Macro-Fiscal Analytic Snapshot: Kenya[1]

Prepared by: Institute for Public Finance (IPF) Kenya and Oxford Policy Management[2]

Foreword

Introduction

Macro-Fiscal Analytic Snapshot (MFAS) is a high-quality research output on Kenya's economy and public finances produced annually by the Institute of Public Finance Kenya (IPFK) in partnership with Oxford Policy Management (OPM) and with funding from the Bill and Melinda Gates Foundation (BMGF). Its overall objective is to facilitate an active and informed public discourse on the economy and allocation and use of public finances as an effective way of policy making. The preparation of MFAS is undertaken through an in-depth analysis, scrutiny, interpretation, and dissemination of publicly available information on the Kenya's economy and public finances. The 2021/22 MFAS is the third iteration, after the 2020/21 and 2019/20 editions.

Key messages:

- **The economic damage caused by COVID-19 has been worse than originally anticipated, and leaves GDP 9 per cent below the pre-crisis forecast by 2023 with more than two years of progress lost on poverty reduction.** The recession has been deeper, and the recovery slower than first expected. Due to fiscal constraints, the government was able to implement only a very modest response to support the economy, so households and businesses were not well shielded from the impacts of the recession; hence the impact will be more enduring and there will be more economic 'scarring' than previously anticipated. Recent forecasts recognise the existing micro-evidence which shows the recession hit poverty harder than GDP, including a severe impact on new groups of urban poor. Overall, progress in reducing poverty has been setback by at least two years because of the recession.

- **Kenya's public finances were being managed in an unsustainable manner prior to the crisis, which made the country vulnerable to shocks, stopped the government from mounting a very significant fiscal stimulus in 2019/20, and now leaves it with a pressing need for fiscal consolidation going forward.** With public debt now substantially exceeding sustainability thresholds, and interest payments accounting for an ever-higher proportion of the budget, delaying fiscal consolidation is becoming increasingly difficult. Kenya did benefit from support provided by the G20 under the Debt Service Suspension Initiative (DSSI) which helped reduce debt service by US$640 million in 2021.[3] However, Kenya remains at high risk of debt distress and as a result, fiscal space will be highly constrained for several years. Even if the government manages to achieve a recovery in revenue to pre-pandemic levels, there will still need to be significant expenditure cuts over the short- and medium-term, and spending won't regain its 2018/19 per capita levels during the forecast period.

- **If the planned cuts to expenditure are implemented, service delivery will be impacted in a significant way.** From highs of over 8 per cent of GDP in 2020/21, the fiscal deficit is projected to fall back to 4.5 per cent by 2023/24. Assuming no major improvement to revenues beyond pre-pandemic levels, this would see spending fall to around 22 per cent of GDP by 2024/25 (down from over 27 per cent in 2016/17). Government projections indicate that this will be achieved primarily by cutting current expenditure and fiscal transfers to counties, whilst protecting the investment budget. The sectors targeted for cuts include the agriculture, rural development and energy sectors. Unfortunately, forward projections of county expenditure are not currently available, so it is difficult to get a full picture of which sectors will lose out (county budgets account for half of spending in certain sectors, including health and agriculture). However, the projected decline in total transfers to counties indicates that cuts at the national level are very unlikely to be offset by additional spending at the county level, indicating that significant pressure on service delivery budgets is set to come. Whether these plans are carried forward into future annual budgets remains to be seen. Fiscal consolidation cannot be delayed much longer but is politically difficult to do.

- **Health spending has risen in recent years, but fiscal consolidation is likely to squeeze allocations over the next few years.** Spending on health rose in 2019/20 to cover UHC and COVID response requirements. However, current medium-term budget projections indicate that allocations for health at the national level will decline in real terms over the next two fiscal years. Combined with planned cuts to fiscal transfers to counties (from which roughly half of health expenditures are financed), declining ODA to the sector, the merging of conditional transfers with equitable share, and population growth, this implies that public spending per capita on health will decline over the next 2-3 years.

Key issues to monitor:

Given the above, the following issues warrant close monitoring over the coming year:

1. **Whether the government sticks to its committed path for fiscal consolidation in the upcoming 2021/22 budget revision and 2022/23 budget.** Given the government's failure to bring the deficit under control in past years, there is reason to question whether it will do so this time, despite the greater urgency. The annual Budget Policy Statement (BPS) will be submitted earlier this year (in November, instead of February) due to the accelerated timeline for budget preparation demanded by the 2022 general election. The budget that is subsequently approved will provide further evidence to judge the credibility of current plans for putting the public finances onto a more sustainable footing. It will also provide greater detail on the extent to which budgets for priority sectors are cut and the likely implications.
2. **The development of the new National Tax Policy Framework.** Kenya has struggled with routine 'revenue optimism' for several years, with revenue collection regularly under-achieving fiscal targets (see Section 2). Kenya has under-executed revenue targets by an average of 10% (equivalent to 1.8% of GDP) over the period 2016/17 – 2020/21. The new national tax policy framework is due to be released in 2021/22 and promises to outline new measures to boost revenue performance, including the reversal of the many exemptions and exclusions that have plagued Kenya's performance for many years. In the context of a difficult fiscal consolidation process, improving revenue performance is especially important, but is politically difficult, so this should be monitored closely.
3. **The impact of fiscal consolidation on county government finances.** Government plans for fiscal consolidation are set to have a major impact on the finances of county governments. According to National Treasury projections, county transfers (equitable share) are set to be cut in real terms for at least the next three fiscal years. This should be monitored closely during the upcoming budget discussions, since if carried through, it will have major implications for service delivery going forward. Furthermore, the merging of conditional transfers with equitable share could ultimately reduce allocations to key sectors such as health further since county governments will have greater flexibility in allocating their budgets. Examining the consolidated data on country budgets (expected to be available soon) will be instructive in this regard.
4. **The impact of continued delays in transfers to counties on service delivery.** Counties are still affected by delayed transfers, which was a major problem in 2020-21, when counties received their final share (around 10 per cent of the total) after the end of the financial year. So far in 2021-22, transfers are on average behind schedule by two months. During the first quarter (July – September) the counties had only received 16.5 per cent of their equitable share, compared to the planned amount of 25 per cent.
5. **Flows of official development assistance.** External development finance has helped ease Kenya's fiscal constraints in the past, but further support will be required over the medium term, to help it deal with the lasting impact of the pandemic on growth and domestic revenue. The global response to the pandemic resulted in additional disbursements from international financial institutions, some of which was made possible by bringing future years' allocations forward – meaning there is a risk of a reduction in official development finance from 2021/22 onwards. If ODA falls below pre-COVID levels, this could slow recovery further.

James Muraguri
Chief Executive Officer
Institute of Public Finance–Kenya

Acknowledgement

The 2021/22 Macro-Fiscal Analytical Snapshot covers six sections: (i) Macroeconomy and public debt (ii) Revenue and Expenditures (iii) Official Development Assistance (ODA) (iv) Health Drill down, (v) PFM institutions and (vi) Key issues to monitor. Its preparation was a consultative and collaborative effort between IPFK team led by Mr. Nyangi John Juma under the guidance of James Muraguri and Oxford Policy Management led by Nick Travis. The IPFK team included Daniel Ndirangu, Winnie Mageto, Bernard Njiiri, Mohamed Salat, Octaviah Wachira, Jedidah Wanjagi, Gideon Masese, Venessa Dacha, Maryanne Wanjiku, Reena Atuma, Maureen Onyango, Mulwa Kasangya, Tina Mulu and Edna Kijogi. Many thanks go to our team of external reviewers from Oxford Policy Management including Stevan Lee, David Jeffrey, Alex Murray-Zmijewski, William Smith, Goufrane Mansour, Terry Roopnaraine and Sonya Rabeneck for their invaluable comments and guidance in developing this MFAS. The technical team is grateful to the office of Finance and Administration at IPFK including Sandra Muchiri, Samson Mwangi, David Warari, Esther Kamau and Mary Njuguna for administrative and logistical support accorded during the preparation of this edition.

Nyangi John Juma
Head of Research
Institute of Public Finance–Kenya

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Table 1. Key indicators (Fiscal Year: July-June)

(% GDP except where indicated)	Estimate	Forecast			Extended Forecast
Economy	2020	2021	2022	2023	2024
GDP (bn, 2020 prices)	101.0	106.1	110.8	116.4	122.2
Change in GDP	-0.3%	5.0%	4.5%	5.0%	5.0%
Change in Agriculture	4.8%	3.1%	2.5%	2.8%	2.8%
Change in Industry	4.0%	4.8%	2.6%	3.3%	3.3%
Change in Services	-2.2%	5.7%	5.8%	6.2%	6.2%
Change in gross investment	3.4%	4.0%	3.6%	4.9%	4.9%
Change in gross exports	-8.2%	8.0%	5.0%	6.5%	6.5%
Current Account Balance	-4.6%	-5.3%	-5.4%	-5.5%	-5.5%
Fiscal	2020/21	2021/22	2022/23	2023/24	2024/25
Gross Revenue	16.5%	17.0%	17.8%	18.0%	18.2%
Gross Public Expenditure	24.1%	23.7%	22.9%	22.6%	22.4%
Public Investment	6.9%	6.4%	5.7%	5.7%	5.7%
Recurrent expenditure (excl. interest)	13.4%	13.4%	13.3%	13.1%	13.0%
Debt Interest	3.8%	3.9%	3.8%	3.8%	3.7%
Fiscal Balance	-7.6%	-6.7%	-5.1%	-4.6%	-4.1%
Public Debt	71.5%	72.9%	72.3%	71.8%	70.0%
memo items					
Headcount Poverty (Int'l poverty rate ($1.9 in 2011 PPP))	35.7%	34.9%	34.1%	33.2%	n/a

Source: All figures are taken from the World Bank's Macro-Poverty Outlook (October 2021) except the figures for public debt which are taken from the latest IMF Debt Sustainability Analysis for Kenya (March 2021).

