution and Planning.

There has been an increase in recruitment of health personnel - less than 2.3 health workers per 1,000 population as recommended by WHO. The devolution of health functions may require the counties to use some resources to hire and retain more health workers for efficient service delivery.

There is need to recruit additional health personnel especially at county level in order and to increase accessibility of health facilities

The number of health facilities has increased from 7,100 in 2010 to 8,375 in 2012. However, the facilities are not evenly distributed and some lack the necessary commodities such as drugs, medical supplies and beds. Patients living far from the facilities have to walk for long distances to access the facility. Furthermore, the out of pocket spending on health is still high and this affects access to health care.

Funding should be channeled towards Promotion of disease prevention measures Preventive health services are not adequately addressed by allocating sufficient capital and human resources yet majority of the diseases causing mortality and morbidity in Kenya are preventable.

Funding in the health sector should be channeled towards preventive health as well as reduction of out of pocket spending on health

Reduction of out of pocket spending on health will reduce individual carrying health burden. The cost of health care discourages many people who are sick from seeking medical care. This is demonstrated by the high number of people who turn up during free medical campaigns by various institutions.

Improved access to health care can be achieved by establishing health facilities within 5 km radius, ensuring they are properly equipped and having requisite personnel and commodities.

Can Kenya break the cycle of Poverty?

Assessment of Poverty in the Country

At independence, poverty, illiteracy and disease were identified as impediments to prosperity. The country therefore embarked on instituting policies and programmes aimed at alleviating poverty.

The first assessment of poverty in Kenya was done in 1992, when the government in collaboration with the World Bank conducted the Welfare Monitoring Survey. This was designed to help in tracking the implementation of the Structural Adjustment Programmes that had been introduced earlier on. Two similar surveys were carried out in 1994 and 1997 and in 2004/05; the Kenya Integrated Household Budget Survey (KIHBS) was conducted. The estimates of poverty rates from the four studies were 46.33%, 46.75%, 52.9% and 46% respectively.

Table: Key Economic Indicators since independence (10 year averages)

Key Economic Indicators	*1963-1972*	*1973-1982*	*1983-1992*	*1993-2002*	*2003-2013*
GDP Const Prices (2005)	244,943,463,856	474,690,338,257	716,977,801,497	935,953,770,155	1,330,241,100,000
GDP Annual Growth (%)	8.0	5.0	4.0	2.0	5.0
GDP Per Capita	23,305	31,723	33,161	31,895	34,847
GDP Per Capita Annual Growth (%)	5.4	0.3	(2.0)	(0.4)	2.3
Population (total)	10,502,250	14,900,879	21,563,864	29,361,451	38,899,373
Population Growth Rate (%)	3.0	4.0	4.0	3.0	3.0

From the table above, it is evident that the Gross Domestic Product exhibited quite irregular growth with sharp declines in late 1980s and early 1990s. Similarly, the GDP per capita demonstrated a fairly inconsistent growth. Also, from the second to third decade after independence, the country experienced a tough economic period before a gradual upward trajectory in 2003. The GDP Per Capita annual growth dropped from 5.4% in 1963-1972 to -2.0% in 1983-1992 before rising again to 2.3% in 2003-2013.

On the other hand, the population has been constantly increasing, from an average of 10.5 million people in 1963-1972 to about 39 million in 2013. However, the growth rate increased from 3% in the first decade to 4% in the third decade before stabilizing at 3% till 2003-2013. It is worth noting that over time, population growth rate has persistently been higher than the GDP Per Capita growth rate and this could threaten long term poverty reduction efforts.

