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Fiscal Policy in Kenya: Looking Toward the Medium-to Long-Term By Kamau Thugge, Peter S Heller, and Jane Kiringai[1] Executive Summary Kenya's authorities, in articulating their vision for the next two decades of Kenya's development, understood clearly that fiscal policy would need to play a critical role in influencing the pace at which the economy will grow and its capacity to deal with the key challenges that will arise over the next several decades.

Domestic policy challenges include a high population growth, rapid urbanization, significant weaknesses in infrastructural capacity, inadequate levels of investments, and pressures for decentralization. External challenges include security risks as well as an uncertain global economic growth environment. Fiscal policy will not only affect macroeconomic stability, but also whether Kenya can transition to a higher economic growth path, reduce its high poverty rate, and address its substantial income, asset, and regional inequalities.

The paper by Thugge, Heller and Kiringai examines whether Kenya's medium-term fiscal policy strategy is responsive to addressing the potential scale of the challenges confronting Kenya, particularly given the inevitable uncertainties associated with the global economic environment. It also takes stock of the impact of recent developments on the viability of the original strategy. Kenya is likely to face in the next two decades and the scope of its policy goals for this period.

Section II will briefly identify both the domestic policy challenges that Kenya's fiscal policy-makers must address in coming years as well as the different potential external policy environments within which these policies

must be formulated. Section III reviews the Government of Kenya's (GOK) fiscal policy strategy, as broadly embodied in its recently issued long-run perspective--Vision 2030, but more concretely in the Medium Term Plan for 2008/09-2012/13 and the Medium-Term Budget Strategy Paper (MTBSP) for 2009/10-11/12.

In particular, it will examine the economic and institutional assumptions underlying this strategy; the policy choices made in terms of the balance between the roles of the public and private sectors; the choice among alternative public spending priorities; the way in which possible downside risks are addressed; the approach to financing fiscal initiatives; and the sustainability of the fiscal and debt strategy. Section IV will then assess whether the GOK's chosen policy strategies appear both responsive to the long-term policy challenges identified in Section II and robust to the downside risks in the external economic environment.

II. Medium to long-run challenges In Vision 2030, Kenya aspires to achieve middle-income status by 2030 through the realization of a 10 percent per annum real growth rate for the period 2012-2030. This is a highly ambitious objective although not an unreasonable aspiration, given the importance of Kenya to the regional economy of East Africa and the many assets that Kenya possesses in terms of its human capital and its industrial, service, and tourism potential.

But achieving this goal will require that Kenya successfully pursue disciplined and ambitious policies that will confront the many domestic and external policy challenges it now faces. It will also require a bit of luck and a bit of skill by Kenyan policy-makers in adapting to the uncertain global economic

policy environment that will undoubtedly emerge in the next two decades. Fiscal policy will need to be finely balanced if Kenya is to achieve the Vision 2030 objectives.

It must facilitate rapid growth—both through the provision of needed infrastructure and human capital—while still being responsive both to the demands of the population for basic public services and the potential downside risks that may emerge. Yet fiscal policy must also be sustainable. Fiscal space will be precious if the various expenditure objectives are to be met without compromising macroeconomic stability or raising doubts about Kenya's solvency. If growth proves less than anticipated—as occurred in 2008 and as expected in 2009—the needed fiscal space may prove inadequate to finance the required government outlays.

Under these circumstances, unrestrained recourse to additional borrowing could jeopardize Kenya's solvency and crowd-out its private sector. a. Domestic policy challenges to which fiscal policy should respond There are several important obstacles that could impede Kenya's progress toward achieving the high growth rate targeted through 2030. First, after years of neglect, Kenya has only recently begun to address the inadequacy of its infrastructure for the realization of a modern, 21st century economy.

Deficiencies exist in terms of Kenya's port facilities, its trunk and secondary roads, its railroad system, its energy plant, and in the availability of clean water and sanitation facilities. While telecommunications has been the bright light of the last several years, there is still much to be done to make the system fully accessible and the proposed undersea fiber-optic cable, The East Africa Marine System, should help in this regard. Vision 2030's

emphasis on rebuilding and creating a productive infrastructure is rightly supported by international observers (e. . , in the IMF's 2009 staff report) and appears responsive to this challenge. [2] But creating this infrastructure will be costly and could easily outstrip the domestic financial capacity of the government if it were to go it alone, justifying the government's interest in seeking public-private partnerships as well as external financial support. Second, while Kenya is blessed with relatively a high quality and deep base of human capital, it has yet to find ways to deploy it more efficiently.

Among African countries, Kenya has always been known for the high aspirations of its population foreducationand the drive of its citizens for self-betterment. But the productivity of Kenya's educational system has long been a source of concern, and the continuing weaknesses in thehealthsystem have meant that infant and mortality rates are still too high, that malaria still poses a heavy health burden, and that the AIDS epidemic has cost Kenya significant losses among its most productive citizens. 3] The success of many Asian countries in realizing high growth rates when they were at Kenya's stage in the demographic transition derived from their ability to productively employ the rising share of the working-age population. Strengthening the quality and exploiting the productive use of Kenya's human capital, particularly looking forward, must thus be a high policy priority. Third, governance concerns remain an obstacle to Kenya fully exploiting its growth potential through foreign investment inflows.

While the World Bank's " Doing Business Indicators" suggest some improvements in creating the conditions for a receptive foreign investment climate (with Kenya ranking among the world's top ten reformers in

2006/07), Kenya still ranks only 82nd on this index out of 181 countries, and ranks 147 out of 180 countries in terms of Transparency International's index of perceptions of corruption for 2008. [4] Prioritizing and effectively carrying out the necessary institutional reforms, while not requiring substantial fiscal resources, may still prove costly and difficult in political economy terms.

