

ACHIEVING SHARED PROSPERITY IN KENYA



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August 2013

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ACRONYMS AND ABBREVIATIONS

AFC	Agricultural Finance Corporation
AG	Attorney General
APR	Annual Progress Report
ASALs	Arid and Semi-Arid Lands
ASDS	Agricultural Sector Development Strategy
BPS	Budget Policy Statement
CDF	Constituencies Development Fund
CG Act	County Governments Act
CRA	Commission for Revenue Allocation
CUCs	Court Users Committees
DoRB	Division of Revenue Bill
EAC	East African Community
EACC	Ethics and Anti-Corruption Commission
ECD	Early Childhood Development
ERC	Energy Regulatory Commission
EU	European Union
FDSE	Free Day Secondary Education
FMA Act	Financial Management Act
FPE	Free Primary Education
GDP	Gross Domestic Product
GJLOS	Governance, Justice, Law and Order Sector
GOK	Government of Kenya
GPI	Gender Parity Index
HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries
ICT	Information and Communications Technology
IFMIS	Integrated Financial Management and Information System
IPPD	Personnel and Payroll Database
IPSAS	Progress towards International Public Sector Accounting Standards
IRA	Insurance Regulatory Authority
JSC	Judicial Service Commission
JTF	Judicial Transformation Framework
KENAO	Kenya National Audit Office
KCPE	Kenya Certificate of Primary Education
KEMSA	Kenya Medical Supplies Agency
KEPSS	Kenya Electronic Payments and Settlement System
KNBS	Kenya National Bureau of Statistics

KPLC	Kenya Power and Lighting Company
KRA	Kenya Revenue Authority
MDAs	Government Ministries, Department and Agencies
MDGs	Millennium Development Goals
MDTS	Medium Term Debt Management Strategy
MfDR	Managing for Development Results
MFI s	Microfinance institutions
M&E	Monitoring and Evaluation
MTEF	The Medium Term Expenditure Framework
MTP	Medium Term Plan
NACF	National Anti-Corruption Forum
NCAJ	National Council on the Administration of Justice
NAP	The National Anti-Corruption Programme
NCLR	National Council for Law Reporting
NER	Net Enrolment Rate
NHIF	National Hospital Insurance Fund
NSSF	National Social Security Fund
OCT	Over the Counter
OGP	Open Government Partnership
PFM	Public Financial Management
PEFA	Public Expenditure Financial Assessments
PEFA	Public Expenditure and Financial Accountability
PMIS	Pension Management Information System
PPDA	Public Procurement and Disposal Act
PPOA	Public Procurement Oversight Authority
PPPs	Private-Public Partnerships
PTR	Pupil Teacher Ratio
RMLF	Road Maintenance Levy Fund
RTGS	Real Time Gross Settlement
SACCO	Savings and Credit Co-operative Society Limited
SAGAs	Semi-Autonomous Government Agencies
SASRA	SACCO Societies Regulatory Authority
SFS	Strategic food reserve
SGR	Strategic Grain Reserve
SMEs	Small and Medium-sized Enterprises
SSA	Sub-Saharan Africa
SUN	Scale Up for Nutrition
TA	Transition Authority
TIVET	Technical, Industrial, Vocational and Entrepreneurship Training
TSA	Treasury Single Account
TVVP	Technical and Vocational Vouchers program
UAC Act	Urban Areas and Cities Act

FOREWORD

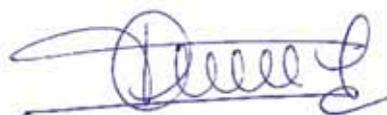
Kenya has just experienced one of the most successful and peaceful national elections in its history. A dynamic new administration has assumed the levers of power and begun to fundamentally shape the country's future. Guiding the new leadership is the 2010 Constitution, which ushered in a sweeping new system of devolved government that will have a profound impact on Kenya's future. Against this momentous backdrop, Kenya's leaders will need to grapple with an extensive range of issues, as they strive to launch Kenya's economy on the path of high economic growth. The purpose of this book, *Achieving Shared Prosperity in Kenya*, is to offer a comprehensive yet digestible assessment of the challenges and possible responses for Kenya's leadership to consider, as it plans its strategy for sustained economic growth.

The analysis and policy recommendations that are presented here were developed by the World Bank in consultation with a wide number of Kenyans from the government, the academia and the private sector. There was widespread consensus among all the participants and reviewers that the issues presented here are fundamental to a sound working economy, and should not have any political affiliation.

This book is organized around three overarching themes under which various topics are aggregated. The first concerns human development and resilience, and discusses issues related to poverty, education, health and social safety nets. This is the human chapter, dealing with crucial areas that are central for the successful development of individual Kenyans. The second theme, growth and competitiveness, delves into the structural issues that need attention for the economy to grow and become more competitive in the international scene. This section of the book discusses needs for infrastructure investments and energy development, along with steps Kenya needs to take to unleash its export potential. The third theme, governance, addresses issues around strengthening public financial management, improving transparency and accountability, and consolidating judicial reform.

The chapters in the book are presented as stand alone discussions, each with a set of policy recommendations. Make no mistake, actions are needed across all these themes for Kenya to grow at a high rate for an extended period of time. For example, in order for manufacturing in the private sector to experience robust growth, not only does Kenya need better roads and more reliable low-cost energy, but it also needs a skilled and healthy labor force, and the ability to do business without corrupt behaviors dragging down its productivity and revenue.

This is an exciting time for Kenya. The World Bank looks forward to its continued partnership with the new government, as it moves forward with confidence and determination.



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The views expressed in this publication are those of the authors. The findings, interpretations and conclusions expressed herein do not necessarily reflect the views of the World Bank Group, its Board of Executive Directors or the countries they represent.

OVERVIEW

By Wolfgang Fengler and Jane Kiringai

Kenya has almost everything going for it. Its people are well-educated and energetic, its location is superb, and its neighbors are growing strongly and using Kenya as a gateway. So why is Kenya underperforming compared to its peers? Why does the average Kenyan earn only half of what the average African south of the Sahara does?

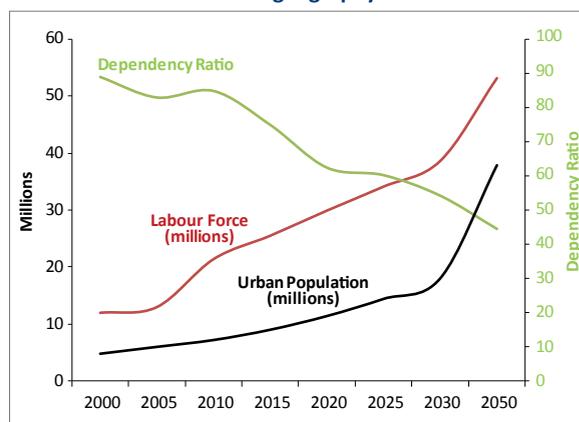
Kenya remains a country of stark contrasts: extraordinary success stands side by side with disappointing failures, socially, economically and institutionally. Between examples of success and failure lies a broad continuum of mixed performance, that sets the agenda for the next administration. These discrepancies span all aspects of Kenya's development agenda.

Historically, Kenya has had strong macroeconomic management, but in recent years, increasing imports, especially of food and oil, have created complications. High international food and oil prices have fueled inflation, especially during periods of low domestic food production, such as the 2009 and 2011 droughts. A growing reliance on food imports (due to a growing population and declining agricultural productivity) and oil imports (including to fuel electricity generation) have further increased Kenya's vulnerability to external price shocks in recent years.

A new administration has come into office at a time when Kenya is at the beginning of major demographic, geographic, education and health transitions. Kenya is adding more than one million people a year, and by 2030, it will be home to an estimated 63 million people. Most of this future population growth will comprise of adults, and will take place in urban areas, bringing both new opportunities

and new challenges. Even though the dependency ratio is expected to continue declining, Kenya's workforce is set to double by 2045. Urbanization is also accelerating, and by 2033, half of Kenya's population will be living in cities (see Figure 1).

Figure 1: Kenya's big transitions: demography and geography



Source: World Bank projections

Development is fundamentally about helping individuals to realize their full potential and to live in dignity. Many Kenyans are not able to achieve their full potential, because they are living in poverty, or so close to poverty, that they need to focus all of their attention on meeting basic needs. Almost half of Kenyans still live on less than US\$ 1.25 per day, and more than 40 percent of Kenyans do not have enough to eat.