I. Macroeconomic context and outlook

The Economy, Growth, and Investment

Prior to the COVID-19 pandemic, Kenya had been experiencing stable and moderately strong growth since 2008, averaging a solid 5.6 per cent per year, driven by a broad-based economy.[4] Kenya recorded consistent growth for over a decade up to the start of the crisis, with its economy doubling in size between 2006 and 2019.[5] Growth has been generated from all sectors of the economy, but services have been the dominant engine of growth, accounting for 56 per cent of GDP in 2019. Ahead of the COVID-19 outbreak, 2020 was looking to be a good year for Kenya with 6 per cent growth forecast, driven by pent-up investment demand and improved business sentiment, as well as continued public spending on the government's Big Four Agenda.[6]

The pandemic has had a more severe impact on the Kenyan economy and the population than originally expected. As illustrated in Figure 1 below, initial World Bank forecasts at the start of the pandemic estimated growth in 2020 to slow significantly, but ultimately remain positive, at 1.5 per cent. However, the latest estimates confirm a more pessimistic outcome, with a downward adjustment to -0.3 per cent for the year. This represents a six percentage point loss in GDP compared with pre-COVID forecasts.[7] As expected, the services sector was most heavily affected, declining by over 2 per cent in 2020 following COVID-19 containment measures, which led to a significant reduction in economic activity in the transport, recreation, tourism, trade, hospitality, and accommodation sectors. Manufacturing was less badly impacted, while the agricultural sector grew at a faster rate than in 2019, due to improved rainfall.[8]

Fig. 1: Real GDP - the impact of COVID was worse than initially projected and will result in a permanent loss in GDP

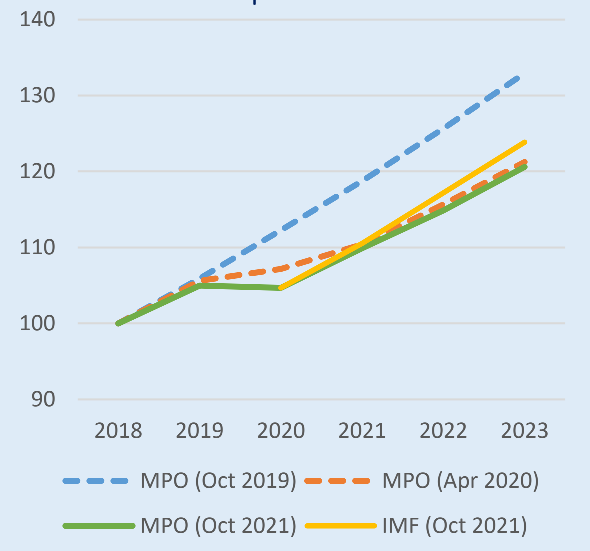
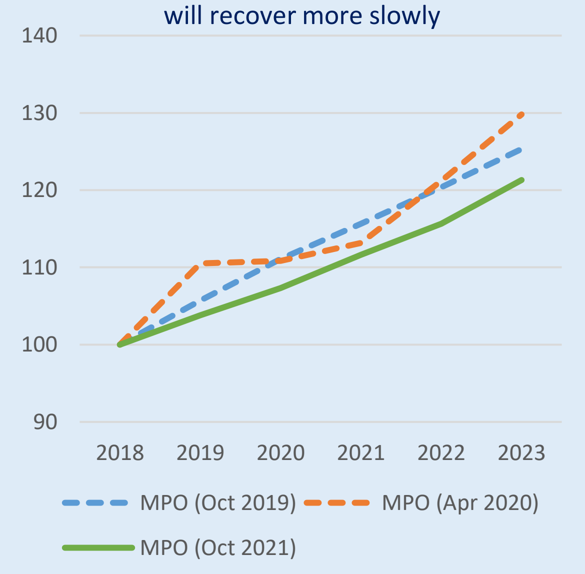


Fig. 2: Investment - the fall in in 2020 was greater than initially expected and will recover more slowly



Source: World Bank Macro Poverty Outlook (Oct. 2019, Apr. 2020, and Oct. 2021) & IMF World Economic Outlook (Oct. 2021).
Note: Both charts use an index starting from 100 in 2018. Data are on calendar year basis.

There are some differences in growth forecasts for Kenya, although there are clear reasons why our forecast shows a more sluggish recovery with a permanent loss of output compared to pre-COVID levels. World Bank forecasts are pessimistic relative to the Government of Kenya's, showing a slower recovery over the medium term, with growth not returning to pre-pandemic levels until 2023, such that GDP is approximately 9 per cent lower by the end of 2023 compared to pre-COVID forecasts. The assumption underpinning this forecast is that the economic damage to some sectors was quite severe, while the government response was quite modest due to fiscal constraints, so it was not able to protect households and businesses (especially informal enterprises) from the impact very much. As a result, the impact is more enduring and there is more 'scarring' to the economy. The latest IMF forecast (revised down from its April 2021 projection) is slightly more optimistic, with growth rebounding to 6 per cent in 2022, although there is still a residual output gap of 7 per cent of GDP by the end of 2023.[9]

Consumption and Poverty

Prior to the pandemic, healthy growth translated into improved livelihoods, with poverty declining by 10 percentage points between 2005 and 2019; however, given Kenya's income level, absolute poverty levels remain too high in comparison to its peers, suggesting that growth gains are not being distributed evenly.[10] Kenya's progress in poverty reduction over the last 15 years has been largely on a par with the sub-Saharan Africa average. However, poverty in Kenya is higher than several of its peers at similar income levels (e.g. Bangladesh, Tanzania) and even those with lower incomes (e.g. Ethiopia).[11] This high level of poverty results from inequality, including rural-urban inequality. Kenya's latest comprehensive poverty report estimates that 53 per cent of Kenyans remain multidimensionally poor, deprived of the realisation of at least three basic needs, services, and rights. These figures are even more stark in rural areas, where it is found that the multidimensional poverty incidence is 67 per cent, more than double the incidence in urban areas (27 per cent). These high poverty and vulnerability rates mean that in the event of an income shock, many households have little to no means of cushioning themselves from the impact.[12] Despite improvements in the Gini index between 2005 and 2015 (from 46.5 to 41.0) inequality in Kenya remains a concern, with levels above many of Kenya's neighbours.[13]

Current estimates show that in 2020, both consumption per capita and poverty worsened by more than GDP, with both losing at least two years of progress, even by 2023. As illustrated in Figures 3 and 4, consumption gap (compared to pre-COVID expectations) is wide and gets wider over time whereas poverty loses just over two years of progress. Furthermore, given that consumption per capita fell (by -5.1 per cent) and poverty rose (by 3.6 per cent) more than GDP fell (by -0.3 per cent) the impact of the recession is skewed towards the poor, which is consistent with other evidence that suggests that the urban poor have suffered more severe and enduring setbacks. In many other countries (for example, Bangladesh) poverty has increased much more sharply than the fall in GDP, representing a change in the relationship between growth and poverty reduction, in which some poor groups – including urban, informal sector households – are more strongly impacted in an enduring way. This is also the observation in Kenya, reflected in the forecast we are using, which is consistent with the fact that the Government of Kenya struggled to resource significant assistance for informal sector enterprises and urban households. There is also some micro-evidence from phone-based surveys that suggests that there was very sharply increased urban poverty due to the COVID-19 induced recession[14] and it is quite likely that poverty estimates will be revised up again when full scale surveys can be done.

Fig. 3: Consumption per capita - declined significantly more than first expected and will recover more slowly

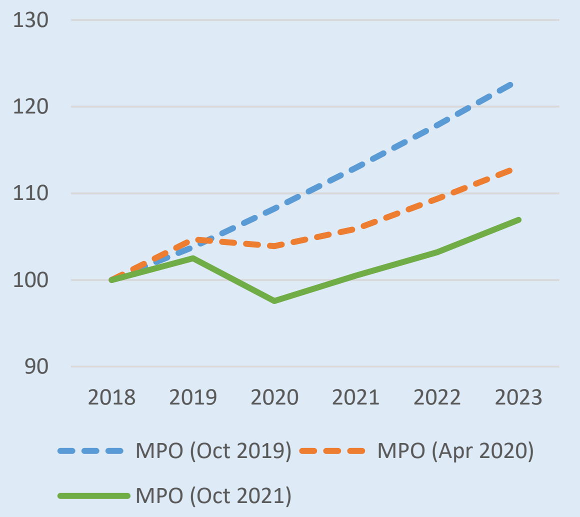
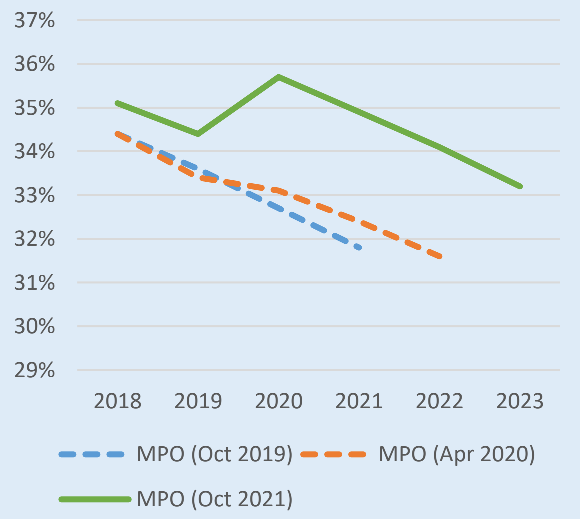


Fig. 4: US$ 1.90 poverty headcount - poverty reduction is setback by at least two years

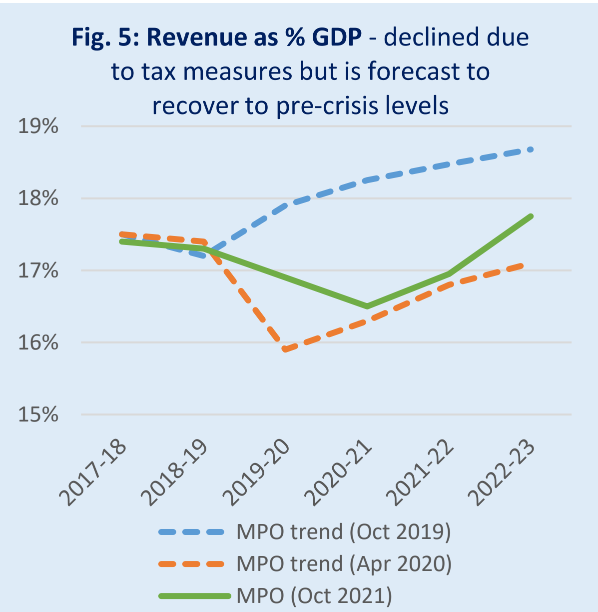


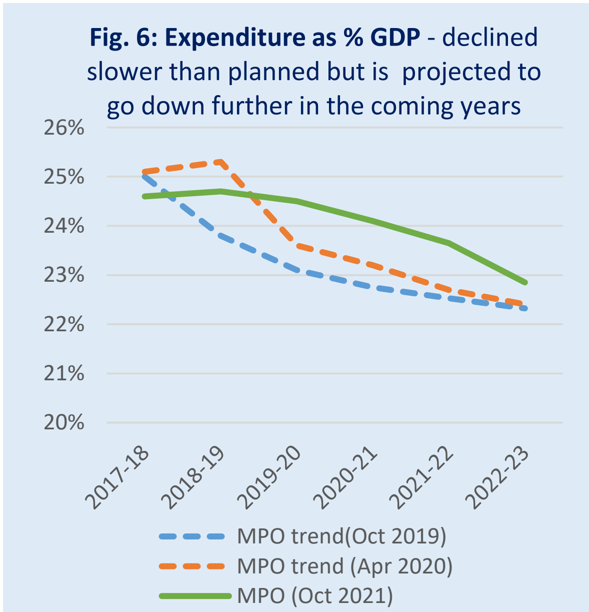
Source: World Bank Macro-Poverty Outlook (Oct. 2019, Apr. 2020, and Apr. 2021). **Notes:** Fig.3 uses an index starting from 100 in 2018. Fig. 4 presents the proportion of the population under the international poverty line ($1.9/day in 2011 PPP). In Fig.4, the Oct. 2021 MPO appears to have re-calculated historic poverty figures, which explains why the latest forecasts start from a higher point in 2018. Nevertheless, the pattern is clear, with the latest forecast showing a bigger impact on poverty than originally forecast in April 2020.