More important, it may play a critical role in determining whether Kenya can meet its ambitious investment goals in infrastructure, given that they are to be primarily financed from private sources through public-private partnerships. Fourth, to achieve its target growth, Kenya will not only need to raise significantly its pace of investment (from an average of 19% of GDP in 2005/06 to 2007/08 to over 30% by 2012/13), but also to maintain the relatively low incremental capital-output ratio (ICOR) of about 3 that it has experienced over the last few years.

The latter may prove difficult. Among low and low-middle income countries, an ICOR of about 4 seems the norm (see World Bank, 2009). For the few non-oil-based countries in the world that have experienced growth rates as high as 10% for a sustained period, investment rates have been in the range of 40% of GDP plus (e. g. , China), reflecting a loss of efficiency in capital investment (and thus a higher ICOR). For Kenya to realize more efficiency from its investments, it must demonstrate a concomitant capacity to mobilize human capital resources effectively (e. . , rectifying both the under- and overstaffing of different public service activities), efficiency in the utilization of capital inputs, adequate attention to routine and periodic maintenance of existing infrastructure and a focus on investments that are of particularly high return (the latter influencing the appropriate structure of

Kenya's public and private investment programme). Linked to these issues is the low absorptive and implementation capacity in the key infrastructure line ministries, particularly for foreign-financed projects.

A key challenge that will determine whether the desired change in the composition of expenditure materializes will be the actual implementation rate of the development budget. In the past, actual expenditures have fallen well short of budget estimates, and in particular, absorption of donor development assistance has been very low—usually below 50 percent of budgeted amounts. Increasing the implementation capacity of the infrastructure ministries, and especially that of the Ministry of Roads and Public Works, will, therefore be critical.

Fifth, generating the required financing for a higher level of investment will be a further challenge. A sound fiscal policy will constrain how much can directly be provided from the budget, leading to the acknowledged need to rely on the private sector, domestic and external, for the remaining financing. The modalities by which Kenya provides incentives and deals with the risks associated with public-private partnerships, and improves governance, will determine the extent of foreign capital participation in Kenya's investment programme.

Six, despite the progress made in reducing poverty incidence from 57% in 2002 to 46% in 2006 (MTBSP, paragraph. 14), Kenya still faces high income and asset inequality as well as significant regional inequality in incomes and assets. While rapid growth over the next two decades would do much to reduce absolute poverty levels, the number of absolute poor will still remain substantial. Together with continued high inequality, this would constitute a

significant drag, in political economy terms, on Kenya's ability to obtain popular support for an ambitious resource mobilization and savings effort.

Certainly, unless addressed, income inequality will constrain growth in the country, dampen the scope for poverty reduction and create an environment for social and political unrest. Seventh, and linked to the latter point, current fiscal decentralization efforts to address regional inequality through the use of a devolved funds mechanism are subject to potential vulnerabilities. In principle, through community-based projects, such an approach can have a positive impact on grass roots[5] support.

However, slippages in governance and accountability, efficiency, or effectiveness in the use of devolved funds could undermine their potential impact, with political pressures engendering spending programs that would not normally meet benefit-cost criteria or address the existing regional maldistribution of resources. In the medium term, three potential threats to the effectiveness of a devolved funds approach require attention.

First, is the poverty-weighted allocation criteria, which effectively incentivises constituencies to be ranked poor in order to qualify for a higher share of the devolved resources. Second, the provision of such 'free' budgetary resources may dampen revenue generation efforts at the local level. Third, the disconnect between community-based projects and the provision for operations and maintenance within the central budget can limit efficiency and effectiveness in the use of these funds[6].

All of the above factors might be considered as relevant in formulating current budgetary policies. But Kenya also confronts other future



developments that can easily undermine the long-term capacity of the economy to sustain rapid growth. These include:

- The rapid rate of urbanization: By 2025, Nairobi and Mombasa will have to invest in urban infrastructure (e. g. , housing, water, sewage, transport, schools and health facilities) to accommodate a virtual doubling of their populations. 7] The size of other urban centers will more than double by 2025 (from 3. 8 million to 9. 3 million). [8] Overall, the urban population is projected to triple to 21-22 million. Such urban infrastructure investments are likely to be of a lower overall productivity (thus implying a higher ICOR), further constraining the prospects for achieving the high efficiency level required to realize a 10% annual growth rate.
- The continued high overall population growth rate: Kenya's fertility rate of 5 is high.

The population aged 5-14—the prospective primary and secondary school-age groups—is anticipated to rise during 2005-2030 by at least 60 percent (more than 5. 2 million children). This highlights both the prospective increase that will be needed in spending on Kenya's primary and secondary school system and the substantial expansion that is likely to be needed for tertiary education facilities. The latter will be particularly costly, and will put enormous pressure on the education budget (with one tertiary student costing the equivalent of 40 primary students).

Without policies that will encourage a reduced fertility rate, Kenya's capacity to create fiscal space by shifting the composition of government expenditure towards growth-enhancing investments will be severely limited.

- The pressures for job creation arising from population growth: In the next 6 years, Kenya's education system will produce at least 14 million new school

leavers seeking jobs. While the public sector cannot be responsible for their employment, government expenditure policies will need to be sensitive to the job creation possibilities associated with the realization of the government's expenditure program.

This burgeoning employment challenge also highlights the importance associated with a successful transition to a high growth policy framework, since this will be the key to meeting the continuing pressure for job creation over the medium- to long-term.

- Cost pressures in the public sector: as with most middle-income and industrial economies, rapid productive growth in the economy typically will outpace productivity growth in the government sector.