About one in four Kenyans lives in areas that are arid or semi-arid, where drought is increasingly common and intense. The threat of climate change looms large, and will impact both rain-fed agriculture and irrigated export crops, which rely on fresh-water lakes and rivers for irrigation. Kenyans living in arid and semi-arid lands will be particularly hard hit. They will require targeted support in the future, including support for food security.

A fundamental challenge for development in Kenya is lifting people out of poverty, and helping them to remain above the poverty line, so that they can share more sustainably and equitably in Kenya’s growing prosperity.

Enabling people to realize their potential involves, at the most basic level, ensuring that they are healthy, that they are educated and have basic life skills, and that they are able to participate in social and economic life. Where people cannot participate fully in social and economic life, due to age or disability or natural disaster, social protection systems must supplement their abilities directly to achieve their potential.

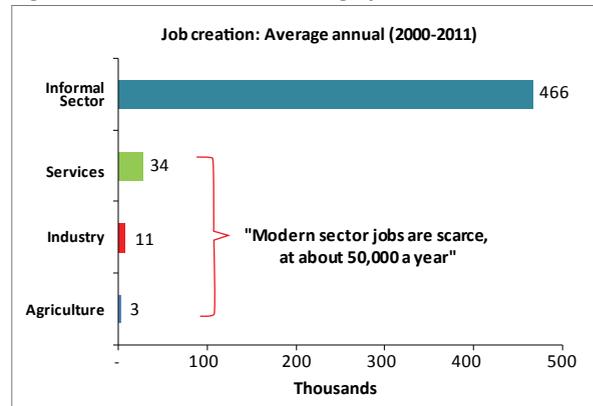
Kenya has made progress in human development, and is now at a critical junction needing to transition from increasing access to essential services to improving their quality. Kenya is achieving gender parity in primary school enrolment, which is now almost universal, and secondary school graduates will triple by 2030, but educational attainment remains low by international standards. In the health sector, Kenya has made notable progress in controlling communicable diseases (tuberculosis, HIV/AIDs, and malaria), and has sharply decreased child mortality, but other Middle-Income health challenges are emerging. In social protection, a number of successful interventions are being scaled-up, though programs are fragmented, with low coverage and limited linkages to disaster risk management.

For most healthy able-bodied people, living a life of dignity and reaching full potential involves having meaningful employment.

So far, Kenya has not created enough jobs to absorb the large number of Kenyans who enter the labor market every year. The current levels and patterns of growth are seriously inadequate: every year, only 10 percent of Kenyans reaching working age can

find jobs in the modern sector (see Figure 2). Youth unemployment is particularly high at 25 percent, even though it declines once Kenyans enter their 30s.

Figure 2: Job creation remains largely in the informal sector



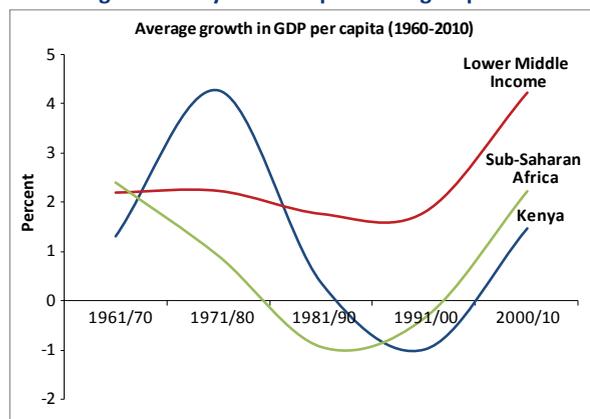
Source: World Bank estimates based on Kenya Economic Update 2012; economic survey various issues

Kenya’s human development sectors now need to achieve “second generation” reforms. Much can be done through getting more value for money out of current spending: Kenya is achieving a lot, but not as much as it can, given how much it spends. Three priorities stand out. First, Kenya needs to ensure a more equitable distribution of basic health and education services, focusing particularly on historically-disadvantaged areas like North Eastern province, where a ‘no child left behind’ strategy would be appropriate. One way to achieve higher equity fast is through a unified and scalable social protection program, which can also respond to crises fast. Second, Kenya needs to shift its focus away from increasing the quantity of children educated (as universal access is now nearly achieved), to increasing the quality of the education received. The easiest way to achieve higher learning outcomes is to increase the numbers of hours teachers spend in the classroom. Third, with a large portion of the population exposed to weather and other shocks, especially droughts, Kenya needs to reduce vulnerabilities, both by improving the management and use of its water resources to expand irrigated

agriculture, and also by establishing a social protection program that can respond quickly to disaster when it occurs.

Kenyans who reach their potential will make a bigger contribution to the economy, and a strong economy in turn helps Kenyans to fulfill their aspirations even more. Over the last decade, Kenya has been growing at a moderate 4 percent per annum. This is higher than in the 1980s and 1990s, but substantially lower than the growth experienced by its East African neighbors and Sub-Saharan Africa as a whole—where growth has averaged 5 percent per annum, and 6 percent if South Africa is excluded (Figure 3). Kenya has been growing at a slower rate than “stable Africa”, due to interruptions in its growth momentum, which since 2008 have included post-election violence and several years of drought.

Figure 3: Kenya is underperforming its peers



Source: World Development Indicators

Kenya’s moderate growth has been driven by domestic demand, mainly consumption, as well as a strong service sector. Sound macroeconomic policy and a broadly supportive approach to private business have led to the turnaround in sectors such as telecommunications and finance. Agriculture remains the source of livelihood for most Kenyans, and the main vehicle for generating export revenues, but much of the sector has been neglected, with the result that Kenya’s

export performance and poverty reduction achievements have been more limited than could have been the case.

Kenya’s recent average growth rate translates to about 1.3 percent growth in incomes per person. This is plainly not sufficient to make a significant dent on poverty. Figure 6 shows the average growth in income per person, comparing Kenya, Sub-Saharan Africa and Low Middle-Income countries. Over the last decades, the economy has experienced very uneven performance. Between 1980 and 2000, the economy stagnated, and growth even declined in per-capita terms. Since 2000, per-capita income has recovered, and Kenya will possibly reach US\$ 1,000 per capita by 2020, the threshold for Middle-Income economies.

Over the last few years, Kenya’s external position has been weakening. The current account deficit has reached record levels (10 percent of GDP in 2011), driven mainly by rapidly rising imports. Nevertheless, the exchange rate has remained broadly stable, supported by increasing financial inflows, especially remittances. This has led to an appreciation of the real exchange rate which is hurting Kenya’s exports.

Kenya’s prospects for attracting job-creating and sustainable Foreign Direct Investment flows are improving, driven among other factors by governance improvements and the favorable conditions created by the country’s booming service sector. Improvements in transportation, telecommunications and finance have increased Kenya’s attractiveness as a “port of entry” for East Africa. Moreover, recent oil and gas discoveries in Turkana county are already leading to sizable investments by foreign energy companies. Going forward, Kenya will need to rebalance the sources of growth, so that it relies less on current domestic

consumption, and more on investment and diversified exports. This rebalancing will require broad-ranging and persistent efforts to improve Kenya’s investment climate—including both its physical infrastructure and regulatory frameworks—as well as to export competitiveness. At the same time, it will be important to continue to promote domestic savings and avoid excessive reliance on short-term speculative foreign exchange inflows, as the main source of financing for the current account deficit. Short-term flows are attracted by quick returns in Kenya’s open financial markets and the ease by which they can quickly exit when conditions change. Moreover, they tend to be associated with larger levels of foreign exchange volatility, with particularly deleterious effects on export-oriented sectors.

Kenya’s new policymakers and government, at both the national and county levels, will have an historic opportunity to strengthen governance—the traditions and institutions by which authority is exercised in Kenya¹. As the experience of many countries has shown, improving governance goes hand-in-hand with achieving the sustained economic growth and efficient and equitable service delivery, that Kenyans expect and demand.

