Setting the scene
Kenya’s 2016/17 pre-budget analysis
Revenue and Expenditure estimates
at National and County level
May 2016

Welcome
This newsletter is the first of a series of our 2016/17 budget highlights and analysis.

The analysis is based primarily on the budget estimates presented by the National Treasury Cabinet Secretary to the National Assembly as part of the 2016/17 budget process as well as reports from the Office of the Controller of Budget.

We hope that you will find the analysis insightful, and look forward to your comments.
Macro-economic environment

Global performance

Against a backdrop of strong growth over five years which lifted four countries globally, including Kenya, from Low Income to Lower Middle Income Status, there is now a global deceleration of activity, including a slow down in key emerging and developing economies.

Global growth in developing economies slowed down to 4.3% in 2015 reflecting domestic and external challenges, including slowing productivity growth, persistently low commodity prices, policy uncertainty and rising borrowing costs.

Global Security concerns remain due to conflicts in the Middle East and other parts of the world including Africa, which has had an adverse impact on growth in some developing economies.

According to the 2016 Economic Survey Report by the Kenya National Bureau of Statistics, Kenya attained an overall economic growth rate of 5.6% in 2015, an improvement from 2014’s 5.2% rate. Kenya’s growth in 2015 trails Tanzania (6.9%) and Rwanda (6.5%) but leads Uganda (5.2%).
Kenya’s fiscal discipline remains key, in order to cushion itself against global economic shocks, reduce public debt and contingent liabilities, drive domestic economic activity, and maintain consistent growth.

Annual inflation rates marginally declined from 6.9% in 2014 to 6.6% in 2015. In contrast to the previous year’s non-expansionary wage regime in 2014 as a support to the country’s industrial expansion, the minimum wage was increased by 12% in 2015 resulting in several employers citing the high minimum wage as a constraint to business (World Bank Economic Review Report). The government is expected to shift its overall strategy to improve support to the agriculture and manufacturing sectors, which are key economic growth engines by channelling some of the budget to support employment creation. Therefore a more cautious approach regarding the minimum wage increase is expected in this year’s budget.

The Kenyan economy growth of 5.6% in 2015 was achieved against a backdrop of a stable macroeconomic environment, characterized by high but stable inflation of 6.6% and a relatively stable exchange rate. Nonetheless, insecurity concerns continue to adversely affect the tourism sector and therefore forex earning capability. Furthermore, the key growth engines for Kenya and other developing economies, agriculture and manufacturing sectors, witnessed only marginal growth.
**Positive Outlook**


Low commodity prices had a net positive impact in Kenya in 2015. The gains through lower oil prices and the rising earnings from tea have offset the loss in earnings from other exports such as coffee, horticulture and tourism. As a result, the budget deficit contracted from 10.4% in 2014 to 8.5% in 2015.

Despite the positive outlook, the report also notes that Kenya’s economy remains vulnerable to domestic risks that could moderate the growth prospects. These include the possibility that investors could defer investment decisions until after the elections, that election-related expenditure could result in a cut back of infrastructure spending, and that security remains a threat, not just in Kenya, but globally.

Finally, changes in monetary policy in industrialized countries could trigger volatility in financial markets putting the Kenyan Shilling under pressure.

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**Revenue review**

**Revenue Trend – National**

The government continues to increase revenues, with a notable significant jump in expected revenues for the 2016/17 budget. This, coupled with efforts to manage recurrent expenditures, underscores the government’s strategy to reduce the overall fiscal deficit.

Despite the ambitious revenue projections for 2016/17, the 2015/16 revenue targets are so far lagging behind (at Mar 2016), as tax revenue targets, which comprise a significant portion of the government’s revenues, have not been achieved as planned.
Expenditure Review

The government’s development agenda is founded on ‘Economic Transformation for Shared Prosperity’ which is the cornerstone of the administration’s fiscal strategy.

The budgeted expenditure proposal of KShs 1.977 trillion in 2016/17, representing an increase of 11% on the 2015/16 budget of KShs 1.947 trillion, is geared at stimulating growth through investment in infrastructure and social services.

For this to be achieved the government must address challenges in absorbing development expenditure at both county and national levels.

National Government Expenditure

In line with the government’s commitment to prudent fiscal management, it has maintained its strategy to reduce recurrent spending and increase development spending, with a total KShs 809 billion allocated to development expenditure against KShs 850 billion and KShs 318 billion allocated to recurrent expenditure and the Consolidated Fund respectively in FY 16/17 as shown below.