Revenue and Expenditure

Government revenue has been on the decline in Kenya for several years, falling from over 22 per cent of GDP in 2009/10 to just 17 per cent in 2019/20 and 16.5 per cent in 2020/21. This general decline is attributed to the government granting numerous tax incentives, eroding the tax base. Tax expenditures and exemptions are estimated to cost Kenya 5-6 per cent of GDP each year – which is the size of the entire primary deficit.[15] In addition, the formal sector has been losing share of the economy relative to the faster growing informal economy, which now accounts for over 80 per cent of total employment and, critically, pays much less tax than the formal sector.[16] At the same time, public expenditure has steadily been rising, reaching as high as 27 per cent in recent years. The combined impact has been an expansion in the fiscal deficit, which has pushed the economy towards a high risk of debt distress, even while the economy was growing strongly.

During the pandemic, both revenue and expenditure fell as a share of GDP, while the net fiscal stimulus was small and was delivered through tax cuts. Revenue fell by 0.8 percentage points of GDP between 2018/19 and 2020/21. This is partly on account of policy – tax relief measures were introduced by the government following the pandemic. These included income tax relief for those earning under KSH 24,000 (c. US$ 225) per month, a reduction in the VAT rate from 16 per cent to 14 per cent, as well as a reduction of the top pay-as-you-earn rate from 30 per cent to 25 per cent.[17] These measures are estimated to have costed the exchequer KSh. 172 billion (about 2 per cent of GDP) in revenue foregone in 2020/21.[18] Government expenditure declined only moderately (by 0.4 per cent of GDP. This meant the deficit widened somewhat, but the fiscal stimulus was small and manifested entirely as tax cuts rather than extra spending (although there was some switching of expenditure from routine activities to COVID-19 related response). The fiscal deficit reached almost 8 per cent of GDP in 2019/20 – about 3 percentage points higher than planned pre-pandemic, but only 0.3 points above the 2018/19 level.





<u>**Source**</u>**:** World Bank Macro-Poverty Outlook (Oct. 2019, Apr. 2020, and April 2021). <u>**Notes**</u>**:** Both figures express data as a percentage of GDP. Data are on a fiscal year basis. In the Oct. 2021 MPO the World Bank has made a level adjustment to current and historic figures for revenue and expenditure, which makes them more in line with Government of Kenya reporting – hence the different starting position of the green line.

Revenue is projected to bounce back over the next two fiscal years, with further expenditure cuts expected to help put the public finances back on to a more solid footing. As illustrated in Figure 5, revenue is expected to rise over the coming two fiscal years and recover to a level that was achieved pre-pandemic. There is a realistic prospect of achieving these increases, given that the temporary revenue measures introduced for the COVID response have now been reversed. There is in fact a large stock of exemptions that could be reversed to improve the revenue take further, but it remains to be seen whether the government's appetite for doing this has changed, given past failures to generate higher revenues. If revenues are not increased, even more expenditure cuts will be needed to achieve fiscal consolidation and a sustainable debt dynamic.

Fiscal Balance, Debt Sustainability and Vulnerability to Future Shocks

Weaker near-term growth projections are once again delaying fiscal consolidation efforts in Kenya, demanding a tough medium-term adjustment. Kenya has been running an unsustainably high fiscal deficit for several years and has been postponing the point at which consolidation takes place. As a result of the pandemic, fiscal consolidation plans were deferred until 2021/22. However, forecasts across the board suggest it will now largely be deferred another year, from which point a rapid reduction in the fiscal deficit is planned. From highs of almost 8 per cent of GDP in 2019/20, the fiscal deficit is expected to fall to 4.1 per cent by 2023/24. This is not impossible to deliver, but it would require a departure from Kenya's recent track record. The government has consistently failed to achieve its revenue and fiscal deficit targets over the last few years; to do so this time they would have to reverse Kenya's declining revenue-to-GDP ratio and cut spending, even as high debt servicing costs continue to take up almost a quarter of revenue collections. However, the government may be forced to change direction, given the rising burden of public debt and the increasing difficulty and cost in financing large fiscal deficits.

Kenya's public debt now stands at very high levels, likely constraining its ability to finance large fiscal deficits going forward. Even prior to the pandemic, Kenya was becoming increasingly exposed to public debt vulnerabilities, with public debt climbing to over 60 per cent of GDP by 2019 (from just 42 per cent as recently as 2012) reflecting an inability to contain fiscal deficits during a period of strong growth. This ratio was expected to breach 70 per cent of GDP by mid-2021. Kenya is particularly exposed to vulnerabilities because it has accumulated relatively expensive debt, with the share of commercial loans rising from 20 per cent of total external debt in 2015 to 29 percent by 2021.[19] This helps explain why interest payments have increased from 2.2 per cent of GDP in 2010/11 to 4.3 per cent in 2019/20, the same size as the wages and salary bill of the national government. Kenya has benefited from support provided by the G20 under the Debt Service Suspension Initiative, which helped reduce debt service by US$640 million in 2021.[20] Nevertheless, the IMF downgraded Kenya's debt carrying capacity from strong to medium in April 2021 due to COVID's impact and continues to assess the risk of debt distress as high – materially much higher than in 2019. Kenya will need to revise its legal debt ceiling or breach it by 2022/23.

Fig. 7: Budget deficit as % GDP - Fiscal consolidation plans were delayed (again) and are now pushed further into the medium-term

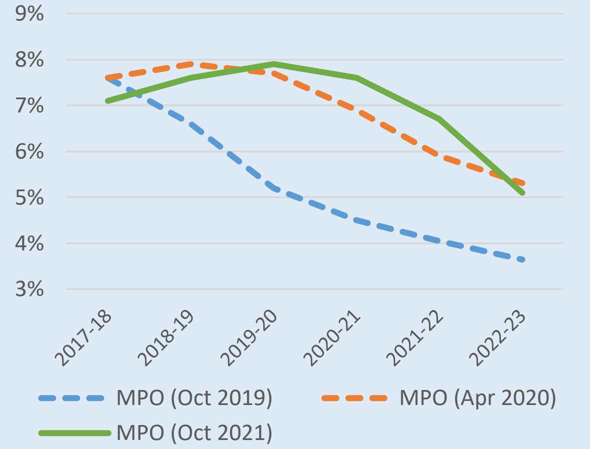
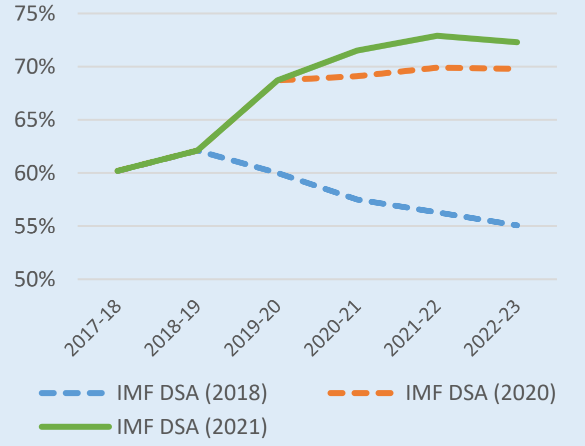
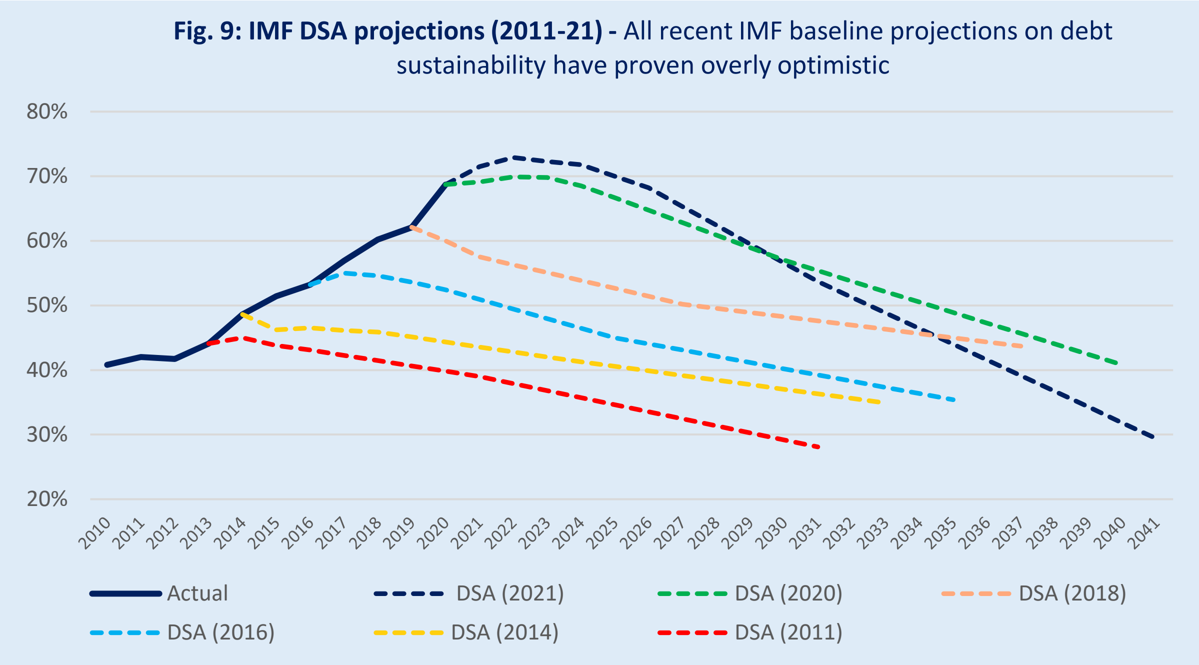


Fig. 8: Public debt as % GDP - Debt has risen much more than planned and Kenya is now assessed to be at a high risk of debt distress



__Source__: Fig. 7 is based on World Bank Macro-Poverty Outlook (Oct. 2019, Apr. 2020, and April 2021). Fig. 8 uses IMF data from the three most recent Debt Sustainability Analyses (DSA) conducted. __Note__: Both figures express data as a percentage of GDP. Data are presented on a fiscal year basis.

Current projections indicate that debt will start declining in the near term; however, past experience illustrates that this is far from guaranteed. The IMF central projection indicates that the debt-to-GDP ratio will steadily decline once fiscal consolidation kicks in from 2022/23. However, this projection is like all previous projections since at least 2011 (see Figure 9) all of which have shown a technically feasible path to sustainability but none of which have proven accurate as forecasts. The fiscal consolidation will be more difficult to achieve during the recovery from the COVID-19 recession than in the previous years of strong growth. Nevertheless, it is possible that the calculus of Kenya's leadership will change and that they will stop repeating past patterns now the debt level is so high. In Figure 9, the threshold for sustainability has been a debt-to-GDP ratio of 70 per cent, until 2021 when this was downgraded to 55 per cent, so Kenya is now firmly at high risk of debt distress.