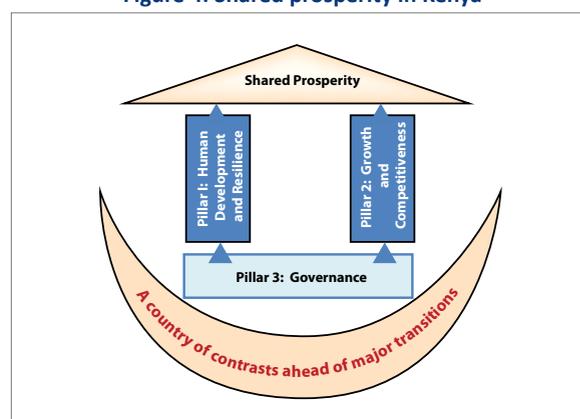
The 2010 Constitution provides renewed momentum to efforts to improve governance in Kenya’s economic, political and social institutions. In implementing the Constitution, initial steps have been taken to strengthen the judiciary, which will be critical to addressing the impunity that has long undermined good governance and anti-corruption efforts. The Constitution and a raft of new laws provide newly-elected national policymakers and county governors with a strong policy and legal basis, better to manage public resources and to build

government institutions and services, that are more accountable and responsive to citizens. The Constitution also mandates the implementation of a highly-ambitious program of decentralization, which will bring government and service delivery much closer to the citizens, than in the past.

Converting the aspirations of the Constitution into tangible benefits for citizens and businesses, will depend on whether and how policymakers, the private sector and civil society translate the provisions of new laws and policies into lasting changes in government institutions.

What concrete steps can incoming policymakers take to improve governance? The government can help Kenya achieve shared prosperity in two ways (Figure 4). First, it can provide the foundation for economic growth, through better infrastructure, and security. Second, it can provide good-quality public services, such as health care and education, which directly impact the lives of citizens. Good governance, as demonstrated through efficient government institutions and effective regulations, is essential in ensuring that these investments and services, deliver sustained and equitable growth.

Figure 4: Shared prosperity in Kenya



Source: World Bank

¹ The exercise of economic, political, and administrative authority to manage a country’s affairs at all levels. It comprises mechanisms, processes, and institutions through which citizens and groups articulate their interests, exercise their legal rights, meet their obligations, and mediate their differences.

Under the multiple governance reforms envisioned in the Constitution, four areas warrant particular attention by incoming policy makers. First, devolution will bring important opportunities to improve governance, and in turn service delivery, but it will also bring new risks that could result in lower growth and a disruption in service delivery if the devolution process is not appropriately managed. Incoming governors face major challenges in making devolution work, given the scope, scale and timing of devolution, as well as Kenyans’ high expectations that devolution, among many constitutional provisions, will improve service delivery and accountability.

Second, incoming policymakers need to continue and deepen ongoing judicial reforms. Kenya is at the beginning of a momentous Judicial reform program, articulated in the Judicial Transformation Framework. The change in leadership and culture at the judiciary, and the reforms initiated so far, give hope to many Kenyans that significant improvements in judicial performance are achievable. It will be critical for the judiciary to show tangible results in the short-to-medium term, especially in reducing case delays, in professionalizing case management, and in issuing well-reasoned judgments, so that reform momentum builds, rather than dissipates. Beyond the judiciary, the full implementation of the Constitution in all its aspects, including enforcing the integrity and leadership provisions, will put Kenya on a trajectory to improve its performance on various governance indicators where it is currently behind its peers.

Third, Kenya needs to redouble its efforts to improve public financial management, and to translate the constitutional provisions on access to information into the legislative framework. Policymakers can build on recent

progress in public financial management—improving controls in public spending and quality of public expenditure—through fully implementing the Integrated Financial Management System, both at the center and sub-national levels. Considerable progress has been made in public financial management reforms, and in moving the public service closer to “Results-Based Management”, through the introduction of tools such as Service Charters, Performance Contracts, a revised Performance Appraisal System, the Rapid Results Initiative and competitive selection for senior jobs. But in each of these areas there is room for making more effective use of the tools to improve service delivery and accountability, including institutionalizing programs like the Open Data Initiative.

Kenya can create shared prosperity over the next decade if the country builds on its strengths and deals decisively with its weaknesses. The success in areas such as macroeconomic management, finance and ICT shows that Kenya does not only need to look outside for good practice. Unlike other countries in the world, especially in Europe, Kenya’s debt is sustainable which means that it has the fiscal space to invest in its development. If all parts of the economy performed as strongly as Kenya’s best performing sectors, the envisaged GDP growth rates of 10 percent would become a reality.

To achieve the Kenyan dream of shared prosperity, the new government will need to address three deficits that are holding the country back:

- (i) a *quality deficit*, especially in the social sectors;
- (ii) an *infrastructure deficit*, which demands a continuous focus on scaling-up investments; and

(iii) a *governance deficit*, which the 2010 Constitution is starting to address, but the challenges go beyond the constitutional changes (the agriculture sector and the port of Mombasa illustrate how poor governance affects economic outcomes).

The new government has a very tall agenda and the next Medium-Term Plan will articulate a new strategy for advancing Kenya's development. Among the many priorities for Kenya's policy makers, there are nine areas which stand out for their significance in addressing the challenges in realizing the potential of every Kenyan, creating a competitive economy and completing institutional transformation (Box 1).

Box 1: Nine priorities for the new Kenyan Government

Realizing the potential of every Kenyan

- (a) **Achieving equity.** Establish a more equitable distribution of basic health and education services, targeting historically-disadvantaged counties.
- (b) **Improving education quality.** Improve learning attainment, by reducing teacher absenteeism and increasing teaching hours in the classroom.
- (c) **Mitigating vulnerability.** Improve the management and use of water resources to expand irrigation, and establish a unified and scalable social protection program, to help respond to disaster.

Creating a competitive economy

- (d) **Maintaining stability and consistency.** Macroeconomic and political stability are the necessary backbone of successful economic development in Kenya. A macro-economic framework consistent with strong exports and investment, rather than consumption and short-term financial flows, will be critical to achieving the objectives of higher and broader economic growth.
- (e) **Expanding infrastructure.** The new government will need to maintain investments in key sectors (energy and roads) which, despite recent improvements, are still lagging behind. Structural change, especially regarding the port of Mombasa and rail services, will be key determinants of the future quality of Kenya's infrastructure services and competitiveness.
- (f) **Reforming agriculture.** The quickest win for all Kenyans would be a turn-around in agriculture, especially the maize sector, which most Kenyans still depend on. The greatest single measure the new government can take is a complete overhaul of the National Cereals and Produce Board, which in the interim, would include the publication of daily transactions and the establishment of a commodities exchange.

Completing institutional transformation

- (g) **Making devolution accountable.** The functioning of the new counties will determine the quality of service delivery for the next years. One important measure which the government can adopt is to measure the performance of county governments, and to connect the allocations of intergovernmental transfers to that performance.
- (h) **Implementing judicial reform.** High hopes in continuing the turn-around of the judicial sector will only be maintained if the government continues fully to implement the Judiciary Transformation Framework, especially measures to improve access to courts and establishing an automated system for reducing backlog, delays and opportunities for corruption.
- (i) **Managing the people's money well.** Given continuing concerns about leakages in Kenya's budget, the full implementation of the Integrated Financial Management System will be critical to enhancing the credibility and quality of Kenya's public finances. In addition, the institutionalization of the Open Data Initiative will create bottom-up pressure for the sound use of public funds, and generate opportunities to find new solutions to Kenya's development challenges.



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Human Development and Resilience

1. Reducing poverty and promoting the well-being of Kenyans

By Paul Gubbins and Miriam Omolo

INTRODUCTION

During the last decade, Kenya has emerged as one of a growing number of success stories on the African continent. Kenya has the largest economy in East Africa and between 2002 and 2011 its economy grew by 4.6 percent per year on average. Fueling this growth is a strong private sector and an incipient middle class. Despite several internal and external shocks in the past 10 years, Kenya managed to sustain economic growth and its prospects remain strong within the world's turbulent economic waters.

Broadly, the government impacts the lives of the poor in two ways. First, it provides the foundation for economic growth and job creation. Infrastructure (such as roads, energy and ports), regulations, a functioning bureaucracy and security are all important foundations for growth that require public investment. Secondly, public services (such as health care, education and social assistance) that equip citizens with skills and that protect in the face of shocks can help Kenyans take advantage of the opportunities that economic growth creates.