We see a conscious effort by the government to boost development expenditure through more allocation to key sectors such as agriculture, manufacturing and to key flagship projects.

The government continues to invest heavily in flagship projects as a strategic move to accelerate economic growth. The Standard Gauge Railway is 70% complete and due for commissioning in June 2017, while energy generation, electricity connection and street lighting is being enhanced.

In the education sector, the government has increased capitation for free primary and free day school education, whilst in the health sector public hospitals are being equipped with specialized equipment. (Source Budget summary 2016-17)
**Consolidated Fund**

The Consolidated Fund Services budgetary allocation is expected to increase to KShs 318.8 billion in 2016/17 from KShs 230 billion for the year 2015/2016. This reflects the increase in interest payments on domestic and external debt and repayment of loans due, that have been taken to finance the government’s infrastructure projects.

With the ever increasing pressure on revenue sources to fund government expenditures, and increasing deficits, the government should adopt a cautious approach, to manage the budget deficit.

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**Expenditure trends - National**

<table>
<thead>
<tr>
<th>FY13/14</th>
<th>FY14/15</th>
<th>FY15/16 (HY)</th>
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<tbody>
<tr>
<td>27% Recurrent</td>
<td>32% Recurrent</td>
<td>34% Recurrent</td>
</tr>
<tr>
<td>52% Development</td>
<td>45% Development</td>
<td>42% Development</td>
</tr>
<tr>
<td>21% Consolidated Fund Services</td>
<td>23% Consolidated Fund Services</td>
<td>24% Consolidated Fund Services</td>
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</table>
Bridging the Financing Gap

Kenya continues to meet its financing gaps through external and internal borrowings, with external debt largely being concessional loans. The budget deficit is projected to be 6.9% of GDP for the financial year 2016/2017 down from 7.9% projected in 2015/2016. Nevertheless, the government continues to diversify its financing sources, and maintain sufficient presence in the international markets.

Revenue collection efficiencies and prudent management remain key to managing the budget deficit through closing on tax loopholes as well as the continued rationalization of recurrent government expenditure.

Managing our debt

The debt to GDP ratio for 2016 is projected at 38.3% (2015: 35.7%).

![Debt to GDP Ratio Chart]

1. Treasury’s current account with the Central Bank through which all or almost all of a government’s expenditure and receipts pass through. The consolidated fund consists

Despite the government financing its deficit and a large portion of the infrastructure project through borrowing, the risk of a debt to GDP ratio beyond the threshold recommended by IMF is considered to be low due to the high level of concessionality of current external debt and the positive outlook in macroeconomic indicators.

Although the debt to GDP ratio has been increasing over time and below the IMF recommended ratios, it is for government to ensure borrowed funds are directed towards financing the targeted development expenditure.
Kenya ranked 108 out of 189 according to the World Bank 2016, ease of doing business report, moving up 21 positions from 2015. The government and public sector are instrumental in creating a more conducive environment for investors and manufacturers to spur improved growth in Kenya’s strong private sector.

Interactions with various statutory offices and especially business registration, the cost of compliance with statutory requirements, and the accessibility of water and electricity and other infrastructure can influence growth or impede growth in the various sectors. Below is an analysis of the budgetary allocation to key sectors for FY 16/17.
Agriculture sector

The Agriculture sector achieved a growth of 5.6% in FY 2015/16 and has a 4.3% share of the total national government expenditure. Under the devolved system, agriculture has been devolved to the counties with policy making and key agricultural projects being left with the National Government. Better rains in 2015 were the key contributors to the modest growth of the agriculture sector in the period.

According to the World Bank Economic report, Agriculture is the mainstay of Kenya’s economy with 7 out of 10 Kenyans relying on it for their livelihood. Agriculture’s contribution to the GDP continued to decline from 26.5% in 2006 to 22.4% in 2014. The 2016/17 budget has allocated KShs 12.2 billion on various flagship projects (Galana Kulalu – KShs 3.2 billion, Mwea irrigation project – KShs 2.2 billion) among others.

The 2016/17 budget statement allocates resources to stimulate and transform the sector from subsistence to more productive output. Investing in irrigation, for example, will help ensure that the agriculture sector can withstand the unpredictable rainfall patterns due to global climate change. There is however need for a more concerted effort by the government (at both levels) to allocate more resources to this sector given its penetration in the society and contribution to sustained economic growth.

Energy, Infrastructure & ICT Sectors

This sector is primarily associated with construction which had a 13.6% growth in FY 2015/16. This sector has been allocated 24.7% share of the total national government expenditure in FY 16/17. The government aims at expanding the economy further and this sector will be instrumental in fuelling this expansion. Growth in energy will also fuel growth in other sectors key among them manufacturing. Infrastructure development is key for Kenya to achieve the Vision 2030 objectives.