Source: IMF Debt Sustainability Analyses (DSA) conducted in 2011, 2014, 2016, 2018, 2020 and 2021. **Note:** The figure illustrates total public debt (domestic and external) as a percentage of GDP. Data are presented on a fiscal year basis (i.e. 2010 = FY 2009-10).

II. Revenue and expenditure overview

Note: The data used in this section come from Government of Kenya sources, given the much greater level of detail provided compared to other sources, such as the World Bank and IMF. This data is not always fully consistent with World Bank data on revenue and expenditure presented in the previous section, for reasons that are not entirely clear. However, despite some differences in the specific numbers, the trends are consistent and therefore the conclusions drawn are aligned with World Bank and IMF analysis.

Revenue

Kenya's revenue effort has been better than some of its peers but has weakened substantially in recent years. Revenue as a percentage of GDP fell from 22 per cent in 2009/10 to just 16 per cent in 2020/21 (down from 18.2 per cent in 2018/19) although this is partly due to tax relief measures implemented by the government in response to COVID-19 (see below). Income tax and VAT account for the majority of revenues collected, although the former has been on the decline (from 45 per cent of total revenue in 2015/16 to 40 per cent in 2018/19) reflecting the increasing proportion of the informal sector in Kenya's economy. Although Kenya's revenue effort is higher than that of most of its East African Community peers, such as Tanzania and Uganda, and several other sub-Saharan Africa states, the World Bank estimates that Kenya's tax to GDP ratio is now between 4 and 7 percentage points lower than countries at similar income levels.[21]

Tax expenditures and exemptions have eroded Kenya's tax base and have contributed to revenue under-performance. Kenya has numerous tax incentives in operation, as well as differentiated corporate income tax, which have eroded the tax base. Furthermore, declines in VAT revenues in recent years have been attributed to the prevalence of exempted and zero-rated items. Revenues have also proven volatile in the face of recent shocks (including the desert locusts' invasion, floods, and the effects of COVID-19), by virtue of the disruption to economic activity, but also because of the additional tax expenditures introduced. For instance, the reduction in corporate and personal income tax and VAT introduced since the pandemic hit are estimated to have cost the exchequer KSH 172 billion in revenue foregone, equivalent to 1.5 per cent of GDP in 2020/21.[22]

After a significant dip due to COVID-19, revenue is projected to recover over the next two fiscal years and stabilise at the pre-pandemic level of 18 per cent of GDP by 2023/24. As illustrated in Figure 10, projections indicate this will be driven chiefly by a recovery in income tax and VAT to pre-pandemic levels, as incomes and consumption recover. Temporary tax cuts that constituted the COVID stimulus have been reversed. The recovery in revenue over the medium term should be supported by planned reforms in tax policy and revenue administration, such as the reduction of tax exemptions and the development of a National Tax Policy Framework that will aim to provide consistency and certainty in tax legislation and management of tax expenditures.[23] However, the implementation of these reforms remains highly uncertain, resulting in an unclear trajectory for revenue in the near term. Nevertheless, it seems likely that any increase in revenue beyond the levels achieved prior to 2019/20 will be dependent on the overall pace of reform.

Evidence suggests that Kenya has suffered from routine 'revenue optimism' in the past, which could undermine forward projections. As illustrated in Fig. 11, revenue targets have been consistently missed – average performance over the last six fiscal years is 91 per cent of original estimates. This makes a material difference in the management of the fiscal deficit, since lower than planned revenue requires either higher borrowing or cuts to expenditure (see below). Tax revenue collection has been hampered by tax administration challenges which include low compliance across the spectrum, with the Kenya Revenue Authority (KRA) having inadequate capacity.[24] However, forward revenue projections are more in line with recent performance (Fig. 10) as opposed to previous unrealistic targets (Fig. 11) which is encouraging. Achieving this recovery in revenue will be vital in preventing further expenditure cuts (on top of what is already planned as part of Kenya's fiscal consolidation) which could be damaging for key services.

Fig. 10: Revenue as % GDP has been falling, but is projected to return to pre-COVID levels by 2023/24

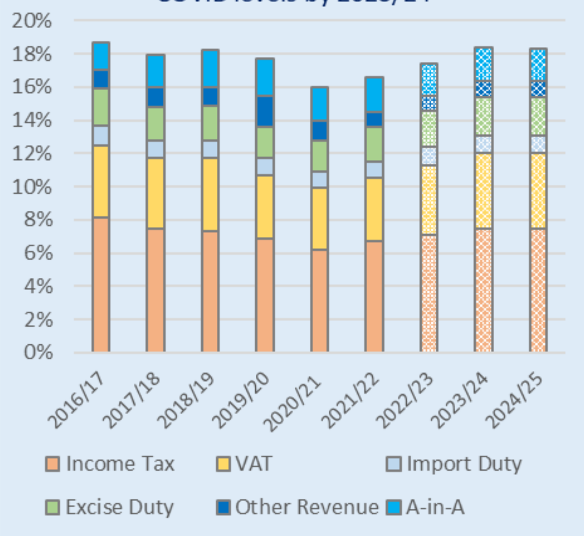
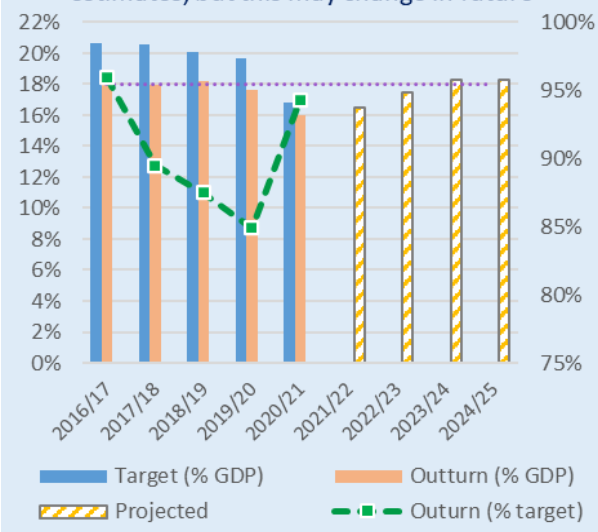


Fig. 11: Revenue outturns are consistently lower than original estimates, but this may change in future



Source: GoK *Budget Review and Outlook Papers* (2017-21); GoK *Quarterly Economic and Budgetary Review* Report (2021).

Revenue optimism has resulted in the fiscal deficit regularly exceeding its targeted level in recent years. Figure 12 illustrates that the fiscal deficit is usually higher than originally planned. This is mainly due to lower-than-expected revenues, as opposed to higher-than-planned expenditures, as illustrated in Figure 13. In the last three fiscal years, expenditure has broadly been in line with the budget, resulting in higher borrowing to replace unrealised revenues, whereas in previous years expenditure declined significantly to offset the revenue shortfall. This implies that the fiscal deficit target is quite soft, although the positive angle is that the Government of Kenya appears to rarely spend more than its original approved budget.

Given that public debt is now exceeding comfortable limits, deficit targets may need to become harder. This means that any revenue shortfalls will force lower expenditures, since there is no longer any cushion of extra borrowing to address the gap. In the past, this was not what happened, but with borrowing now becoming more difficult and more expensive, it is possible that the government will change its thinking and stop repeating past patterns of deficit management.

Fig. 12: The fiscal deficit is invariably higher than originally planned

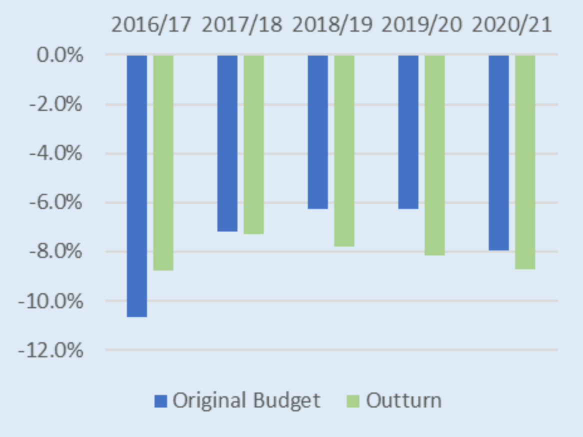
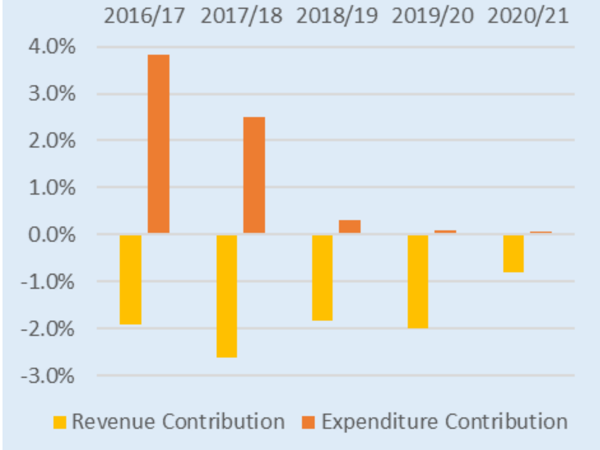


Fig. 13: This is due to revenue optimism rather than excess expenditure



Source: GoK *Budget Review and Outlook Papers* (2017-21); GoK *Quarterly Economic and Budgetary Review* Report (2021). **Note:** Yellow bar (-ve) show the additional fiscal deficit (in % of GDP) caused by revenue optimism. Orange bar (+ve) show the reduction to the fiscal deficit caused by under-execution of expenditure.

Counties are highly dependent on transfers from national government and collect relatively little revenue directly, resulting in vulnerability to any delays. In 2019-20, the counties expected, on average, 88 per cent of their revenues to come from the national government, with only 12 per cent of their expenditures planned to be financed by own source revenues (OSR).[25] Over-reliance on block transfers (known as 'equitable share') by the county governments can lead to critical services being affected when disbursements from the national government are delayed. In the fiscal year 2020/21, counties faced a cash crisis as they did not receive any equitable share in the first quarter, due to a political stalemate concerning reform of the formula used to determine allocations. This problem has continued into 2021-22, albeit on a slightly smaller scale – as of the end of the first quarter (30th September 2021) counties had only received 16.5 per cent of their equitable share, instead of the planned 25 per cent.[26] Furthermore, counties have consistently failed to meet OSR targets in recent years – on average, around 65 per cent of target between 2015/16 and 2019/20. The underperformance of OSR is linked to capacity constraints, with most counties lacking the skills to forecast and collect revenue effectively.[27]

Expenditure

Public expenditure fell in 2020/21, as the decline in revenues forced the government's hand on cuts, given its limited financing options. After several years of unsustainable expenditure growth, large fiscal deficits and the accumulation of public debt, the government was forced to reduce its budget in 2020/21 by 7 per cent in real terms, in response to the contraction in revenue collection caused the COVID-19 induced downturn. Despite this, the fiscal deficit remained above target at over 8 per cent of GDP. This means that Kenya technically delivered a fiscal stimulus, although this wasn't felt on the expenditure side (it was achieved via temporary tax cuts). Ultimately, the lack of fiscal buffers at the onset of the crisis meant that the government response was more muted than in other countries (e.g. Bangladesh, Indonesia) which may explain the relatively more sluggish recovery projected for Kenya.