The government's commitment to the provision of public services to Kenyans is encoded in the 2010 Constitution and under the aspirations of Vision 2030. Article 43(1) of the Constitution states that every person has a right to basic rights such as food, shelter, education, health and security. The social pillar of Vision 2030 has at its core 'investing in the people of Kenya' with a focus on health, education, youth and sports, gender, children and social protection, environment and housing among other welfare improving programs. These programs and flagship projects are intended to ensure that the provision of public services will improve livelihoods of Kenyans. Vision 2030 targets the creation of 3.5 million jobs and a reduction in the poverty incidence from 46 in 2005 to 28 percent in 2030, and an increase in the human development index from 0.47 in 2005 to 0.7 in 2030.

Despite notable improvements, Kenyans, particularly the poor, often face difficulties in getting public services and are frequently compelled to pay bribes. This is the case when Kenyans need to receive medical care, obtain documents, get a child into school, avoid problems with the police, or to get household services like piped water and electricity. There is optimism that the decentralization of many government functions to the county level will improve public services delivery by

putting citizens into close contact with the responsible authorities. However, increased government accountability and active citizenship is not a guarantee.

The implementation of the 2010 Constitution and a devolved government brings both opportunities and risks for poverty reduction. If the 2010 Constitution is implemented effectively, the conditions for increased accountability and therefore pressure to improve the quality of public services will be in place. To the extent that county governments are responsive to these pressures, devolution has the potential of improving welfare and reducing poverty. However, the decentralization process is complex and carries with it significant challenges. There is a risk of weak governance and corruption within county governments and an increase in inequality, as counties with greater endowments develop faster than the rest.

KEY FACTS AND TRENDS

The most recent and reliable poverty estimates in Kenya date to 2005. Based on Kenya's national poverty line, 47 percent of the population (16 million Kenyans) was poor in 2005 and the vast majority of the poor lived in rural areas. Figure 1.1 shows estimates of poverty at the county level, based on the 2005 Kenya Integrated Household Budget Survey (KIHBS). This poverty map shows that patterns of poverty are highest in northern and northeastern counties, which are sparsely populated. Poverty rates are lowest in the urban hub of Nairobi and neighboring counties. Poverty rates are at intermediate levels in counties in the southeast of the country (which also has low population density, apart from the coast) and the more densely populated areas in Western and Nyanza regions.

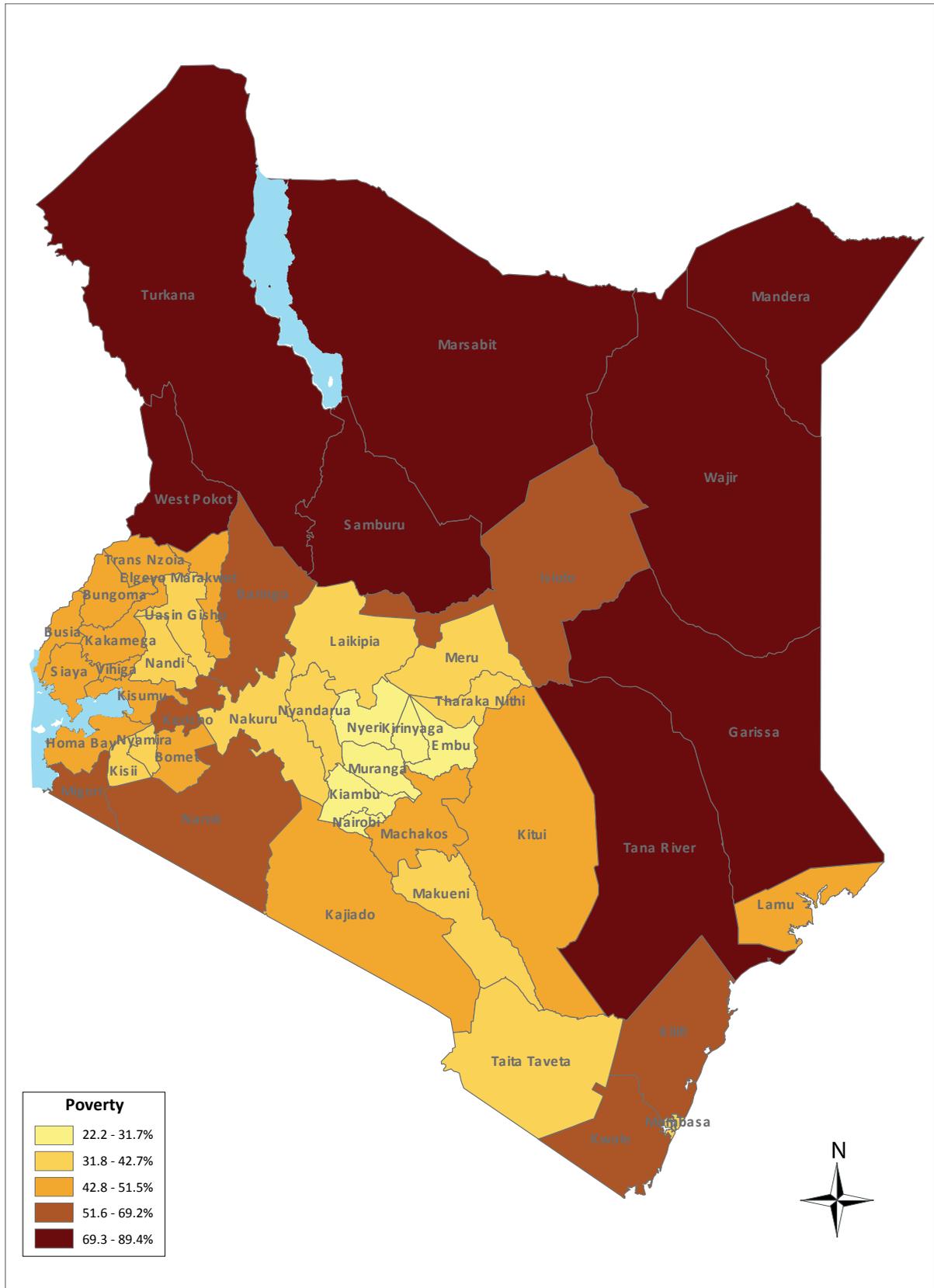
Approximately 44 percent of Kenyans go without the basic required minimum food intake per month. Food security—a major determinant of the country's welfare—is largely affected by the performance of the agricultural sector. The high incidence of food insecurity can be attributed to Kenya's over reliance on rain fed agricultural production.

Income inequality is high, with 10 percent of the richest in the population holding 40 percent of total income. This is in sharp contrast to only 2 percent of incomes being held by the poorest 10 percent of the population. Disparities in living conditions between urban and rural areas are also reflected in poverty rates: in 2005, 34 percent of urban households were poor compared to 50 percent in rural areas.

Updated poverty estimates will not be available until after the next nationwide household budget survey is conducted, likely in 2014. In the absence of new poverty estimates, it is possible to track how welfare has changed over time using other non-consumption measures that partially capture the quality of life of Kenyans. Table 1.1 summarizes trends in select indicators at the national level for education, health and household services.

School attendance rates have increased substantially over time, and are now over 90 percent for both younger and older children. Key child health measures, such as infant and under-5 mortality rates declined substantially in the past decade (Table 1.2). A study of the drivers of infant mortality credits the scale-up of insecticide treated bed nets as a major contributor to this decline. With respect to household services, access to electricity, sanitation, and drinking water stagnated during the 1990s as infrastructure expansion failed to keep pace with population growth.