Economic Growth and Poverty Linkage

Poverty levels in the country have remained high despite numerous interventions coupled with modest economic growth. For instance, between 2003 and 2007, the economic grew from 1.7 percent to about 7.1 percent without significant reduction in poverty levels. This indicates that even during periods of economic growth, the anticipated trickle-down effects have not been experienced. It therefore raises pertinent concerns as to whether economic growth alone is a cure for poverty reduction, or still if poverty reduction objectives were well articulated at the policy formulation stage. Various policy reviews commissioned by government have shown that there is nothing wrong with policy formulation. Perhaps, perennial institutional weaknesses in the implementation of such policy strategies could explain the failure.

full transfer of functions and resources in the coming budget. The enactment of the Division of Revenue Bill, 2013 was particularly taxing owing to disagreements over revenue allocations to county governments. The Division of Revenue Bill was introduced in the National Assembly soon after the official opening of Parliament. Since at the time of consideration of the Division of Revenue Bill the Budget and Appropriations Committee had not been formed, the bill was considered in the National Assembly plenary.

Disagreements ensued over revenue allocations to county governments

The Schedule to the Division of Revenue Bill provided revenue allocations as follows: out of total shareable revenue equal to Ksh. 920.4 billion; the national government would receive Ksh. 721.7 billion, while County governments would receive Ksh. 198.7 billion, divided into Ksh. 154.8 billion "unconditional" allocations and Ksh. 43.9 billion for "conditional" allocations. Conditional allocations would be used for "the financing and continuation of on-going services in accordance with Articles 187(2) and 203(1)(d) of the constitution." The Division of Revenue Act eventually allocated Ksh. 210 billion: Ksh. 190 billion would be shared using the approved revenue sharing formula among counties, and Ksh. 20 billion would cater for referral health facilities and donor commitments. The Ksh. 210 billion exceeded the threshold for allocations to county governments set in Article 203(2) of the Constitution. The National government received 730.4 billion out of the shareable revenue.

Counties received unconditional and conditional revenue allocations from the national government to finance ongoing services

Disagreements over "inadequate" revenue allocation to county governments and transfer of functions persisted through the first quarter of 2013/14 financial year. Latent weaknesses in the county level budgeting process through the first quarter of 2013/14 led to financing gaps in the first budgets, and delays in

Weaknesses in county budgeting process in first quarter of 2013/14 led to financing gaps in the first budgets based "resource requirement" approach could form best grounds for negotiation of resources through a supranational organ such as the Intergovernmental Budget and Economic Council prior to the introduction of the Division of Revenue Bill.

3. **Each level of government to live within its means:** increasing competition of resources by both levels of governments could lead to inadvertent fiscal expansion. In a real world revenue allocations need not exactly meet all government spending needs or costs. However, soaring demand for resources to fund various services by the national government and counties continue to pile pressure on the national and county treasuries. To enhance fiscal prudence, all levels of government should be mindful of wastage. Ideally, each level of government should face a real budget constraint given that tax resources are limited. Fiscal policies at each level of government should be consistent with the need to maintain sustainable public debt, low inflation, stable interest rates, and a external competitiveness.

To enhance fiscal prudence, each level of government should face a real budget constraint and be mindful of wastage

4. **Fostering the symbiotic relationship envisaged in Article 187**: sharing of functions in accordance with Article 187 could help in moving away from the present antagonistic competition over resources. Often intense competition for resources could mask underlying adverse incentives expressed in wasteful spending and corruption at either level of government.

Sharing of functions in accordance with Article 187 could assist in moving from antagonistic competition over resources

5. **Addressing emerging issues raised in the Controller of Budget Reports:** recent Controller of Budget reports highlight low absorptive capacity in various governments. For instance, the Controller of Budget reported that the counties had an average absorption

Box: Devolution Experiences in Other Jurisdictions.

Box: devolution experiences in other jurisdictions.