As wages in the public sector respond to market wage developments in the private sector, this will create cost-push pressures on public service delivery (particularly in the social sectors) (the so-called “ Baumol effect”), pushing up the recurrent cost budget and generating further need for a higher revenue share.

- The looming costs of climate change: Recent World Bank reports suggest that Kenya is among the countries most at risk from an increased frequency and intensity of drought conditions.

Addressing the potential deleterious effects on agricultural productivity will require a combination of intensified investment in water-control systems that promote enhanced efficiency in the use of water resources; a further shift in the role of nonagricultural outputs (and thus a capacity to become competitive in earning the foreign exchange required for a higher level of food imports); and new R&D efforts at promoting agricultural techniques robust to drought and uncertain precipitation conditions.

Given the importance of Mombasa as Kenya's principal port, the probability of a sea level rise raises the question of when it will become necessary for Kenya to undertake the investments required to cope with the potential longer-term damages to Mombasa and what alternative approaches might be needed to ensure a continued viable port capacity. Less of a challenge and more of an opportunity is the possibility that Kenya might be able to exploit its comparative advantage with respect to solar and geo-thermal energy generation, and earn additional export and fiscal revenues from selling carbon credits to other high-emission countries. The budgetary risks associated with recognized contingent liabilities: the most obvious include those associated with the pay-as-you-go budgetary funding of civil service pensions; the potential for the National Social Security Fund (NSSF) to be relatively unfunded; and the possibility of losses associated with the parastatal sector. The anticipated effort by the Government to seek public-private partnerships in a number of infrastructure projects carries with it the potential for additional contingent liabilities.

b. External policy challenges

Kenya's ability to achieve its Vision 2030 objectives is not wholly subject to its own making. The global financial crisis which commenced in 2008 has adversely impacted Kenya, and highlighted the importance of external factors in influencing the growth of an economy. Kenya is vitally integrated within the global economy, being dependent on external commodity markets for its exports and critical energy imports, sensitive to the state of global tourism markets, significantly reliant on remittances, a recipient of aid flows, and ambitious in its pursuit of both direct foreign investment flows and possible external credits.

In geopolitical terms, it has already experienced terrorist incidents and is a vital transport hub for many important countries in Central Africa. But of course the future is uncertain, particularly if one is considering policy options looking out more than 20 years. There is, thus, an important argument for seeking a policy program that is robust to potential downside risks and the possibility of very different external environments. One approach to exploring the robustness of the Vision 2030 fiscal strategy is to examine its viability in the context of alternative scenarios of the future.

In 2005, the World Bank undertook just such an exercise to consider alternative scenarios for how the global economy might evolve through 2020. Each of the three scenarios elaborated were meant to constitute “relevant, compelling, plausible, and logically consistent”, but, importantly, divergent stories of what the global economy might look like in 2020. As emphasized by the Bank, “no single scenario will ever come true in its entirety, but if it is to be a valuable stone against which to sharpen one’s strategy, one must believe it just might! Box 3 provides a brief summary of these three different worlds, and section IV will examine more concretely the robustness of Vision 2030 in the context of these scenarios. At this point, what is important to emphasize are the key external policy factors to which the success of Vision 2030 might prove sensitive, and the way in which these scenarios highlight potential issues to which Kenyan policy makers might need to be responsive. Among the key factors that could affect Kenya’s prospects, the following appear most relevant: Robustness of global growth: Kenya’s capacity for mobilizing the fiscal resources required to implement its public investment program (and equally the prospect for the private sector

to also achieve the targeted growth in its investment share) will be strongly influenced by the pace and structure of global growth. Given its dependence on external commodity and tourism services, a slower global growth scenario (such as in the GU scenario) would probably be reflected in slower Kenyan growth, lower fiscal revenues, and the need for a smaller budgetary envelope.

How would the budget be prioritized in such circumstances? Would the same infrastructure and human capital investment priorities be relevant under a lower global growth scenario? Certainly, with the pace of population and urban growth (not to mention climate change) not affected by external factors, the pressure would be to cutback on precisely those investments most likely to generate additional growth and employment!

Moreover, if global growth were to be dominated by a higher share derived from emerging markets, would this adversely affect Kenya (perhaps through reduced tourism from industrial countries)? Would reduced dynamism in the US and European economies imply a lower level of concessional financing, or would Kenya be able to obtain such assistance from alternative sources (e. g. , China and India)? With changes in the pace or sources of global growth, would Kenya still be able to realize the currently anticipated level of direct foreign investment flows?

Would these derive from different sources and if so, would they be directed to the same sectors? | Box 1: Alternative Scenarios for the World of 2020 | | |  
| The following provides a brief summary of how these different worlds will appear, with our focus principally on the character of | | the alternative potential external economic environments facing Kenya. | | | Affluence, Ltd.

(AL) | | Years of rapid, US-centered, economic growth will nearly double world GDP, an annual increase of more than 4 percent. States have | | shifted their focus from guaranteeing outcomes to providing opportunities.

Rapid innovation and new technologies enable continuous | | improvements in productivity, which global corporations spread around the world as they expand. But economic success is not | | universal. Forty less competitive countries have been left behind due to geographic isolation, poor governance, small market size, | | or lack of strategic relevance. For most major economies, however, the United States has guaranteed political stability and open | | trade-conditions that have encouraged the creation of massive amounts of wealth. | GlobalizationUnwinding (GU) | | Through 2020, economic growth has been slow worldwide, averaging less than 2 percent for more than a decade. Weaker states have | | collapsed, as economic pressure translates into domestic unrest, while other states have resorted to authoritarianism or populism | | in order to stay in power. Costs of military interventions, energy price volatility, and years of deficits brought a sharp | | contraction in the US economy, and the consequent dollar crisis triggered a global economic downturn.