Figure 1.1: Map of poverty rates by county 2006



Source: KIHBS 2005/06

Table 1.1: Selected economic trends 2007 - 2011

Indicator	2007	2008	2009	2010	2011
GDP growth rates (percent)	7.0	1.5	2.6	5.6	4.4
GDP percapita growth rate (percent)	4.0	-1.0	0.1	3.7	1.5
Inflation rate (percent)	4.3	16.2	10.5	4.1	14.0
Savings/GDP (percent)	13.9	14.9	12.4	11.3	13.2
HDI	0.486	0.493	0.499	0.505	0.509
Employment					
Modern sector ('000)	1,977.3	2,011.3	2,067.6	2,130.2	2,127.7
Informal sector ('000)	7,501.6	7,942.3	8,388.9	8,829.8	9,272.1

Source: Various economic surveys and UNDP human development index reports

Table 1.2: National trends in key indicators of well-being in Kenya

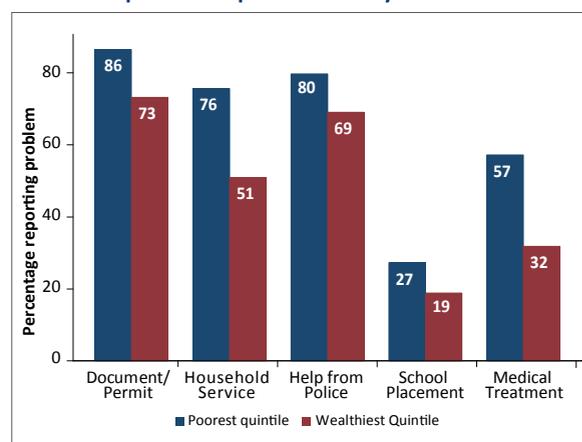
Indicator	1993	1998	2003	2008
Education				
School attendance (age 6-10 percent)	84	82	89	91
School attendance (age 11-15 percent)	88	88	89	95
Health				
Infant mortality rates (per 1,000 births percent)	62	74	77	52
Under-five mortality rates (per 1,000 births percent)	96	111	115	74
Child vaccination rate (age 12-23 percent)	71	58	49	65
Percent owning insecticide-treated bednet	-	-	4	56
HIV prevalence (ages 15-49 percent)	-	-	7	6
Household Services				
Percent with access to electricity	11	15	16	23
Percent with access to improved drinking water source	54	54	41	47
Percent with access to improved sanitation	16	19	19	33

Source: Kenya demographic health survey data and reports – National Bureau of Statistics

Since 2003, there have been modest gains, but still only a minority of Kenyans has access to these basic services.

The government influences health and education outcomes largely through the quality of public services. Despite improving health and education indicators, large numbers of Kenyans, particularly the poor, report problems with public services. While citizen perceptions are influenced by expectations, they are nevertheless useful as a reflection of how Kenyans think about public services. Figure 1.2 shows the percentage of the wealthiest and poorest

Figure 1.2: Fractions of citizens reporting difficulty obtaining services, wealthiest 20 percent versus poorest 20 percent of Kenyans 2011



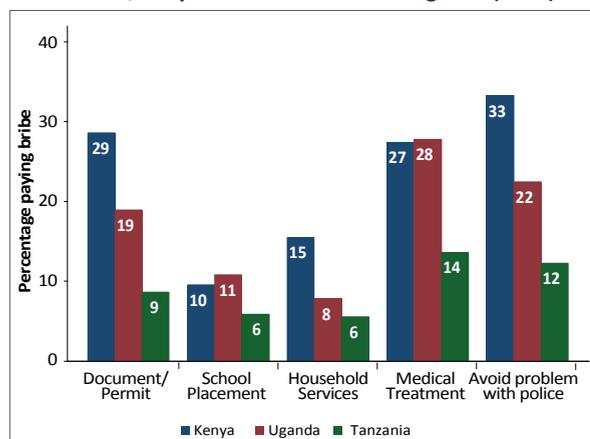
Source: World Bank calculation from afrobarometer Data 2011

Kenyans who reported experiencing difficulty obtaining various services.

A majority of the poorest fifth of Kenyans, as well as a substantial percentage of the wealthiest fifth say they have difficulty obtaining services, including documents or permits, household services like drinking water, getting help from the police, and medical treatment. Problems with placing a child in primary school are much less frequently reported, which likely reflects the benefits of the government’s efforts to expand access through the free primary education program.

Large numbers of Kenyans also report having to pay bribes to obtain public services. Figure 1.3 shows the percentage of people in Kenya, Tanzania and Uganda who reported having paid bribes for various services. Kenya has the highest rate of bribe payments to obtain household services, documents or permits, and avoiding problems with the police. Bribe payments to obtain medical treatment are also common.

Figure 1.3: Percentage of citizens paying bribes to obtain services, Kenya versus Tanzania and Uganda (2005)



Source: Afrobarometer data 2005

POLICY RECOMMENDATIONS

Kenya’s inconsistent record of monitoring poverty calls for a systematic program of rigorous household data collection. In

the 30 years spanning 1980 to 2010, Kenya conducted four surveys that provided a basis to measure poverty; an average of one survey every 8 years. The latest reliable poverty estimates are almost a decade old. Investing in a system of routine household budget surveys to monitor poverty and inequality will put the government in a better position to learn about the poverty reducing impact of their policy choices and make incremental improvements to policies over time.

Leveling the playing field in access to key opportunities—such as quality education, energy, water and sanitation—has the potential not only to boost growth but also to reduce poverty and inequality. Despite improvements in critical areas such as child mortality and school attendance over the last decade, access to basic household infrastructure such as electricity, water and sanitation remains low and large numbers of Kenyans report facing difficulty in accessing key services, and being compelled to pay bribes in order to obtain services.

This section provides a framework for public investment based on Kenya’s spatial development. The gap between the more prosperous parts of Kenya and poorer areas, such as the arid lands presents a case of lagging and leading regions, similar to the situation in faced in many countries. A crucial question facing policymakers is what type of public investment should be made in the lagging areas? The insights from broad historical experience with the geography of development are captured in the “3-Ds” namely: density, distance, and division model and matching this with the “3-Is” set of policy approaches, namely institutions, infrastructure, and incentives which offer clear applicability to Kenya. For poor low-density areas like those in northern and northeastern Kenya, the long-run path for a

great deal of the population will be moving to leading areas like larger towns, who then continue to support those who stay behind through remittances, as has been the trend across the world, as well as in Kenya, where remittances sent via mobile money systems are a life-line for the rural poor.

The fact that many living in northern and northeastern Kenya, particularly children will migrate to other areas, strongly suggests a refocusing on institutions, principally those that help people to migrate to places with economic opportunities. This can be done through guaranteeing access to basic services, such as education and health care, regardless of one's location. Given the low population density and remoteness of the population in some areas, the cost of delivering these services is relatively high. This cost is justified by ensuring equality of opportunity for children from these areas, and in promoting economic growth.

A second lesson that emerges from historical experience is that policy should seek to connect lagging areas to leading areas through infrastructure. In Kenya, the mobile phone revolution and the rise of mobile money, have helped some to cope with the effect of drought, by providing a lifeline to remittances. Government investments in roads can help to further link remote areas with more prosperous areas and to neighboring countries.

Finally, given the divisions that stand in the way of migration in the arid lands, the primary focus on institutions and investments can be complemented with limited and carefully defined incentives to encourage economic activities in these areas. The experience with such policies has been mixed and in cases where spatially targeted interventions have been successful, they have been coupled

with policies that foster both institutions (ensuring equality of opportunity), and those that are spatially connective. Without laying the foundations through a principal focus on institutions and infrastructure, targeted incentives are unlikely to succeed.

Overall, this section puts emphasis on recalibration of priorities in terms of investments in poor and remote areas. Recognizing that the future welfare for people in these communities is likely to be driven largely by migration to areas of economic concentration and remittances sent by migrants, top priority should be given to ensure that children in these areas receive basic education and health care, so that they can be well equipped when seeking for opportunities elsewhere. This emphasis can be complemented with investments in infrastructure, as well as targeted programs to encourage economic activities.

One way of dealing with unemployment is through investment in infrastructure (roads, energy and telecommunication) which is known to have strong multiplier effects that positively affects other sectors through job creation. Firstly, better infrastructure will see the expansion of the private sector to areas originally neglected, but with high business potential. Secondly, improved infrastructure generally reduces business risks, which ultimately results in low risk premiums associated with access to credit, which is important for business expansion and job creation.

Food security policy measures adopted in the agricultural sector will greatly influence overall poverty incidence in the country. Maize is Kenya's main staple food and policies should therefore be geared towards improved performance agriculture, in order to have implications for food security. Reforms

in the maize subsector must be geared towards having low and stable maize prices, through efficient production and marketing incentives, in order to reduce the persistent structural maize deficit. Maize deficits tend to increase prices above the market range, and these have strong distributional effects that worsen food security and any poverty reduction initiatives that are put in place.

The implementation of the 2010 Constitution accompanied by strong institutional reforms that guarantee the protection of human and property rights can reduce the corruption that is important for poverty reduction. The implementation of the 2010 Constitution is seen to provide stronger checks and balances between the three branches of the government, and has also created a stronger institution for dealing with corruption through the Ethics and Anticorruption Commission. These initiatives carry the potential of reducing the corruption that determines access to key services such as education, health and security, which are important vehicles for poverty reduction.