Further cuts to expenditure are planned over the medium-term as part of the GoK's fiscal consolidation plan. This would see spending fall to around 22 per cent of GDP by 2024/25 (down from over 28 per cent in 2016/17). Government projections (see Figure 14 and Figure 15 below) indicate that the government plans to cut recurrent spending and transfers to counties, while maintaining the development budget at around 5 per cent GDP. Debt interest payments will inevitably continue to account for 4-5 per cent of GDP, but should reduce over the medium term if future deficits can be reined in. Per capita spending is expected to rise from 2023/24 onwards, but only at a very slow rate and will not recover to previous levels for some time (see Fig. 15). Although these targets are not impossible to achieve, it remains to be seen whether they are carried forward in upcoming annual budgets, given the government's previous unwillingness to begin consolidation efforts and considering the upcoming general election in 2022. Unlike revenue, the plan for spending implies a significant departure from pre-COVID expenditure management.

Fig 14: Recurrent expenditures and county transfers are forecast to be squeezed as part of fiscal consolidation efforts

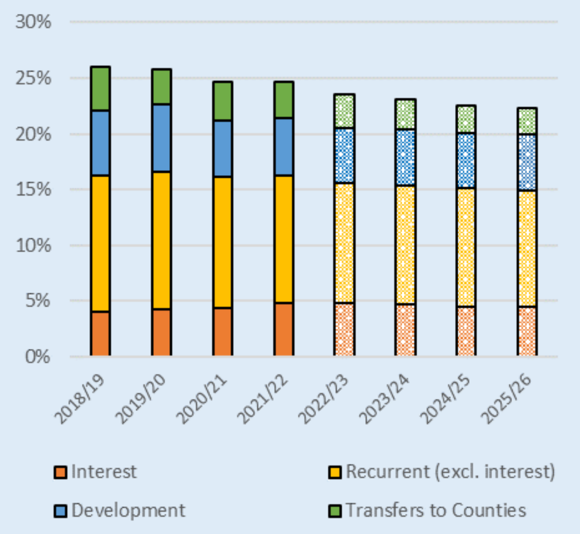
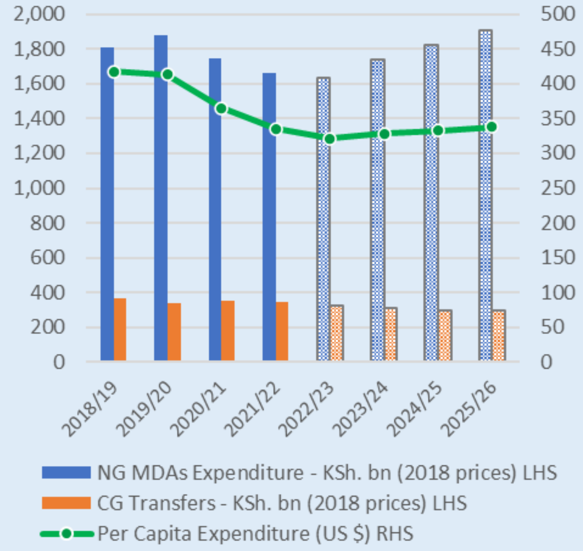


Fig 15: The GoK plans to cut the budget (in real terms) until FY 2023/24, but spending per capita will take longer to recover



Source: GoK *Budget Review and Outlook Papers* (2018-21); GoK *Quarterly Economic and Budgetary Review* Report (2021). **Note**: Fig.15 presents budget for national MDAs and Counties in real terms (2018 prices – LHS) and per capita expenditure (line – RHS) using projections from GoK MTEF and GDP deflator.

Fiscal consolidation is already affecting budgets in the social sectors, which may be cut further in 2022/23 before rising again from 2023/24. Since 2017/18 the composition of public expenditure has been relatively stable, with the health sector increasing moderately as a share of total spending (by 1 percentage point). The most significant increase has been to general public services (which includes debt interest payments) while education and social protection have fallen as a share of total expenditure. However, in the 2021/22 budget, some of the social sectors (including health) received a budget cut, as part of a broader push to bring down the fiscal deficit (see Figure 17). Given that current fiscal consolidation plans indicate further expenditure cuts in 2022/23, it is likely that the social sectors will experience more pain before spending increases are possible. This seems especially the case for the health and agriculture sectors, given that half of their financing comes from county budgets, which are dependent on transfers from national government, and which are projected to be cut up to 2025/26 (Fig. 15).

Fig 16: Health accounted for a greater share of spending in recent years, together with general public services

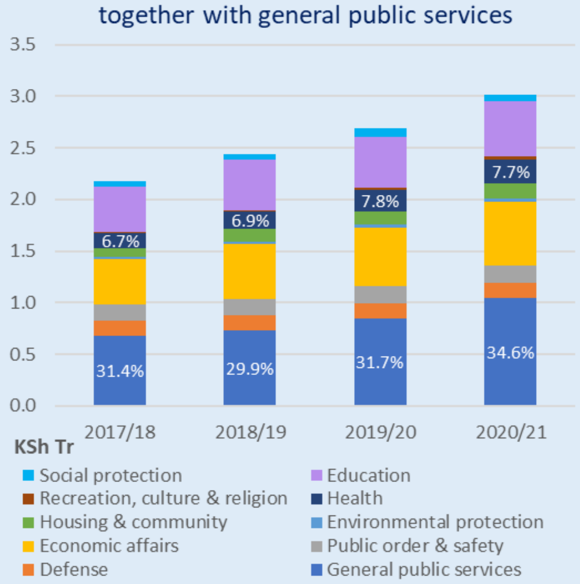
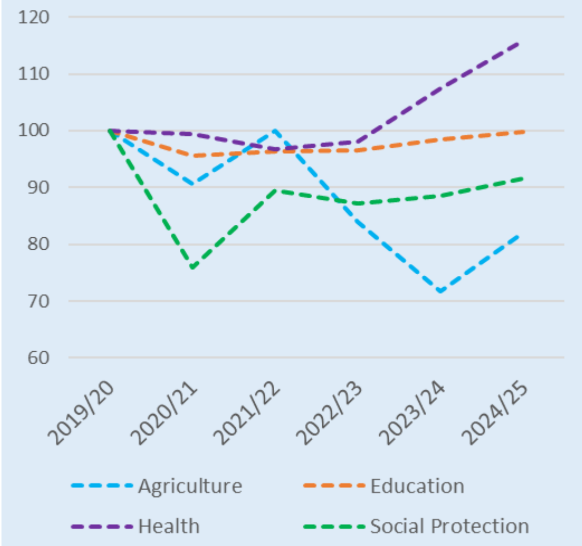
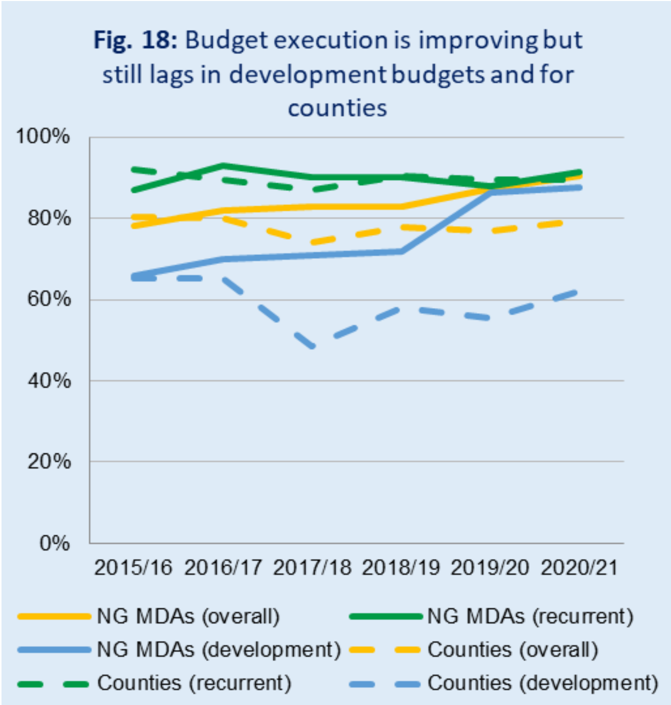


Fig. 17 Projections suggest that per capita *national* spending on social sectors will take time to recover



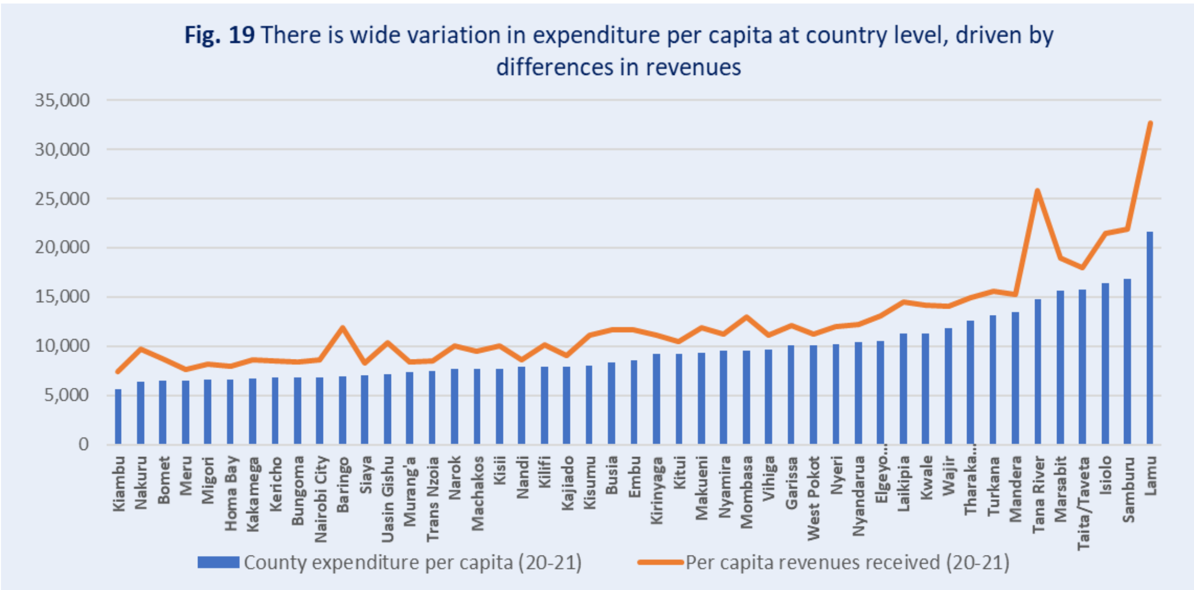
Source: Fig. 16 uses data from the KNBS Economic Survey (2021). Fig 17 uses data from National Treasury. Fig. 17 creates an index and illustrates the evolution of real per capita spending in four sectors (at the national level only).