Europe and Japan lacked the | | dynamism to lead the world out of recession, while the growth engines of China, India, Korea, and other " emerging economies" all | | sputtered-as did those of Russia and Latin America. Most developing countries have proven unable to mitigate the worst effects of | | the downturn. A deep-seated cynicism about the value of free markets prevails in the world, and economic decisions are generally | | focused on short-term returns. Protectionism grew rapidly following the downturn, and

the path to recovery looks difficult. | | | Competing Horizons (CH) | | | Large emerging markets of China, India, Brazil, Indonesia and much of Southeast Asia have sustained rapid long-term | | growth—particularly in comparison to older industrialized economies—and a second wave of developing countries has joined their | | ranks. The developing world accounted for almost two-thirds of global GDP growth between 2005 and 2020.

Regional economic powers | | have started to contest US primacy in their regions, and in global forums. Poles of cutting-edge R&D have emerged, with growing | | numbers of firms from these high-growth countries rivaling the multinational companies from the United States, Europe, and Japan. | | Many other developing countries have grown rapidly following improved policies and governance and benefiting from rising volumes of | | global trade. However, rising tensions between Old World and New World powers seem inevitable in the medium term.

Despite strong | | networks of trade and continued rising demand for raw materials and basic commodities, growth in parts of the developing | | world—particularly in parts of Africa—remains low. In addition, the environmental costs of broad-based growth are significant: | | accelerating environmental degradation and severe resource constraints for water, strategic minerals, and energy are the order of | | the day. | | | |\* Source: World Bank, Rehearsing for the Future: the World and Development in 2020 (Washington DC, 2006) (www. worldbank. rg/2020) | • Scale of security threats: the alternative scenarios highlight the potential for different degrees of ethnic, terrorist and regional security tensions. Kenya may thus need to be prepared for the possibility of a higher level of security-related military outlays than

presently envisaged under Vision 2030. Depending on the extent of external financial support to deal with terrorism and regional security threats, this may prevent the realization of the current strategy to shift funding away from such “other sectors” for the purpose of creating fiscal space for social or growth-oriented outlays. Nature of the trade environment: the extent to which further global trade barriers are reduced, or rather shifted towards bilateral or regional trading arrangements, may potentially influence the pace of growth and potentially the sources of Kenya’s principal comparative advantage, again influencing both the prospects for revenue mobilization and the focus of the investment programme.

- Importance of governance concerns: Were there to be a shift in the global economic center more towards emerging market countries, there might be a reduced incentive for Kenya to focus as much on governance issues.

However, given the possibility of the AL scenario also arising, and given the merits on political economy grounds for strengthening Kenya’s governance and regulatory system (particularly given the increased role envisaged for PPPs), current strategies would appear robust to the alternative possible scenarios.

- Pace of technological change: Alternative scenarios also suggest differences in the future pace of technological change. This could be important, particularly with respect to certain kinds of infrastructure (e. g. , in the energy and possibly the ICT sectors).

Would the nature of infrastructure investment decisions be influenced by the possibility that newer and more advanced technologies might make existing infrastructure or technologies inappropriate? All of these uncertainties raise the question of whether fiscal policy, to be robust under alternative



scenarios, should be more conservatively managed, particularly with respect to the level of nonconcessional borrowing that would be appropriate in financing the investment program (or more pointedly, in the level of any fiscal debt anchor that might be considered in managing fiscal policy).

They also raise questions as to the core investment programme which would appear appropriate, given the uncertainty as to which scenario might eventuate.

III. Kenya's fiscal strategy underpinning the Vision 2030

A. Background and macroeconomic assumptions

Under the Economic Recovery Strategy (ERS) covering the period 2003-07, Kenya made significant progress in macroeconomic management and in implementing key structural and governance reforms. As a result, the economy staged a remarkable broad-based recovery as growth of real GDP accelerated from 0.5 percent in 2002 to 7. percent in 2007. In the aftermath of the post-election-violence (PEV) in early 2008 and the global economic slowdown, growth fell sharply in 2008 to 1.7 percent. In 2009, the economy is projected to rebound only slightly to 2.5 percent. Underpinning the good economic performance of recent years was the implementation of sound macroeconomic policies, and in particular, through 2007, the pursuit of a prudent fiscal stance in which the overall budget deficit (on a commitment basis, including grants) was contained to an average of about 2 per cent of GDP compared with a target of 3. percent in the ERS. As a result, there was a net domestic repayment of 0.7 percent of GDP in 2007/08, relative to a net borrowing of 3.6 percent of GDP in 2002/03, thereby contributing to a decline in the ratio of net domestic debt to GDP from 23 per cent in 2002/03 to roughly 17 per cent in June 2008. This facilitated a reduction in interest

rates and an expansion of credit to the private sector in support of productive activities.

With the conclusion of the ERS at end-2007, the Kenyan Government elaborated a medium-term development plan, the National Vision 2030, aimed at achieving rapid economic growth and poverty reduction. The vision had three pillars: • an economic pillar whose goal was to achieve and then sustain annual real GDP growth of 10 percent by 2012 with a view to making Kenya a middle-income country by the year 2030; • a social pillar aimed at creating a cohesive society enjoying equitable social development.

This pillar would address inequality and poverty challenges faced by many Kenyans and move Kenya towards achieving some of the Millennium Development Goals; and • a political pillar calling for an issues-based, accountable and democratic political system. Achieving the Vision 2030 growth target would require Kenya to increase its investment share in GDP from about 22 percent in 2007/08 to 33 percent by 2012/13. Over the same period, domestic savings would need to increase from about 16 percent of GDP to 28 percent. Details of the key indicators underpinning the macroeconomic framework are provided in Table 1.