2. Jobs as the path to a brighter future for Kenyans, higher productivity for the economy and greater cohesion in society

By Paul Gubbins

Jobs are essential to the well-being of Kenyans. Fundamentally, people work to make a living, to earn either cash income or food on which to survive. Higher yields in agriculture, access to small off-farm activities and transitions to wage employment are milestones on the path to individual prosperity. From the macroeconomic perspective, growth happens as jobs become more productive, as more productive jobs are created and as less productive jobs disappear. Finally, jobs foster social

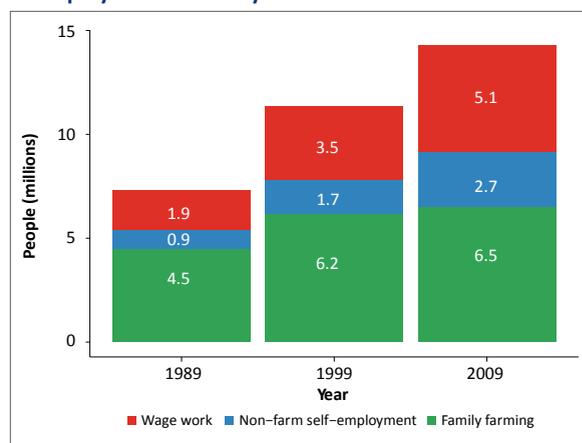
cohesion. Unemployment and job loss are associated with lower levels of trust and civic engagement, and thus, societies that can widely create productive opportunities for citizens are better able to avoid the social fragmentation and conflict that can accompany economic change.

KEY FACTS AND TRENDS

Family farming is the predominant job in Kenya. In 2009, 6.5 million worked on family farms out of 14.3 million employed Kenyans of working age.

However, the composition of jobs in Kenya is moving away from farming. The large number of Kenyans in family farming masks a fundamental shift in the nature of work (Figure 2.1). In 1989, farming represented 61 percent of total employment. By 2009, 45 percent of the employed were working on farms. Kenyans of every age have shifted out of family farming into non-farm self-employment and wage work. While in 1989 majorities in all age groups worked in family farming, in 2009, only adolescents and those above the age of 50 had majorities working on the farm.

Figure 2.1: Wage jobs & self-employment have increased, employment on family farms have remained constant



Source: World Bank analysis of census data

Most work in Kenya does not pay a wage. Almost two thirds of all jobs do not have the benefit of a stable, predictable wage. These

jobs include family farming but also a host of other non-farm work, ranging from such low skill trades like street vending to skilled trades like dressmaking, butchery, carpentry and other *jua kali* trades. Individuals in these jobs often run their own small businesses, occasionally hiring one or two other people, or recruiting family members to help. Most non-farm self-employment is in commerce—such as retail food or textile sales—but also includes manufacturing, transportation and other services.

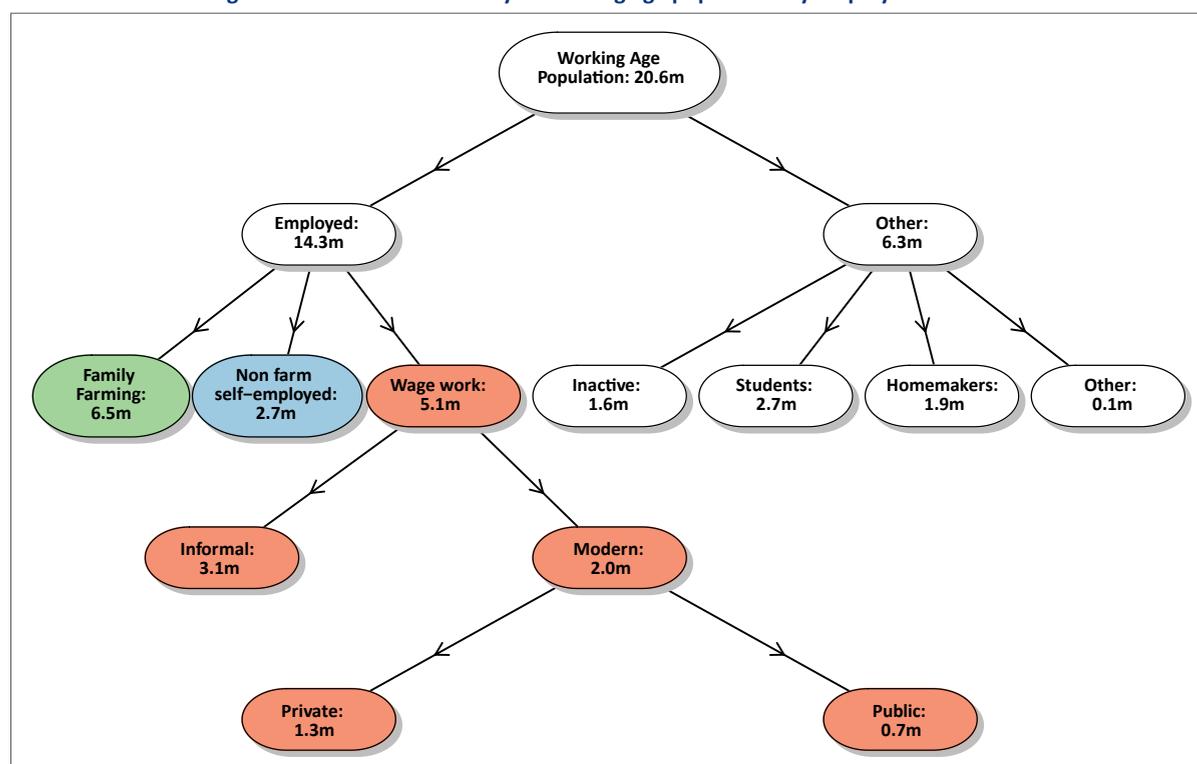
A vast majority of work takes place outside of contractually based employer-employee relationships. What most would consider a modern or formal job, such as an engineer in a large telecoms company or a doctor in a public hospital, is the exception not the rule in Kenya. Only two out of five wage jobs (a little over 2 million) are modern or formal employment (Figure 2.2). Overall, only 15 percent of working Kenyans hold a modern job that provides a wage and the opportunity

to access social security benefits, such as a pension or health insurance.

The rate of modern wage job creation is severely outpaced by the rate of growth of the working age population. Estimates from the annually released Economic Survey, put modern wage job growth from both the public and private sector at about 50,000 per year, while the working age population is increasing at about 800,000 per year. This creates an environment of intense competition for good jobs. This situation means that many young Kenyans who aspire to modern wage work as a first best option, will have difficulty finding jobs and resort to secondary options, such as self-employment or low end wage work.

Unemployment is almost entirely an urban phenomenon, while underemployment is more widespread in rural areas. Overall unemployment rates (for all ages) in 2009 using the conventional definition—the

Figure 2.2: Breakdown of Kenya's working age population by employment status



Source: World Bank analysis of census data

percentage of the labor force that is seeking work—stood at 7 percent of urban adults and 2.5 percent of rural adults. In rural areas, unemployment rates are low because most of those without other jobs are working on family farms. Rather than unemployment, in rural areas, the more common phenomenon is underemployment—people working at below their productive potential.

Unemployment rates are highest for young people, especially those in urban areas. In 2009, the overall unemployment rate for Kenyans between the ages of 20 and 24 was 8.1 percent. The unemployment rate for urban residents in this age group is 13.2 percent.

While youth unemployment is seen as a major concern in Kenya, the employment outlook improves as individuals grow older. Data from multiple censuses enable tracking of inactivity rates of groups over time. In 1999, inactivity rates for 20-24 year olds was nearly 15 percent, by 2009, the inactivity rate for these same individuals, who were then 30-34 years of age, had fallen by more than half, to 7 percent. This suggests that youth unemployment is high as Kenyans transition from school to work but after some time, most of them find work.

Over the long run, the average level of skills in Kenya's workforce has increased dramatically. At the time of Kenya's independence in 1963, approximately three out of four adults in their 30s had never attended school. Today, very few do not attend school at all. In 2009, two out of three adults completed primary school, and half of primary school graduates completed secondary school. Due to policies in the last ten years that have boosted primary school enrollments, both primary and secondary completion rates are likely to see substantial gains in the near future.