Indonesia

Devolution in Indonesia began in 2001 and it was occasioned by the clamour to reduce the power from Jakarta and also increase local participation in politics and the economic. It is a 3 tier system comprising of the central, the provincial and the local governments. During the implementation of devolution, there was suspicion, just like has been seen in Kenya, that the central government was not keen on decentralization and it wanted to revert back to centralized system. Further, there were some local governments that depended only on the general purpose grant (devolved funds) since their own local revenue was too thin. Nonetheless, the local governments imposed some fees and charges that were somehow considered illegal or disruptive, just like what some of our counties have been doing recently, and it impacted negatively on the local investment climate. In the case of foreign financing, the central government could sign agreements with international agencies on behalf of the local governments to get the funds and lend such that in case of default, the charge is done through intergovernmental transfers on the share of that local government. If this is emulated, it may lift the burden of contingent liabilities off the national government due to loan guarantees to county governments. Nonetheless, despite all the initial challenges, Indonesia is said to have come out strong by broadening and spreading its growth due to local competition for investment.

South Africa

South Africa's system is composed of the national, provincial and local governments. In the course of implementing devolution, there have been calls from some political quarters for the disbandment of the provincial governments due to a feeling that their role was unnecessary but it was realized that it is not easy to disband a system embedded in the constitution. There have been similar calls in Kenya to disband one of the Houses of Parliament and this presents a learning experience. Now, the Provinces are clustered according to economic and regional development areas but still 7 of the 9 provinces have similar linguistic majority like the case in most of the Kenyan Counties. Because of this, there were suggestions to change the ethnic boundaries to create functional, effective, economically viable and integrated communities but it has not been successful because of boundary intricacies involved. It is also noted that whereas in Kenya politics is ethnic, the South African political system is based on ideology and economic policy and to what they have done to guard against constituting a single party electoral result in the devolved units is to use proportional representation where elections are coupled with party list so as to produce proportional results. This is a system that might be considered in Kenya since there are counties, for instance Mombasa, where all Members of its Assembly are from one party.

Note: Drawing experiences from other countries which have implemented devolution, it is evident that challenges have been faced in a good measure but their devolution dreams realized. Therefore, it is a call for Kenya to learn from the successes as it endeavours to deliver on devolution promise.

Appendix 2: Selected Macroeconomic Indicators

Contributions to real GDP	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
Government final consumption expenditure						
of which wage bill government	0.2	0	0.2	0.2	0.2	0.2
of which material consumption government	0.7	1.2	0.9	0.3	0.2	0.2
Private final consumption expenditure	4	3.3	7.4	4.5	5.4	5.6
Gross fixed capital formation						
of which private investments	2.9	0	0.9	0.9	0.8	0.8
of which govt investments	-0.1	3.9	-0.5	0.3	0.4	0.4
Changes in inventories	0	0	0	0	0	0
Exports of goods and services	3.2	1.6	0.3	1.5	1	0.9
Imports of goods and services	4.7	6.6	4.1	2.8	2.6	2.6
Discrepancy 1	-1	1.1	-0.3	0	0	0
Gross domestic product at market prices	5.1	4.5	4.9	4.9	5.4	5.5
Contributions to GDP Deflator						
Government final consumption expenditure	1.1	1.2	1.4	0.9	0.8	0.8
of which wage bill government	0.6	0.8	0.4	0.4	0.4	0.3
of which material consumption government	0.5	0.4	0.3	0.6	0.6	0.5
Private final consumption expenditure	6.1	8.6	3.7	6.4	6.4	6.5
Gross fixed capital formation	1	1	1.2	2	2	2
Changes in inventories	0.3	-0.4	0	0	0	0
Exports of goods and services	2.9	2.3	0.7	1.9	2.1	2.1
Imports of goods and services	5.7	3	0.1	3.9	4	4
Discrepancy 1	2.7	1.1	0.1	-0.3	-0.3	-0.3
Gross domestic product at market prices (with weights 2001 at market prices)	8.4	10.9	7	6.9	7	7.1
Poverty						
Share Households below poverty line (Percent)	44.4	45.9	44.1	43.4	42.6	42
Individuals:						
WAGE EMPLOYMENT (individuals)						
Private sector (Million)	1.4	1.5	1.5	1.5	1.6	1.6
Public sector (Million)	0.7	0.7	0.7	0.7	0.7	0.7
of which Central Government	0.2	0.2	0.7	0.7	0.7	0.7
TOTAL WAGE EMPLOYMENT (in million)	2.1	2.1	2.2	2.3	2.3	2.4
Self-employed and unpaid family workers (in million)	0.1	0.4	0.4	0.4	0.5	0.5
INFORMAL SECTOR (in million)	9	9.9	10.4	10.9	11.4	11.9
TOTAL EMPLOYMENT ecl. Other (in million)	11.2	12.5	13	13.6	14.2	14.8
Other (traditional self-subsistence sector) in million	8.4	7.7	7.7	7.6	7.5	7.5
Total Employed	19.6	20.2	20.7	21.2	21.7	22.3
Seeking Work / No Work Available						
Total population (Million)	39	40.1	41.1	42.1	43.2	44.3
informal sector ratio	80.7	79.4	79.8	80.2	80.5	80.8
real GDP per capita	2.6	1.6	2.4	2.3	2.8	2.9