Table 1: Key Macroeconomic Indicators Underpinning Vision-2030 and the Medium-Term Plan

	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Medium-term projections						
(Annual percentage change)						
National accounts and prices	6.2	8.3	9.0	9.7	10.0	
Real GDP	5.7	7.5	5.0	5.0	5.0	5.0
CPI (end of period)	28.5					
(In percent of GDP)						
Investment and savings						
Investment	21.0	21.9	23.3	27.3	29.9	32.6
o/w Central Government	8.2	8.6	8.4	8.6	9.0	9.5

Gross domestic savings	15. 9   15. 1   17. 4   21. 8   24. 6   27. 5	o/w
Central Government	0. 4   1. 6   2. 7   2. 9   3. 2   3.	Central government
budget		Total revenue
	21. 3   21. 6   21. 8   21. 8   21. 9   22. 0	
Total expenditure and net lending		Overall balance (incl. grants)
	29. 4   28. 6   27. 6   27. 6   27. 8   28.	Domestic debt, net (eop)
Total Public Sector Debt	-6. 2   -5. 6   -4. 2   -4. 0   -4. 0   -4. 0	17. 8   16. 8
	16. 5   15. 7   15. 0   14. 3	41. 6   43. 0   40. 2   41. 3   38. 0   38.
External sector		Current account (incl. official transfers)
Reserves (months of import cover)	-6. 0   -6. 8   -5. 9   -5. 5   -5. 3   -5. 1	
		3.   3. 5   3. 7   3. 9   4. 2   4. 5

Source: Ministry of Finance; Medium-Term Budget Strategy Paper, 2008/09-2010/11. The fiscal framework underpinning the Vision 2030 scenario called for increased spending on the critical “flagship” projects, while at the same time ensuring that the overall fiscal deficit (after grants) would progressively narrow from 6.2 percent of GDP in 2007/08 to a sustainable level of around 4 percent of GDP over the medium term. This would allow net domestic debt to decline substantially from 17.8 percent of GDP to 14.3 percent by 2012/13.

The strengthened fiscal position would be supported by the implementation of revenue administration measures by the Kenya Revenue Authority (KRA), which would sustain the revenue-to-GDP ratio at around 22 percent throughout the medium-term. Under Vision 2030, public expenditure was to be restructured in favor of development spending and other priority social interventions. Improved management of public sector finances was expected to lead to a positive shift in investor and creditor confidence as well as to boost growth by providing the fiscal resources to raise public development

spending from 8. percent of GDP in 2007/08 to 9 ? percent of GDP by 2012/13. B. The Medium-Term Plan, 2008-2012 (MTP)[9] To understand how the Kenya government envisaged the role of fiscal policy in its broad vision for development in the coming two decades, it is useful to begin with the first five-year development strategy, the Medium-Term Plan (MTP), issued in 2008 and intended to be the instrument for implementing the Vision 2030 development strategy. Two important elements underpin the MTP. First, the MTP clarified how overall resources in the economy would be allocated among the three pillars and the enabling sectors (i. . the Foundations for National Transformation) during the course of the first five-years of the Vision 2030 (see Annex Figure 1 and Annex Table 1). In particular, it highlighted the overwhelming importance that would be played by investments in infrastructure projects, particularly beginning in 2010/11. [10] While in 2008/09 and 2009/10, 21 percent of the resources was to be on infrastructure,[11] this share was to rise in the three subsequent years to about 60 percent with a heavy emphasis on roads (reflecting the inadequate maintenance and limited construction on new roads during the 1990s and earlier).

The MTP also indicated that (with the exception of a short burst in 2009/10), the social sector would absorb about 20 percent of available resources. Spending on the economic sector pillar was to drop sharply after 2008/09 (being replaced by infrastructure spending), but would then be held roughly constant for the remaining four years of the MTP period (see Annex Table 1). [12] Second, given the limited resources available to Government, the MTP emphasized that the financing of infrastructure should rely heavily on the

private sector through the use of public-private-partnership (PPP) financing initiatives.

For the five-year period, at least 80 percent of infrastructure spending should expect to be financed through PPPs, particularly starting in 2010/11. Thus, the success of infrastructure financing would be predicated on two important fundamentals: first, that domestic savings could be increased from about 16 percent of GDP in 2007/08 to reach 28 percent of GDP in 2012/13 and second, that a legal and regulatory framework for public-private-partnerships could quickly be put in place so investors would feel comfortable about investing in this strategy.

Regarding the latter, we note that a PPP framework has been developed but has yet to be made operational. C. Medium-Term Budget Strategy Paper, 2009/10-2011//12 (MTBSP) Each year, the MTBSP provides much more detail on the government's fiscal framework over the next three budget years, not only in terms of the allocation and financing of the budget for the different government ministries, but more importantly with regard to the key policy objectives. The most recent MTBSP was issued in June 2009 at the time of the Budget

Speech for fiscal year 2009/10. Unlike the MTP, the MTBSP is guided by the need to be prudent on growth prospects to mitigate the risk of being overly optimistic, and in the event that higher than expected growth rates are achieved, the medium-term macroeconomic framework can be modified accordingly, with the higher revenues allocated to priority expenditures. Table 2 below summarizes the main macroeconomic indicators underpinning the more cautious fiscal framework in the 2009 MTBSP.

The table reveals the striking contrast between what had been assumed in the Medium-Term Plan for the next few years and the new assumptions dictated by recent domestic and external developments. Reflecting the domestic and external shocks of 2008 and 2009—the violence following the December 2007 election and the global economic slowdown—real GDP growth over the next three years is now projected to average under 5 percent, much lower than the 6.8 percent projected in the 2008 MTBSP and half the 10 percent targeted under Vision 2030.