More education opens up the possibility of wage employment and higher earnings, especially for secondary or post-secondary graduates. Data shows that the probability of getting a wage job increases steadily with education level. More than half (52 percent) of those with secondary education or more have wage jobs, compared to barely a quarter (27 percent) of those with only some primary education. Among those with wage jobs, analyses of how much wages increase with each year of education, suggests that the returns to primary education are very low, but wages do increase more rapidly for each additional year of secondary or post-secondary education. This means that the payoff in the wage market from more education at the high levels is very substantial, but not at the low end.

Low wage returns to primary education suggest that the quality of basic education is limited. Results from tests (conducted by *Uwezo* to a randomly selected group of schools) in basic literacy and numeracy point to low levels of learning overall, particularly, for poor students. Overall, one third of Standard 3 students cannot pass a Standard 2 level test. Among 10 to 16 year old students from poor or extremely poor households, a little more than half can pass literacy and numeracy test for their grade level. Among the non-poor the pass rates are close to 80 percent, suggesting that wealth buys better quality education opportunities for children.

KEY CHALLENGES

Kenya needs to expand high productivity jobs in the private sector. Kenya has had success expanding its wage-based agricultural sector—in cut flower farming, tea, and coffee—and also in creating jobs in information and communications technology (ICT). These sectors are competitive internationally, and have been a vehicle for Kenya's growth. While there are strong firms

in the manufacturing sector, what stands out in Kenya's economic trajectory is the lack of a takeoff in manufacturing. At 11 percent of GDP, the share of manufacturing in the economy has not changed since 1960.

Firm surveys suggest that the key barriers to creating good jobs in Kenya are macroeconomic instability, constraints created by infrastructure and energy bottlenecks, and corruption. More than half of surveyed manufacturing firms in the 2007 Enterprise Survey, report these factors to be major or very severe constraints.

In a 2011 survey of employers in Kenya, almost three-fourths cited macroeconomic conditions and instability as an obstacle to growth, and 44 percent cited political instability. Kenya's macroeconomic management in recent years has been strong, but political instability, especially after the 2007 elections, has consistently had a negative effect on growth.

Manufacturing firms face a combination of high inventory and transportation costs. Supply chain problems due to challenges with transportation have resulted in Kenya's manufacturing enterprises holding an average of 47 days of critical inventory for production. Transport costs in Kenya are more than double the costs in South Africa, China and India, and are driven by several factors including poor infrastructure, long waits at weighbridges, delays due to inefficiencies and low capacity at the port of Mombasa, and demands for bribe payments.

A large majority of firms in Kenya experience financial losses, due to power interruptions. Close to 80 percent of firms cited power disruption as a source of financial loss, amounting to about 7 percent of sales on average. Due to power shortages, two out of three firms in Kenya own or share a

generator, and use it for 16 percent of their electricity needs. This is costly, requiring expensive fuel purchases and substantial capital investments. Additionally, obtaining a power connection is still difficult in Kenya. The country ranks 162 out of 185 in the ease of getting electricity, in the World Bank's 2012 Doing Business rankings.

A third drag on job creation comes from kickbacks on government contracts and pervasive demands for bribe payments. Overall, 71 percent of firms say they need to give gifts to obtain government contracts, and the average amount paid is 12 percent of the value of the contract. Close to 80 percent of firms cited having to give gifts to public officials to "get things done". Firms report that on average, 4 percent of the value of their sales is directed towards bribe payments. On both counts, corruption rates surpass the average for the world and for countries in Sub-Saharan Africa. Overall, the total costs of corruption in 2011 was estimated at over KES 104 million, which is the equivalent of more than 253,000 well paid wage jobs. This is close to the number of urban unemployed youth in Kenya. In other words, if firms were able to redirect all the funds they use for bribes to salaries, they could hire almost every young unemployed Kenyan.

Many young Kenyans face considerable hardship as they enter the job market. Findings from a qualitative study conducted by the World Bank revealed that nepotism, tribalism, demands for bribes and sexual harassment are common challenges faced by youth entering the job market. Young people from wealthier and better connected families are seen as having large advantages in finding work, regardless of skills and qualifications. For those with the least power in Kenyan society, the possibility of obtaining a wage job—or even just the access to markets for a self-employed job—can seem daunting or

hopeless. Pervasive discrimination stacks the deck against the poor and women, threatening to exacerbate inequalities over time. In addition, if exploitation rather than merit, continues as a means of allocating jobs, frustration and a sense of injustice will increase the risk of conflict.

Informal is normal—today and for the foreseeable future. The reality in Kenya is that even if the country accelerates wage job creation, the fastest growing category of employment and source of livelihood in a setting where people of working age are larger in number, increasingly educated and moving off the farm, will be informal non-farm self-employment. The challenge is that this sector is dominated by informal household and micro enterprises, with very low levels of capital and productivity.

Harassment by authorities, access to finance and lack of skills represent three main challenges that face the self-employed in the informal sector. One study among women street vendors in Nairobi found harassment from city authorities relating to licensing, taxation and site of operation, as the most significant challenge they faced. Demands for bribes from police amounted to 3 to 8 percent of income. Other studies highlight the lack of adequate space as a challenge, which points to little consideration in urban planning of the needs of informal enterprises. Access to financing—particularly lack of credit and savings instruments—also emerges as a consistent challenge faced by household enterprises. Lastly, the skills that are needed to run a productive enterprise are typically not provided by formal schooling.

There are few clear guidelines on how to improve the productivity of informal enterprises. Since both policymakers and researchers have largely neglected household enterprises, there is limited knowledge

on what works to improve earnings and productivity. Research on alleviating financing constraints through cash grants and micro-credit, has provided evidence that these instruments can increase entry into self-employment, but not on whether they improve productivity. One study in Kenya offers evidence that facilitating access to savings accounts to women market vendors, encouraged more savings and more productive investment. Despite the existence of several public and private programs to improve skills—primarily training in business skills, training in technical skills through apprenticeships or vocational training, and training in behavioral skills—rigorous evaluations of these programs are scarce and when evaluated, show limited effects on productivity or earnings.

POLICY RECOMMENDATIONS

Reduce barriers to private sector growth to boost wage job creation. Most good jobs in the future will come from the private sector. Encouraging the growth and expansion of the private sector requires improving operating and investment conditions. The government can create these conditions by maintaining political and macroeconomic stability; reducing the costs and improving the reliability of transportation and energy; and eliminating job-smothering corruption.

Enforce the principles in the Bill of Rights in the 2010 Constitution that asserts equal opportunity regardless of tribe and gender. Kenya can adopt measures to fight tribalism, bribery and sexual harassment—the hardships that adversely affect job-seekers—through education, legislation and enforcement of non-discrimination policies.

Recognize informal micro enterprises as part of the legitimate economy and provide the space for them to operate. The single most important action that the government

can take to improve the welfare of the self-employed is to recognize them as a legitimate part of the economy, and encourage urban authorities to provide safe operating spaces, while protecting them against pervasive harassment.

Experiment with training programs to improve the productivity of informal enterprises, but do so through rigorously evaluated pilot programs. One promising training approach—the Technical and Vocational Vouchers program (TVVP)—is currently being examined with a rigorous impact evaluation. Initial analysis of this program has yielded interesting insights, about how to boost enrollment in training programs, and the role of choice in increasing the chances that trainees complete the programs. Continued experimentation and evaluation will continue to provide insights, about how to best support the self-employed.

Investments that will increase output on family farms include developing rural roads and irrigation systems, as well as improving farming techniques through agricultural extension. The broad formula for making small farms more productive is well known. It includes improving the institutions relevant to smallholder agriculture, as well as targeted public investment. Improvements in property rights would help, as would reforms of the relevant marketing boards, to increase incentives for producers.

Improve primary education, so that it works for all Kenyans. Kenya has made impressive gains in making schooling more accessible to children. Next steps are to ensure that Kenya continues to work towards achieving universal primary completion, increasing completion rates for secondary school, and increasing the quality and relevance of education at all levels, so that people leave school with skills that are demanded in the economy.

Continue to invest in cities, so that they work for everyone. Cities are centers of job creation and innovation for many industries. They facilitate idea exchange—the ICT innovation cluster in Nairobi is a good example of this—and they reduce operating costs for business, as they naturally bring firms, suppliers and customers closer together. As cities expand, it is important for the government to invest in urban infrastructure, so that they continue to flourish as drivers of job creation. Urban planning should also take into account the operating needs of Kenya’s growing category of informal self-employed workers.