Key projects in the energy sector include the National Street Lighting, Power transmission, last mile connectivity and Rural Electrification Programme, whilst those for infrastructure relate to road constructions and railway development (SGR).

Manufacturing sector

The growth in the manufacturing sector has been marginal standing at 3.5% for the year 2015/16, and its contribution to GDP has stagnated at 11.8% for the period between 2006 and 2014. Even though this sector is expected to contribute significantly to the country’s economic growth and GDP, growth has been marginal.

The World Bank Economic report cites the lack of development of deep public-private networks of regulation, facilitation, skills and infrastructure as the root cause of this.
Security Sector

This sector has an allocation of 7.5% of the National Budget. Security influences growth in all sectors of the economy. Kenyans want to see budget allocations that will strengthen security and provide an intervention mechanism to address internal and external threats to the country.

These efforts will reassure local and foreign investors alike. External threats continue to remain a key issue that should be tackled by the government.

The 2016/17 budget estimate aims at encouraging investment, securing the borders, accelerating economic growth and creating more employment for the youths. Key highlights of the allocation include KShs 13.2 billion for enhanced security services, KShs 2.0 billion for the securitization of borders, KShs 15.6 billion for military modernisation, KShs 13.2 for enhanced security operations and KShs 10 billion for a police modernization programme.

Education Sector

This sector has an allocation of 23% share of the total national government expenditure. The allocation will primarily be to fund the free primary; day school secondary education and deployment of laptops to schools.

The government has made a deliberate effort to increase its allocation to post-secondary institutions by allocating KShs 2.5 billion to the Technical Training Institutes, KShs 9.1 Billion to the Higher Education Loans Board and KShs 57.8 billion marked towards university education.

This is in a bid to improve on the quality of tertiary education and ensure a work force adequately skilled to meet the needs of the job market.
**Counties – The trend towards devolution and its implications**

Devolution is rated the biggest gain from the August 2010 constitution, which ushered in a new political and economic governance system. It is transformative and is expected to strengthen accountability and public service delivery at local levels.

The Public Financial Management Act (2012) requirement of at least 30% of expenditure on development will continue to drive the budgetary allocation for counties.

**Revenue Review**

Although counties continue to rely heavily on their share of the national revenue, there are positive steps towards raising revenue from other sources such as donor funding and local revenue generation. As the counties prepare their budgets, we expect them to reflect a cautious balance between the need to diversify revenue sources, and maintaining a conducive business environment devoid of punitive business rates, levies and taxes.

The table below shows the County Governments revenue trend which indicates that the budgeted county governments revenue from the National Equitable Share has been increasing since FY13/14.

![Trend - County Governments National Equitable Share](image)

Counties continue to grapple with increased service demands from Kenyans. At the same time, they have to contend with limitations on financing, which is evident in the percentage of local revenues contributing to the total revenue kitty.

As with most local governments around the world, the counties may require to increase efficiencies in expenditure, particularly on wages.
The government, in line with the revenue sharing criteria approved by Parliament has allocated an equitable share of the national revenue totalling KShs 280.3 billion, which is more than the constitutional minimum of 15%. The equitable share of national budget has increased over the years.

Kenya continued to benefit from devolving services and functions to county level which has increased economic activity and is expected to contribute positively to employment creation.
**Expenditure Review**

The table below shows the trends for actual expenditure, compared to the budgeted expenditure for county governments.

Whereas the under-utilization of the budget could be attributed partly to late receipt of funds from the national government through the exchequer releases, another reason for under-utilisation of the budget is failure by the county governments to raise the budgeted local revenue.

![Expenditure trend - County Governments](image)

Meanwhile, administrative expenses driven by a rising wage bill continues to put pressure on recurrent expenditure, which results in underspending on development budgets.

Nevertheless, this is improving, as counties ease into their roles and responsibilities as outlined in the constitution as shown in the charts in the next slide.
Split – Actual Expenditure in Counties

<table>
<thead>
<tr>
<th>Year</th>
<th>Recurrent</th>
<th>Development</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY13/14</td>
<td>22%</td>
<td>78%</td>
</tr>
<tr>
<td>FY14/15</td>
<td>35%</td>
<td>65%</td>
</tr>
<tr>
<td>FY15/16</td>
<td>29%</td>
<td>71%</td>
</tr>
</tbody>
</table>
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