Table 2: Key Macroeconomic Indicators Underpinning the MTBSP, 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | Prel. Est. | Medium term projections | (Annual percentage change) | National accounts and prices | Real GDP | 4.0 | 2.5 | 3.1 | 5.2 | 6.4 | CPI (end of period) | 29.0 | 18.0 | 10.1 | 5.9 | 5.0 | (In percent of GDP) | Investment and savings | 19.1 | 18.1 | 19.2 | Investment | 8.2 | 7.6 | 10.2 | 22.1 | 23.3 | o/w Central Government | 13.5 | 11.9 | 14.1 | 8.9 | 9.1 | Gross national savings | 1.7 | 2.3 | 17.3 | 19.0 | o/w Central Government | 3.1 | 3.5 | Central government budget | Total revenue | 22.0 | 22.6 | 22.3 | 22.5 | 22.6 | Total expenditure and net lending | 27.2 | 28.5 | 30.3 | 28. | 28.3 | Overall balance (incl. grants) | -3.5 | -4.9 | -6.6 | -4.5 | -4.2 | Domestic debt, net (eop) | 16.9 | 18.5 | 20.6 | 21.1 | 21.1 | Total Public Sector Debt | 39.3 | 42.6 | 44.5 | 44.3 | 43.8 | External sector | Current account incl. off. transfers | -5.6 | -6.2 | -5.1 | -4.8 | -4.3 | Reserves (months of import cover) | 3.4 | 2.8 | 2.9 | 3.1 | 3.5 |

Source: Ministry of Finance; and the MTBSP, 2009/10-2011/12

With respect to the saving-investment balance, there is also a significant divergence between the MTP's medium-term targets and the revised targets in the 2009 MTBSP. For example, the saving-

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to-GDP ratio is projected to reach 19 percent compared with 24.6 percent in the MTP in 2011/12—a shortfall of 5.6 percentage points of GDP. Similarly, the investment-to-GDP ratio is now projected to reach only 23.3 percent in 2011/12 compared with 29.9 percent in the MTP—a shortfall of 6.6 percentage points of GDP. Virtually all the projected shortfall in both saving and investment are associated with the private sector as public sector saving and capital spending are broadly as envisaged in the MTP. The large projected shortfalls in private sector saving and investment suggests that the Vision 2030 growth objectives are unlikely to be met within the timeframe originally envisaged of 2012/13.

Moreover, unless the level of productivity rises sharply (or the ICOR is reduced markedly compared with the target in the MTP) in the next few years, achieving the growth objectives of the Vision 2030 with lower investment is unlikely to be realized. Therefore, to avoid a prolonged divergence between actual outcomes and the Vision 2030 objectives, it is critical for Kenya to fast track the implementation of key reforms aimed at rapidly improving the investment climate, while putting in place the institutional framework to facilitate private sector participation in infrastructure projects through the PPPs.

Without these reforms, the timeline for achieving the Vision 2030 growth objectives will not only be delayed substantially but could be seriously compromised. As in the previous year, the 2009 MTBSP also aims at maintaining revenue collection at around 22 percent of GDP over the medium term. This is quite reasonable by historical Kenyan standards and

high by Sub-Saharan African standards, and reflects an assumption that revenue collection will keep up with growth in nominal GDP.

No major tax rate increases are envisaged in line with Kenya's intention to maintain a competitive climate for foreign and domestic investors by reducing the cost of doing business. Avoiding higher taxes seems, at this time, to be a reasonable policy position, though the issue of a further increase in the overall tax share will become more important to consider as one moves further into the next decade (as discussed below). The MTBSP rightly takes a cautious view on the availability of grants and concessional loans, which are projected at roughly 3.5 percent of GDP annually through 2011/12.

However, even for this amount of financing to become available, the MTBSP recognizes that improving public expenditure and financial management will be critical in order to give comfort to development partners that their resources are being efficiently used to support economic growth and poverty reduction. The decision to exclude budget support in formulating the medium-term framework is informed by the recent success of having more predictability in budget execution by ensuring that resources allocated to line ministries are not disrupted by the ups-and-downs of donor relations and conditionalities.

This practice has been highlighted positively by Standard and Poor's and Fitch Ratings. However, as the 2008 MTBSP emphasized, the exclusion of budgetary support should not suggest a slowdown in implementing reforms in public expenditure management, in the financial sector, and in the restructuring and/or privatizing of public enterprises. Indeed, the assumed



lower donor inflows should be accompanied by an intensification of the pace of structural reforms, especially in the modernization of tax and customs administration, to ensure Kenya's recent financial independence is sustained in line with KRA's motto of "Tulipe Ushuru--Tujitegemee. "

On the expenditure side, the 2009 MTBSP proposes an increase in overall spending from 28.5 percent of GDP in 2008/09 to 30.3 percent followed by a gradual reduction thereafter to about 28 percent by 2011/12, while simultaneously effecting a slight shift in the composition of expenditure towards development projects. As a result, the share of recurrent outlays in total outlays will have declined from a high of 90 percent in 2002/03 to 80 percent in 2006/07 and to 67 percent by 2010/11. This is consistent with Vision 2030's objective of increased funding for the flagship infrastructure projects while still maintaining macroeconomic stability.

Reflecting the importance of the other pillars of Vision 2030, and in particular, the social pillar, the proposed expenditure profile in the 2009 MTBSP provides for spending on education and health to remain broadly unchanged at around 30 percent of total spending over the medium-term (Table 3). [13] This follows significant increases in resource allocation to both sectors in recent years. Nevertheless, it may still be necessary to provide more resources to both sectors (see below) and this will require careful prioritization of spending to create the fiscal space for the shift in budget priorities.