Source: *COB BIRR & CBIRR (FY 2015/16 – 2020/21).*

Budget execution rates have improved gradually overall, but counties continue to underspend, notably on development budgets. While improving at the national level from 66 per cent in 2015-16 to 88 per cent in 2020-21, development budget execution has deteriorated at the county level, falling to as low as 56 per cent in 2019-20 before a gradual increase to 62% in 2020-21. Despite improving overall, in some counties execution was under 50 per cent (Baringo at 27%, Narok at 32%, Tana River at 38%, Kisumu at 41%, Uasin Gishu at 44%, Lamu at 44%, Busia at 46% and Nakuru at 48%). The expenditure on development activities in 2020-21 (KSh.116 billion) translated to 29 per cent of overall county expenditure, just shy of the 30 per cent minimum requirement set out in the Public Finance Management (PFM) Act (2012).

There are significant inequalities in expenditure per capita between counties, driven by variations in revenue. Expenditure per capita is unequal across counties, driven by variations in revenue received. Spending per person in Lamu County was nearly four times that of Kiambu County. Counties with the highest per capita spending tend to be those with the lowest population; for example, the population of Kiambu is about 17 times larger than Lamu.



Source: COB BIRR (2019-21) and KNBS Census report, 2019

In summary, Kenya is facing a difficult period of fiscal adjustment, predicated on a recovery to revenue performance and painful expenditure cuts. *Several years of loose fiscal policy combined with revenue optimism contributed to large fiscal deficits and the build-up of public debt, even before the impact of the pandemic hit. This led to an erosion of fiscal buffers during a period of strong growth, resulting in the government being unable to mount a significant fiscal response to the crisis, precisely at the time that it would have been beneficial. With public debt now at very high levels, and interest payments accounting for an ever-higher proportion of the budget, Kenya is now vulnerable to another shock. Delaying fiscal consolidation further – as has happened in previous years – is becoming increasingly difficult, as reflected by the cuts to expenditure approved in the 2021/22 budget. Assuming a recovery in revenue to pre-pandemic levels, but no further improvements thereafter, more expenditure cuts will be necessary in 2022/23, before they can rise again – albeit at a more moderate pace – from 2023/24. The focus of the cuts appears to be on the recurrent budget and county transfers, which are likely to have a significant impact on service delivery. This is especially the case for health and agriculture, which are predominantly county responsibilities. While the overall fiscal consolidation plan is realistic, it will not be easy politically. Fiscal consolidation cannot be delayed much longer, perhaps one more year until after the 2022* *election. Revenue could be increased by reversing exemptions and other historic measures, but if it isn't, expenditure cuts will be the main tool for achieving fiscal sustainability.*

Agriculture

The total budget for agriculture fell in 2020/21, which, together with execution problems at the county level, resulted in significantly lower expenditure than previous years. Agriculture is primarily a county responsibility, with the national government leading on policy and assisting county governments on sustainable agricultural development for food security. The share of county budgets going to the sector stood at 11 per cent in 2020/21, while the national government allocated just 3.4 per cent – a lower share than in 2019/20 at both levels. Looking at both levels of government together, allocations to the sector amounted to 5 per cent of consolidated budgets in 2019/20, considerably lower than the benchmark of 10 per cent set out in the Maputo Declaration.

The sector has been faced with several food security challenges in recent times, which have not been matched with commensurate additional funding. Most recently, a national disaster was declared on 8th September 2021, due to a major drought in the arid northern region of the country. Over two million Kenyans are estimated to face the risk of starvation, after poor rains between March and May resulted in poor harvests.[28] This follows the desert locust invasion in 2020, which coincided with the disruption caused by the COVID-19 pandemic, and the extreme weather and flooding in 2019.[29] Despite these threats to food security, the sector did not received additional resources in the post-COVID supplementary budget of 2019/20, and the budget at national level has remained flat in real terms in 2021/22.

Nutrition

Undernutrition remains a significant problem for mothers and children in Kenya. The most recent Global Nutrition Report finds that Kenya is on track to meet four of the global nutrition targets for which there is sufficient data to assess progress.[30] Nevertheless, undernutrition among children is still a concern, with almost one in four children under five being stunted (although this is lower than the 29 per cent average for the Africa region). It is estimated that child undernutrition costs the economy 6.9 per cent of GDP through its effects on health, education, and productivity. The COVID-19 crisis has interrupted the improvements made in reducing undernutrition, as critical health and nutrition services were disrupted due to fears of contracting the disease and inadequate support for health workers. This has lifetime implications for these children's health and economic outcomes and will have implications for future economic growth for Kenya.

Proven, effective nutrition interventions lack sufficient coverage, due to insufficient funding. Costed plans of action for nutrition are in place at the national level (via the Kenya Nutrition Action Plan for 2018-2022) and in some counties, such as Busia, Vihiga, Nandi, and Makueni. However, rapid surveys on nutrition interventions have shown major gaps in coverage of key nutrition interventions, which if offered at scale would have positive impacts.[31] An analysis of trends in nutrition spending in Kenya is complicated by cross-cutting nature of the sector and the split in responsibilities between the national and county governments. However, current estimates suggest that Kenya only meets about 10 per cent of the estimated required financing for scaling up high-impact nutrition-specific interventions. The non-profit sector continues to be a significant source of funding for nutrition programs across Kenya, and out-reach to vulnerable households remains a large part of their work. There is, and will likely remain, a high dependency on external sources of financing for nutrition, in particular for nutrition-specific programmes (in 2017, only 10 per cent of public spending on nutrition in health accounts was from the government).

WASH

Despite some recent progress, there are significant gaps in water access and sanitation in Kenya. According to the latest data from the WASH joint monitoring programme, rural water supply coverage improved from 48 per cent in 2015 to 52 per cent in 2020 countrywide.[32] However, the improvement in sanitation has been more muted, with the percentage of Kenyans living in rural areas that have access to safely managed sanitary services rising only half a percentage point over the same period to 29.5 per cent.[33] Further progress is held back by a lack of funding: a study by the United States Agency for International Development (USAID) estimates that Kenya requires US$12.9 billion to achieve universal access to water, hygiene and sanitation by 2030, but there are only US$ 5.6 billion in available government funds, leaving a US$ 7 billion gap.[34]

Tracking WASH funding is difficult in Kenya, due to changing administrative structures and the lack of a dedicated budget programme for the sector. The Constitution of Kenya assigns responsibility for water resources management to the national government, while devolving the provision of water and sanitation, including hygiene services, to county governments. In Kenyan budget documents, responsibility for providing water services is sometimes merged with irrigation, natural resources, or both, while in other instances health and sanitation are amalgamated. It is therefore not possible to track WASH spending at the national and county level through routine budget documents, or to measure progress against funding commitments.

COVID-19 increased the need for basic hygiene, but the limited additional spending measures enacted in response did not extend to WASH. The pandemic called for WASH-related interventions like safe water and hygiene services supply, adequate preparedness, and communication to promote handwashing, safe water, and hygiene. It also called for rapid low-cost water service provision, coupled with emergency response to communities, to allow them to fulfil their basic needs. However, in Kenya the COVID-19 funds that were included as part of the 2020/21 budget included very little for WASH.[35]

Gender

Kenya has a solid policy framework for gender equality but is not yet practising gender responsive budgeting (GRB) and been cutting expenditure to the sector. Kenya upgraded its National Policy on Gender and Development through a Sessional Paper in 2019. The policy is anchored in international and national laws, with the aim of achieving gender equality and women's empowerment in national development. However, despite the existence of GRB guidelines, there has so far been no attempt to monitor spending to provide a holistic view of what share of public resources are promoting the policy's gender equality goals. This has likely not been helped by recent budget cuts to the key agencies responsible for gender equality – following a cut of 23 per cent in 2020/21, the State Department of Gender has suffered from a further cut of 5 per cent (in nominal terms) in 2021/22. The responsibility for overseeing gender at the county level is subsumed under a broader set of departmental responsibilities and so spending cannot be determined through routine budget data.

The impact of COVID-19 was disproportionately felt by women and girls. According to a recent report, 20 per cent of women lost their jobs or suffered from a loss of income, compared to just 12 per cent men.[36] More broadly, COVID-19 resulted in an increase in gender-based violence and teenage pregnancies, and a decrease in health-seeking behaviour. Pregnant women and girls were impacted the most, especially those who had to forgo antenatal services due to the fear of contracting COVID-19.[37] The government's economic recovery strategy – which contains ambitions for gender mainstreaming post-COVID initiatives – should help to address some of these problems, although it remains to seen how commitments will be turned into specific programmes.

PFM Performance

The PFM system in Kenya still faces some critical weaknesses, as highlighted by the latest Public Expenditure and Financial Accountability (PEFA) report. The recently published PEFA report identified numerous weaknesses in the PFM system. Amongst these are substantial deviations between budgets and outturns, primarily because of the priority given to aggregate fiscal stability over service delivery (i.e. the Treasury will introduce delays in releases of resources during the year in response to revenue shortfalls and/or unexpected extra expenditure demands, which has a negative impact on service delivery). It also noted that revenue administration continues to underperform, as does public investment management, and that medium-term budget allocations are unreliable, and audit reports are often late and recommendations not followed up. The assessments also identify a few key strengths, such as the orderly budget preparation process (discussed below), and some areas of notable improvement, including the existence of costed strategies in all sectors, as well as wider use of competitive procurement methods.[38]

The PFM reform agenda is addressing these but capacity constraints and insufficient prioritisation have hindered progress in the past. The current fiscal pressures arising from the pandemic might focus efforts. The National Treasury's Strategic Plan proposes some corrective measures to address the shortcomings flagged in the PEFA. For example, the plan aims to streamline the initiation, execution, and delivery of public investment projects, and to boost revenue collection through more technology and reforms to enhance own-source revenue at the local level.[39] However, as noted in the PEFA, past progress in implementing PFM reforms has been slower than planned, partly because of capacity constraints, and insufficient prioritising and sequencing of reforms, taking into account these constraints.[40] It is possible that the heightened fiscal constraints imposed by COVID-19 may bring the necessity of these reforms into sharp relief.

The national government has continued to make efforts to strengthen budget transparency, but county information is limited. The 2019 Open Budget Survey shows that the national government is moving towards making publicly available most of its budget information, with Kenya's score on transparency increasing by four points, from 46 to 50, between the 2017 and 2019 Open Budget Surveys, due mainly to the new publication of in-year reports (the global average score is 45).[41] Audit reports, however, remain only for internal use. At the time of writing, county governments had not made their FY 2021/22 budgets publicly available, and there continues to be no 'one-stop shop' for accessing country budgets. Some consolidated information is published in the Office of the Controller of Budget's County Budget Implementation Review Reports (CBIRRs), but offer purely financial data, and come with a three- to five-month lag.