APPENDIX 4: ANALYSIS OF COUNTY BUDGETS

County	% Personnel Emoluments to Total Expenditure	% Operation and Maintenance to Total Expenditure	% Development to Total Expenditure	Total Expenditure (Ksh Billions)
BARINGO	16%	54%	31%	4.4
BOMET	13%	53%	34%	5.6
BUNGOMA	14%	53%	33%	8.0
BUSIA	16%	53%	32%	4.1
ELGEYO-MARAKWET	8%	51%	42%	8.7
EMBU	20%	50%	31%	4.0
GARISSA	21%	48%	30%	3.3
HOMA-BAY	26%	45%	30%	8.3
ISIOLO	20%	44%	37%	3.2
KAJIADO	28%	42%	29%	3.3
KAKAMEGA	24%	41%	35%	5.1
KERICHO	30%	40%	30%	8.1
KIAMBU	19%	38%	44%	3.5
KILIFI	33%	36%	30%	10.0
KIRINYAGA	23%	35%	42%	4.6
KISII	35%	35%	30%	5.5
KISUMU	23%	34%	43%	3.5
KITUI	13%	34%	53%	3.2
KWALE	18%	33%	49%	4.0
LAIKIPIA	33%	33%	35%	3.4
LAMU	28%	32%	40%	5.1
MACHAKOS	19%	29%	52%	8.0
MAKUENI	21%	29%	50%	5.4
MANDERA	16%	29%	55%	2.4
MARSABIT	16%	28%	56%	3.8
MERU	30%	28%	41%	4.5
MIGORI	41%	28%	32%	25.7
MOMBASA	21%	27%	51%	21.8
MURANG'A	34%	27%	38%	4.4
NAIROBI CITY	35%	27%	38%	5.8
NAKURU	13%	27%	61%	4.2
NANDI	13%	27%	60%	8.5
NAROK	23%	26%	51%	5.7
NYAMIRA	31%	25%	43%	12.6
NYANDARUA	27%	25%	48%	3.1
NYERI	13%	24%	62%	7.0
SAMBURU	14%	24%	62%	2.2
SIAYA	33%	24%	43%	6.5
TAITA-TAVETA	25%	23%	52%	3.8
TANA-RIVER	29%	21%	50%	3.6
THARAKA-NITHI	38%	20%	42%	7.1
TRANS-NZOIA	36%	19%	45%	3.6
TURKANA	27%	18%	55%	13.3
UASIN-GISHU	22%	17%	61%	4.3
VIHIGA	44%	16%	40%	5.3
WAJIR	36%	15%	49%	4.1
WEST POKOT	48%	11%	41%	2.9
Total	**26%**	**31%**	**43%**	**288.6**

Source: Controller of Budget