In particular, spending on other parts of the budget (including public administration, defense, internal security, etc), which is currently projected to remain broadly stable at around 46 percent of total spending, may need

to be rationalized in order to release resources for the social sectors. . | Table 3: Spending on the Social and Economic Sectors (in percent of total expenditure) 1/ | | | | 2007/08 | 2008/09 | 2009/10 | 2010/11 | 2011/12 | | Social Sectors | 28. % | 29. 3% | 30. 4% | 30. 6% | 29. 6% | | Health | 6. 1% | 5. 7% | 6. 8% | 6. 0% | 6. 0% | | Education | 22. 0% | 23. 6% | 23. 6% | 24. 7% | 23. 7% | | Economic Sectors |... | 24. 8% | 22. 9% | 23. 6% | 24. 8% | | Productive, incl.

Agriculture |... | 4. 3% | 3. 5% | 4. 3% | 4. 4% | | Physical Infrastructure |... | 20. 5% | 19. 5% | 19. 3% | 20. 4% | | Other |... | 45. 9% | 46. 7% | 46. 3% | 45. 6% | | Total |... | 100. 0 | 100. 0 | 100. 0 | 100. 0 | / Source: The Medium-Term Budget Strategy Paper, 2009/10-2011/12 Based on the projected revenue and expenditure, the overall budget deficit (after grants) is estimated to initially rise from 4. 9 percent in 2008/09 to about 6 percent of GDP in 2009/10—reflecting the impact of the fiscal stimulus package—and then decline to 4. 2 percent by 2011/12. (see Table 2). It is anticipated that concessional financing, mainly from multilateral institutions, non-concessional borrowing through the issuance of sovereign bonds, and domestic borrowing will cover the deficits.

The projected domestic borrowing (including issuance of domestic infrastructure bonds) would result in a gradual increase in the stock of outstanding net domestic debt from 17 percent of GDP in 2007/08 to about 21 percent in 2011/12. This increase, while necessary in the context of the economic slowdown and government policy response, carries with it the risk of potentially crowding out of the private sector. This could pose difficulties in allowing the private sector to play its role in financing economic activities

consistent with achieving the higher growth path. D. Overall fiscal and debt sustainability

The projected medium-term fiscal deficits are broadly consistent with fiscal and debt sustainability. Throughout the period covered by the MTBSP, the ratio of public sector debt-to-GDP fluctuates within a narrow range of 40-44 percent of GDP, implying that the net present value of debt-to-GDP ratio is well below 35 percent. [14] It should be noted that the issuance of sovereign bonds to fund high-return infrastructure projects does carry some debt sustainability risks arising from the exchange rate, making it important that the projects be subjected to rigorous cost-effectiveness analysis.

Also, some caution may be needed with regard to the timing of issuance of these bonds, given the increased borrowing spreads currently facing many developing countries, as well as the recent and potential further depreciation of the Kenya Shilling against the Euro and the US dollar. Regarding contingent liabilities, a significant amount has already been taken into account in the context of the financial restructuring of the National Bank of Kenya (over Ksh. 21 billion) and during the course of privatizing Kenya Telecom.

However, owing to lack of data, not all potential contingent liabilities from the parastatal sector and from the pension scheme have been included in the debt sustainability analysis. Including such contingent liabilities would increase the official public debt and the risk of the overall public debt becoming unsustainable. Another potential source of contingent liabilities is the Government's planned heavy reliance on public-private-partnerships to finance many of the infrastructure projects for Vision 2030. It will be critical

to ensure that increased use of the PPP framework is well managed and minimizes potential contingent liabilities.

Reliance on PPPs in some instances involves some assumption of the government ultimately, in the future, financing the purchase of the privately-built assets. Moreover, depending on the terms of an individual PPP, the government could bear a number of potential risks associated with each project (demand risk, financing risk, political risk, supply risk, legal risk, etc). The Government appears to be cognizant of this danger, and intends to establish a PPP unit in the Ministry of Finance to vet all new PPP funded projects.

In the meantime, the Government should avoid any new PPP projects before the finalization of the PPP legal and regulatory framework.

E. The Potential Role of PPPs Can and should Kenya realistically rely on PPP mechanisms? First, there are some areas of public infrastructural spending where potentially the private sector may be willing to invest and provide services without the need for a PPP (e. g. , as has already been demonstrated in the telecommunications sector). In other sectors, the challenge is for the government to ensure that the same public policy factors that originally motivated public sector investment and provision, e. . , equity factors, natural monopoly conditions, or externalities, are taken into account in the way in which the private sector produces and delivers services. Here the government's task is to ensure that a clear and well-designed regulatory structure is in place, particularly with regard to pricing policy. Second, private financing in the form of a PPP entails both opportunities and risks to a government, and management of these risks is essential if there is to be a

genuine sharing of both the gains and the associated risks between the public and private sectors.

What makes a PPP attractive to a government is the ability to harness the potential of the private sector to construct and operate a facility with greater efficiency than would be the case for the public sector, with such efficiency gains offsetting the presumably higher borrowing or equity costs associated with private as opposed to government borrowing. Such efficiency gains are particularly relevant when the private sector can bundle the construction and operating phases of a project, thus allowing for internalization of cost-reducing incentives (Scandizzo and Sanguinetti, 2009).

At the same time, by substituting the private sector for public provision, the government can also save scarce public funds and relieve strained budgets. But PPPs can also be used, inappropriately, to bypass spending controls and move public investments off budget and debt off the government's balance sheet. This could leave governments bearing most of the risks involved and face large fiscal costs over the medium to long term.