Kenya's public finance systems are generally ill equipped to respond to emergencies. Kenya is prone to emergencies, including drought, floods, landslides, epidemics, terrorist attacks, and major accidents. Poor coordination between state departments leads to coordination challenges, and agencies mandated to handle emergencies in Kenya are confronted with limited budgetary allocations. This often leads to funds being diverted from development expenditure in the case of emergencies, as happened following the 2016 drought, and as happened in 2020/21 in response to the pandemic. At the county level, the PFM Act 2012 allows the County Executive Committee Member for Finance to establish an emergency fund. However, since this is not a requirement, and due to fiscal space constraints, few counties have done this, being unable to countenance the opportunity cost of setting funding aside. As such, counties often resort to supplementary budgets, reallocating monies meant for development projects, which further worsens budget credibility.[42]

III. Aid update

Official Development Assistance (ODA) has been on the decline in recent years, but increased in 2019. ODA increased by 20 per cent in 2019 in nominal terms, driven by increases to the agriculture, production and energy sectors. The health sector accounts for a high proportion of total aid but has declined since 2017 (from nearly $1bn to just over $700m in 2019). Net ODA received in 2019 was 3.7 per cent of GDP – an increase from 3.5 per cent in 2018 – and remains a more important source of foreign financing than FDI, which declined from 1.9 per cent of GDP in 2018 to 1.4 per cent in 2019. The largest donor over the period 2010-19 is the United States, accounting for 29 per cent of disbursements, followed by the World Bank at 19 per cent. However, grants from the United States fell in 2019 by 19 per cent, while grants from World Bank doubled.

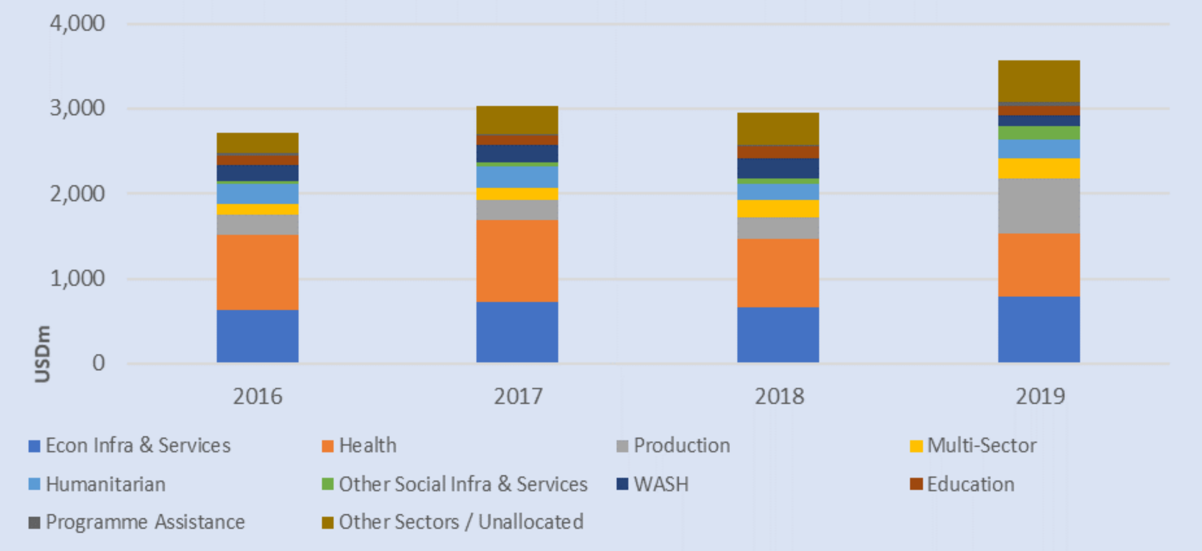
Kenya received significant COVID-related ODA in 2020, which may be offset by future reductions. Pandemic specific disbursements were equivalent to 1.7 per cent of GDP in 2020/21. Much of this was made possible by bringing future years' allocations forward, meaning there is a risk of a reduction in ODA for Kenya from 2021/22 onwards. Should this fall below pre-COVID levels, this would act as an aftershock that slows recovery and adds to fiscal pressures. Therefore, ensuring sufficient flows of development finance to Kenya over the medium term is an important issue for the government and donors to engage on, including through fora such as the OECD's Development Assistance Committee.

Table 2: ODA disbursements by sector

Donor(s)	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	%
United States	659	818	922	987	878	766	861	898	850	689	28.7
World Bank	216	247	283	460	542	489	467	591	748	1,494	19.1
IMF	0	293	208	205	0	0	0	0	0	0	8.1
Japan	95	123	172	316	112	249	165	168	228	290	6.6
AfDB	99	154	191	238	220	269	207	204	186	89	6.4
UK	116	131	165	232	197	217	182	206	154	172	6.1
Germany	87	156	351	106	112	76	92	129	94	92	4.5
France	130	98	106	170	113	107	92	79	111	129	3.9
Sweden	42	63	66	64	59	63	52	60	52	49	2.0
Global Fund	64	25	77	111	111	119	111	173	85	114	3.4
Other	379	509	534	581	502	522	479	524	448	445	17.0
Total	**1,888**	**2,616**	**3,075**	**3,470**	**2,846**	**2,877**	**2,708**	**3,032**	**2,955**	**3,563**	**100**

Source: OECD Creditor Reporting System (CRS)

Fig. 20 ODA is dominated by the economic, health and production sectors



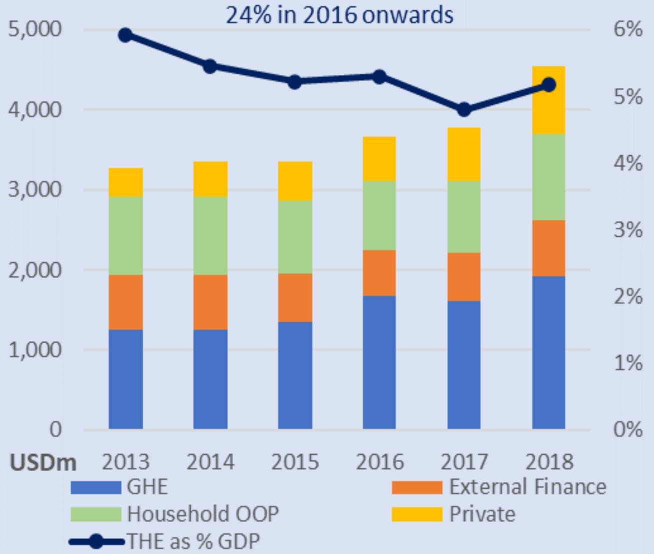
Source: OECD Creditor Reporting System (CRS)

IV. Health drill-down

The health sector in Kenya is primarily funded by the government and households' out-of-pocket (OOP) expenditures, averaging 41 per cent and 26 per cent of total health expenditures (THE) from 2013 to 2018, respectively. Household OOP spending declined from 30 per cent of THE in 2013 to reach 24 per cent in 2016 and has stagnated at same level up to 2018. This is a positive movement for reducing citizens financial risks when accessing healthcare. However, the nominal increase in OOP per capita spending from $19 in 2017 to $22 in 2018 increases the risk of people being pushed into poverty because of unexpected illness that requires them to use up their life savings, sell assets, or borrow.

Official health funding has increased in recent years but still does not meet international norms for Universal Health Coverage (UHC) in 2018. Per capita official health funding for Kenya stood at US$ 55 (US$ 40 from GoK plus US$ 15 from donors) in 2018 having increased from US$ 49 in 2017 (US$ 35 from GoK plus US$ 14 from donors). This is still below the international official health funding benchmark of US$ 86 per capita that is required to achieve UHC.[43]

Fig. 21 THE is equivalent to 5.2% of GDP, with OOP spend declining from a third in 2013 to 24% in 2016 onwards



Source: WHO Global Health Expenditure Database (GHED)

The 2020 roll out of UHC has increased government spending on health and the utilisation of public health services. Kenya begun the roll-out of UHC to all 47 counties in 2020 after the conclusion of a one-year pilot in four counties in 2019.[44] Government budget data shows the additional health spending due to the roll out of UHC, with GHE reaching US$ 44 per capita in 2020/21, up from US$ 24 in 2015/16. Lessons from the pilot showed an increase in utilization of services from 20 per cent to 50 per cent.[45] However, this implies that many Kenyans remain unable to access services due to financial constraints. Additionally, it is difficult to see how UHC can be achieved without a substantial increase in government spending, at a time when donor support is declining (see Fig. 20 above).

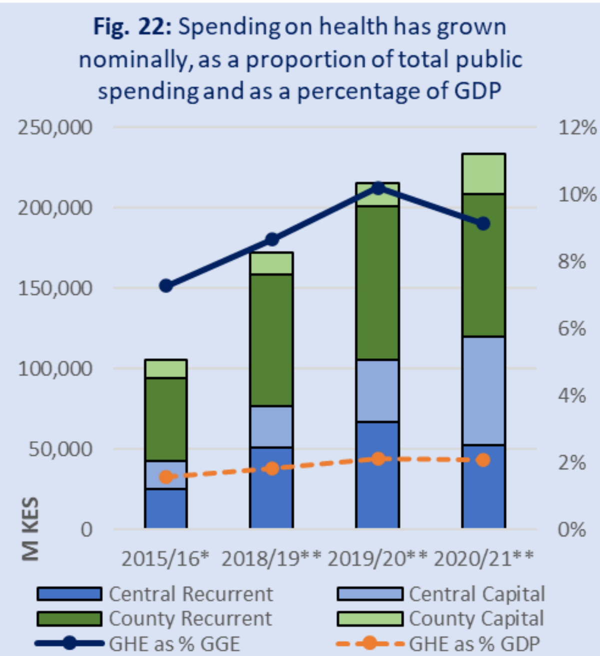
Table 3: Government Health Budget and Expenditure Data (Million KES)

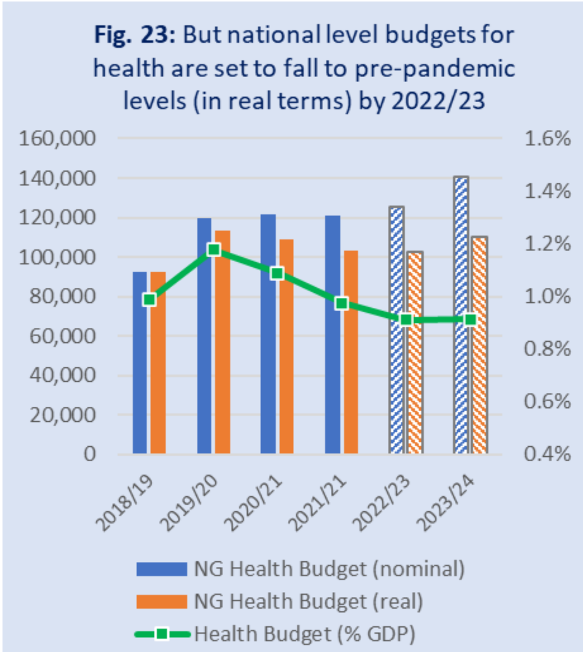
	2015/16	2018/19	2019/20	2020/21	Av. ER (%)
Total Health Budgets	**146,359**	**215,040**	**248,549**	**243,692**	**88%**
National	61,736	92,480	119,858	119,196	87%
Recurrent National	*29,195*	*53,199*	*76,097*	*67,084*	*94%*
Capital National	*32,541*	*39,281*	*43,761*	*52,112*	*77%*
County	84,623	122,560	128,691	124,495	85%
Recurrent County	*68,545*	*96,559*	*104,022*	*99,661*	*89%*
Capital County	*16,078*	*26,001*	*24,670*	*24,834*	*70%*
Total Health Expenditure	**105,807**	**171,772**	**215,253**	**233,482**	
National	42,272	76,632	105,405	106,503	
Recurrent	*25,199*	*50,793*	*66,653*	*66,452*	
Capital	*17,072*	*25,839*	*38,751*	*40,051*	
County	63,535	95,139	109,848	113,678	
Recurrent	*51,554*	*81,560*	*95,578*	*88,934*	
Capital	*11,981*	*13,579*	*14,323*	*24,744*	
Execution Rate (%)	**72.3%**	**79.9%**	**86.6%**	**95.8%**	

Source: BROP (2016-21), Economic Survey 2021, BIRR Reports, QEBR FY2020/2021, Approved 2021/22 PBB

Fiscal space for health is being squeezed in the medium-term budget. Spending on health rose in 2019/20 and 2020/21 to cover UHC and COVID response requirements. According to available government data, approximately 50 per cent of this growth was attributable to COVID requirements.[46] However, current medium-term budget projections indicate that allocations for health at the national government level will decline in real terms over the next two fiscal years to reach the same level as 2018/19 – this means when measured as a proportion of GDP, health spending will decline. Combined with cuts to fiscal transfers to counties (Figure 15), low execution rates, declining ODA to the sector, the discontinuation of conditional transfers in health (to be merged with the equitable share) and a normal rate of population growth, this implies that public spending per capita on health will decline over the next 2-3 years.

Budget allocations to health are insufficient to meet COVID-19 vaccination needs. The budget for FY 2021/22 allocated KSh 14.3bn for vaccine roll-out.[47] This is insufficient, according to the National COVID-19 Vaccine Deployment Plan, which aims to vaccinate the whole adult population by the end of 2022. According to this plan, a total of KSh 46bn is required.[48] This is complicated further by the major challenge of global vaccine supply chain; so far, Kenya has received only one quarter of the expected vaccines.[49]





Source: Fig. 22: National data from BIRR reports. *County data from UNICEF (2017) PER Health, Water and Sanitation. **County data are an estimate based on administrative breakdown of county budgets in CBIRR. Fig. 23: Medium Term Expenditure Framework Report (Period 2021/22 2023/24); Approved 2021/22 PBB. Note: At county level, some departments have responsibilities beyond health (e.g. the Department for Health and Sanitation) so this may be an overestimate. This is likely to explain the inconsistency between Fig. 21 and Fig. 16.

V. Institutional update

In Kenya, several key laws guide the workings of the public financial management system; however, these are not always adhered to. The overarching PFM framework features in Kenya's new Constitution (2010) which establishes a set of principles that spell out the role of the public finances in promoting an equitable society, public participation in the budget process, and transparent financial reporting. The Public Financial Management Act 2012 provides for the effective management of public finances, which is operationalized in the 2015 Public Finance Management Regulations, for both national and county governments. Another key law has been the Public Finance Management (COVID-19 Emergency Response Fund) Regulations, 2020 which established the COVID-19 Emergency Response Fund, to provide for a framework to mobilize resources for an emergency response towards containing the spread, effect and impact of the COVID-19 pandemic.

Despite having measures in place to ensure strong management and oversight, emergency procurement during the COVID-19 response was marred by cases of non-compliance. One case that received wide media attention was the abuse of the emergency procurement process by the Kenya Medical Supplies Authority (KEMSA). Following the revelations of the COVID-19 'millionaires' documentary[50] and other enquiries about corruption, a special audit of the utilization of COVID-19 funds for the period 13 March – 31 July 2020 found that KEMSA had improperly used UHC funds for COVID-19 procurement.[51] The office of the auditor general also conducted a special audit to confirm whether public funds for combating the COVID-19 were used in a manner that is lawful and effective.[52] The review established there were inconsistencies in procurement records, raising queries on the authenticity of the transactions, and unsupported payments. The Ethics and Anticorruption Commission claimed that a substantial proportion of COVID-19 relief funds were misappropriated and recommended the prosecution of at least 15 top government officials and businesspeople over alleged misuse of the funds. So far, no action has been taken.[53]

The budget process in Kenya has four major stages. This is reflected in Fig. 23 below, which also illustrates the lead actors and key decision-makers at each stage. The budget process is dominated by the powerful National Treasury (NT). Parliament, mainly through the National Assembly (NA), also play a key role, as provided for in the 2012 PFM Act. Kenya will have a general election in mid-2022 and this will affect the key budget dates for the development of the 2022/23 budget, as shown in Table 4 below. The changes were communicated by the National Treasury through Circular No. 8/2021 – *Guidelines for Preparation of 2022-23 to 2024-25 Medium Term Budget*.[54] The National Treasury has kicked off preparations for the upcoming budget, four months earlier than usual, as it seeks to conclude the process before Parliament breaks for the election, which takes place in August. The president of Kenya, Uhuru Kenyatta, is currently serving his last term in office, along with 22 governors.

Fig. 24: The 4 stages of the budget cycle

Table 4: Key dates in budget cycle (FY runs from July to June)

Event	Usual Date	2022-23
Budget circular issued	30-Aug	19-Jul
Annual development plan prepared; public consultations held	Sept-Oct	
Budget Review and Outlook Paper submitted to Assembly by NT / County Treasury	21-Oct	6-Sep
Budget Policy Statement (BPS) tabled in Parliament (NG)	15-Feb	15-Nov
BPS approved by Parliament (NG); County Fiscal Strategy Paper tabled in County Assembly	28-Feb	30-Nov
County Fiscal Strategy Paper approved	14-Mar	30-Nov
Budget estimates proposed to Parliament (NG and Counties)	30-Apr	31-Jan
Budget appropriations Committees hold hearings and table reports to Parliament	May	March
National/ County Appropriation Act enacted	30-Jun	31-Mar

As a result of fiscal devolution, the sharing of revenues between the different levels of government are now determined annually by law through the enactment of the Division of Revenue and County Allocation of Revenue. The County Allocation of Revenue Act provides for the equitable allocation of national revenue amongst county governments and each January the Commission on Revenue Allocation proposes to the Senate how the revenue allocation should be determined. The third basis of revenue sharing among the county governments since the promulgation of the constitution in 2010 was finally approved by the Senate and was first used in the current FY 2021/22.[55] The proposed basis has varied the parameters (as shown in the table below) upon which the revenue is shared. Due to these changes, it has been perceived to reallocate funds from poorer, less populated, and historically marginalized counties to relatively richer and more populated counties.[56] While the Commission on Revenue Allocation (CRA) is required to professionally determine the technical criteria that should guide the development of the formula and make recommendations to the senate, the role of the senate in deciding on the formula is political. Disagreements had previously prevented several earlier attempts to approve the new formula, but parliament subsequently recommended a phased implementation to ensure that it does not destabilize the functionality of county governments and disrupt service delivery.[57]

The Building Bridges Initiative (BBI) proposes to amend the constitution to increase the minimum share of revenue for Counties from the current 15 per cent of revenue raised at national level to 35 per cent. This process has been stopped by both the High Court and the Court of Appeal as being unconstitutional, but the promoters have moved to the highest court on the land – the Supreme Court – to challenge the decision of the court of appeal and the case is set to begin in January 2022.

Conclusion

Prior to the pandemic, Kenya enjoyed over a decade of robust growth, which enabled the diversification of the economy and a considerable reduction in poverty. However, underlying this growth, economic vulnerabilities began to emerge, including persistently large fiscal deficits and deteriorating revenue performance, leading to the steady build-up of public debt, to levels that could only be sustainable for as long as strong growth was maintained.

The pandemic delivered a shock that brought these vulnerabilities up to the surface. COVID-19 has had a severe impact on the Kenyan economy, through both global and domestic channels. Even by 2023, the economy is projected to be 9 per cent smaller than it would have been without the shock. The government efforts to contain the virus resulted in job losses and reduced working hours, which has had a disproportionate impact on the poor, with poverty levels rising more that the contraction of the economy. Revenue as a proportion of GDP continued to fall, meaning the government once again had to scale down its plans for fiscal consolidation. Fiscal deficits of 8 per cent of GDP in 2019/20 and 2020/21 (estimated) are expected to push debt to over 70 per cent of GDP by the end of 2021/22, with Kenya continuing to be assessed as being at high risk of debt distress by the IMF As a result, fiscal space will be highly constrained for several years.

Government plans to narrow the deficit imply significant cuts to public spending from 2022/23 onwards, at both levels of government. Unlike previous years when public spending was reined in, government intends to protect public investment, with the recurrent budget and county transfers bearing the brunt of the cuts. This would have serious consequences for service delivery, especially for health and agriculture, which have a high share of their budget financed by counties. Whether these plans are implemented as planned remains to be seen, however. Given Kenya's recent history of changing tack on fiscal consolidation plans every year, the actual path of the public finances over the medium-term are subject to considerable uncertainty. Kenya is also vulnerable to climate-related shocks, such as drought or pest infestations, which would make matters even worse should they occur (as they have in 2021, with the declaration of a national emergency in the northern Kenya following a drought).

Issues to monitor in light of this outlook include whether the government is able to stick to the committed path of fiscal consolidation beyond 2021/22. If consolidation does occur, attention should be paid as to whether this is achieved through higher revenues, lower expenditures, or a combination of both – and whether any change in the composition of expenditure is impacting budget allocations to priority sectors. If consolidation does not occur, and revenue collection does not improve as much as expected, careful attention should be paid to the nature of the additional debt sought. Interest payments are already substantial in Kenya, consuming 25 per cent of revenues in 2019/20. Additionally, the disbursement performance of transfers to counties should be closely monitored now that the political deadlock on revenue sharing has been resolved. Official development finance could be an important source of funding to help bridge this gap, alongside much-needed augmentation of revenue collection.

In terms of opportunities, many desirable fiscal adjustments that have eluded Kenya for several years have now become more urgent and if implemented would put the public finances in a more sustainable position. For example, the elimination of some of Kenya's many tax exemptions, built up over several years, would make Kenya's revenue collection efforts more sustainable over the longer term. The development of the new National Tax Policy Framework in 2021/22 should be closely monitored in this regard, as it may signal a turning point in revitalising efforts to improve revenue performance. The National Treasury's PFM Strategy has also been recently completed and provides a roadmap for reforms around fiscal discipline and improving the efficiency in public finance, which will be all the more necessary in the COVID-19 recovery process.

Endnotes

[1] This brief provides an analytical snapshot of the economy and public finances in Kenya. It is based on publicly available data produced by the Government of Kenya and a range of secondary analyses. It is part of a package of 6 country briefs commissioned by BMGF and is intended to provide a common analytical backdrop to BMGF programming in the country.
[2] The lead authors of this brief are James Muraguri, John Nyangi, Winnie Mageto, Bernard Njiri, Jedidah Wanjagi, Gideon Masese, Daniel Ndirangu, Maryanne Wanjiku, Octaviah Wachira, Venessa Dacha, Mulwa Kasangya Reena Atuma. Additional inputs were provided by Nicholas Travis, David Jeffrey, Alex Murray-Zmijewski, Goufrane Mansour, Terry Roopnaraine, William Smith, and Sonya Rabeneck.
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