Experience in other countries suggests that to work effectively and for a PPP to be an appropriate approach, several key prerequisites should be satisfied: the quality of services should be contractible; there should be competition or incentive-based regulation; as noted, there should be an appropriate distribution of risks; the institutional framework should be characterized by political commitment, good governance, clear supporting legislation (including with regard to pricing); and a transparent procedure for award of performance incentives and enforcement of sanctions throughout the concession period.

Finally, a government needs to have a capacity, both in the finance and sector ministries, to effectively appraise and prioritize public infrastructure projects; design PPPs; evaluate affordability, value for money and risk transfer; correctly select those projects that are appropriate to undertake as PPPs; draft and scrutinize contracts, monitor, manage and regulate ongoing projects, and undertake periodic performance evaluations (see Sutherland et al, 2009; Scandizzo and Sanguinetti, 2009; IMF, 2004; and Tchakarov, 2007).

This underscores the importance of Kenya moving at a deliberate pace to put in place a strengthened management capacity in the Ministry of Finance and given, past governance failures, caution to ensure that the government sector is not burdened with excessive risks that ought legitimately to be borne by the private sector. In terms of negotiating the distribution of risk, the experience of Latin American countries with PPPs suggests that some are appropriately borne by the private partner—those associated with the construction or the operation of the project in particular.

Others, such as political and regulatory risk, clearly should be borne by the government. Others—such as market demand risk, some supply side risks (the cost of foreign exchange, some factor cost risks), may be influenced by government but not fully under its control. How such risks are shared is an obviously important and sensitive aspect in the negotiation of a PPP with a private partner, since it will bear on how large are the contingent risks to which a government is exposed. Experience also has taught that governments entering into PPPs need to be aware, that there is a strong tendency for contracts to be renegotiated.

Tchakarov (2007) notes that in Latin America and the Caribbean, over 30 percent of PPPs were renegotiated (particularly in transportation and water projects), often within the first two to three years of the award of a PPP. Key factors forcing renegotiation have included the fixed term nature of concession contracts, the challenges posed by demand risk, poor decisions at the design stage, government acceptance of aggressive bidding, or changes in the rules of the game by the government after the contract award.

Tchakarov also notes that an “ improper regulatory framework and poor regulatory oversight [can] increase the chances of conflict, rent capture by operators, or opportunistic behavior by government. ” In sum, private sector financing offers important opportunities for Kenya to augment its fiscal space for infrastructure, but successful exploitation of this source requires important capacity building within the government in order to ensure both fiscal savings and efficiency gains relative to public provision.

F. Risks The MTBSP recognizes that the underlying medium-term assumptions are not without risks, and that the projected rate of economic growth may not be achieved. Under such circumstances, the MTBSP indicates that the government would take appropriate measures to mitigate the risks to macro-economic stability, such as by delaying or scaling back on expenditures on non-priority programs. However, the MTBSP does not identify which programs would be curtailed should revenues fall short of projection. IV.

Assessing the Vision and the Medium-Term Budget Strategy A Does Vision 2030 and the MTBSP Address the Key Challenges facing Kenya? In assessing

Kenya's fiscal policy going forward, it is probably best to work from the plans indicated in the recent MTBSP, primarily because Vision 2030 and the MTP provide less detail on the macroeconomic and fiscal policy framework. Vision 2030 is also of course more ambitious in its objectives for growth, so that any doubts raised about the MTBSP would only be more the case concerning Vision 2030.

At the outset, it is worth pointing out that the fiscal framework in the MTBSP appears to be based on fairly conservative assumptions and has introduced some degree of flexibility that can accommodate several alternative scenarios. In particular, the assumed lower growth in the MTBSP compared with the Vision 2030 is, regrettably, realistic in light of recent global developments. However, the projected constant ratio of revenue-to-GDP ratio also comes at a time when KRA is undertaking significant reforms in the customs and tax administration.

This means that there is likely to be a revenue windfall. The projected disbursement of concessional loans in line with GDP assumes no improvement in absorption capacity in the key line ministries from the low levels of between 40-50 percent and the authorities have underscored this as an objective to pursue in coming years. With the recent enhanced monitoring of project implementation, the absorption of donor funds should increase. The exclusion of donor budget support from the framework at a time when PFM/PEM reforms are on-going also suggests a potential upside in donor support.

Finally even with the increase in government spending associated with the fiscal stimulus, the level of public sector debt to GDP ratio still provides some



scope for additional domestic borrowing to fund key infrastructure projects, if warranted, without jeopardizing Kenya's debt sustainability status. All in all, with the exception of the growth scenario, most of the other assumptions appear fairly cautious and leave room for some over performance. Thugge et al make several key observations on these issues.

While acknowledging that the authorities have articulated a sensible and ambitious policy strategy, recent domestic political events and the global economic downturn highlight the setbacks to its realization almost from the outset. Revenue shortfalls, limited efforts at rationalizing spending in noncritical sectors, and the slow pace of civil service rationalization will limit the potential for meeting policy objectives in the health and education sectors, both in terms of levels of spending and efforts at increased sectoral efficiency.

The need for increased infrastructural spending is recognized, but financing efforts remain impeded by the lack of progress on setting out the policy framework for enhanced private sector participation and an improved investment climate. Enhanced revenue efforts will also be needed, particularly from personal and corporate income taxes and from an increase in the effective VAT rate. Fifth, the MTP calls for a sharp increase in overall investment in order to achieve the planned 10 percent real GDP growth.

However, in light of the sharply lower medium-term levels of saving and investment now projected in the MTBSP, the government needs to move with deliberate speed to implement structural reforms and improve the investment climate in order to raise productivity rapidly. Without a

significant increase in total factor productivity, achieving the Vision 2030 growth objectives could be seriously impaired.

One implication of the limited amount of resources available to G