3. Education and training for long term growth

By Helen Craig and Fred Wamalwa

INTRODUCTION

Kenya has a population of around 39 million, comprising of 14 million school-going children. Of the 14 million, 17 percent are 4-5 years old and have the potential to be enrolled in early childhood education programs, 59 percent are of primary school-going age of 6-13 years, and 24 percent are secondary school-going children aged 14-17 years. The population of Kenya is also increasing at 1 million people per year. Today the number of Kenyans with basic education has outpaced those with none, and the demand for tertiary education is also growing. The provision of quality and relevant education and training remains a national priority.

The government’s commitment is to provide globally competitive, quality education, training and research for the country’s human and economic development. This commitment is well recognized in various policy documents including the 2010 Constitution, Vision 2030 and the Millennium

Development Goals. Education and training help to provide the knowledge, skills and mindsets necessary to drive economic growth and create a knowledge-based economy. Education and training are also essential for political growth and social cohesion, as they help citizens to be tolerant, to uphold democratic values, to respect the rule of law, and develop caring and healthy communities.

In order to achieve this, the education and training sector has embraced the provisions of the 2010 Constitution and endorsed the Vision 2030 goals. The mission of the government is to create an education and training environment that equips learners with desired values, attitudes, knowledge, skills and competencies, particularly in technology, innovation and entrepreneurship, enabling all citizens to develop their full capacity, live and work in dignity, enhance the quality of their lives, and make informed personal, social and political decisions.

Vision 2030 places great emphasis on the link between education and the labor market, on the need to create entrepreneurial skills, attitudes and competencies, and on strong public-private partnerships. It assumes the development of Kenya as a middle-income country in which many citizens embrace entrepreneurship, engage in lifelong learning, perform more non-routine tasks, and are capable of more complex problem-solving. This makes citizens confident to take decisions, understand more about what they are working on, and assume more responsibility with accountability. As vital tools towards this end, they will have better reading, quantitative reasoning and expository skills. Reforms in education and training seek to move from knowledge-reproduction to knowledge-creation and application.

An enabling environment for raised learning achievement is needed, related to strong leadership and management at all levels, quality service delivery, relevant curriculum and high teacher quality. The government has undertaken major reforms to attain its policy goal of providing quality education and training to its citizens. The most notable include the ongoing Free Primary Education (FPE), Free Day Secondary Education (FDSE), and bursaries and loans to needy students mainly at secondary and tertiary levels. Other reforms in the education sector include the Sessional Paper No.1 of 2005 on a Policy Framework for Education, Training and Research; the adoption of a sector-wide approach to the planning and financing of education and training (the Kenya Education Sector Support Program); and several new education Bills.

The government has also committed significant financial resources to the sector, and this has delivered returns. Spending on education has been growing in real terms, maintaining a 20 percent share of the national budget and about 6.5 percent of Gross Domestic Product. Kenya spends more on education relative to its comparators. It has succeeded in getting many children into school and the number attending school has been increasing for all levels, to the extent that by 2020, the number of Kenyans with a university degree should exceed those with no education. Despite these gains, there are remaining concerns regarding equitable access for all, student learning levels, curriculum relevance, fiduciary oversight, and system efficiency.

Recent reforms in the sector have focused on making the education system responsive to the aspirations of Vision 2030 and the 2010 Constitution. Institutional and management arrangements will also change with the

implementation of the 2010 Constitution. County governments will take over the responsibility for providing early childhood education and running village polytechnics, while the national government will retain the responsibility for education policy, standards, curricula, examinations and the granting of university charters. It will also provide basic education, and manage public universities and other institutions of research and higher learning. The current two education ministries are likely to be merged, while the Teachers Service Commission (TSC) has been established as an independent commission.

KEY FACTS AND TRENDS

Kenya is getting returns on its investments in education, and now the majority of Kenyans have attained some basic level of education.

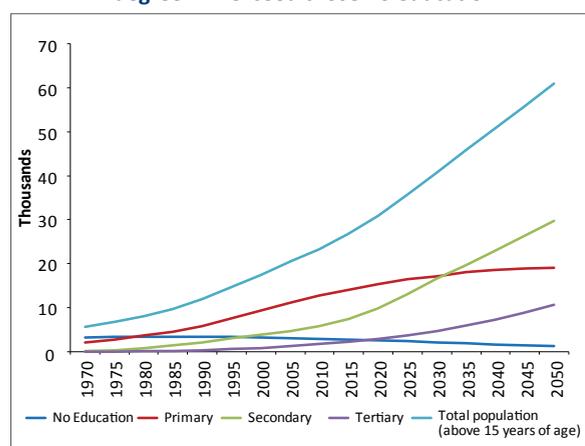
Enrolments in Early Childhood Development (ECD) and primary programs have increased from 1.6 million and 7.2 million in 2003 to 2.3 million and 9.9 million in 2011, respectively. Primary school net enrolment rates have been consistently over 80 percent over the period 2004 to 2011 (see Table 3.1). As shown in Figure 3.1 since 1980, the number of Kenyans with primary education has exceeded those with none. Over a decade later, those with secondary education also exceeded those

with no education. The number of Kenyans with secondary education has risen from 4 million in 2000 to 7 million in 2011, and this number will triple by 2035 according to projections on educational attainments in Kenya by the Wittgenstein Center for Demography and Global Human Capital. In absolute numbers, secondary enrolments increased from a low base of 0.9 million in 2003 to 1.8 million in 2011.

Tertiary education has increased and estimates show that by 2020 the number of Kenyans with a university degree is expected to exceed those without any formal education. Enrolments in Technical, Industrial, Vocational and Entrepreneurship Training (TIVET) institutions increased from 70,500 in 2005 to about 100,000 in 2011. Enrolment in public universities almost doubled between 2005 and 2010, as shown in Table 3.1. But there are still not enough places, because 77 percent of secondary school graduates with the minimum required university entry grade of C+ are not able to get places in public universities. Most join either public universities as self-sponsored students, or private ones.

Nationally, enrolment rates at ECD and primary levels do not indicate a significant attendance bias by gender. Across ECD and primary schools, boys and girls share almost equal attendance opportunities, with the Gender Parity Index (GPI) coming closer to 1. There is however a wider gender gap in favor of boys at secondary school, where the GPI was 0.86 in 2011—with not much improvement over the last 5 years, as shown in Table 3.1. Also, in some regions there are huge disparities in access to education opportunities between girls and boys, even at primary level. Generally, girls are much less likely to go to school in the arid areas, including in Mandera, West Pokot, Garissa, Samburu, Turkana and Wajir.

Figure 3.1: By 2020, Kenyans with a university degree will exceed those no education



Source: Vienna based Wittgenstein Center for Demography and Global Human Capital

Notes: In the figure, total population (15 years of age) is the summation of those with no education, primary, secondary and tertiary education

Table 3.1: Trends show that Kenya has made successes in getting children into school

		2005	2006	2007	2008	2009	2010	2011
Pre-primary	Enrolments (000)/¹	1,643.2	1,672.3	1,691.1	1,720.2	1,914.2	2,193.1	2,370.0
	GER	57.9	58.8	59.0	59.8	60.6	60.9	65.6
	NER	32.9	33.6	42.1	43.0	49.0	50.0	52.4
	GPI	0.98	0.93	0.93	0.94	0.98	0.99	1.02
Primary	Enrolments (000)/¹	7,691.5	7,632.1	8,253.9	8,563.9	8,831.5	9,381.0	9,857.9
	GER	107.6	103.8	108.9	109.8	110.0	109.8	115.0
	NER	82.8	83.5	91.6	92.5	92.9	91.4	95.7
	GPI	0.95	0.96	0.95	0.96	0.96	0.97	0.98
	Completion Rate	83.2	79.8	81.0	79.8	83.2	76.8	74.6
Secondary	Enrolments (000)/¹	934	1,030.1	1,180.3	1,335.9	1,472.6	1,653.4	1,767.7
	GER	28.8	32.4	38.0	42.5	45.3	47.8	48.8
	NER	20.5	22.5	24.2	28.9	35.8	32.0	32.7
	GPI	0.89	0.89	0.85	0.85	0.87	0.87	0.86
	Primary to Secondary Transition	66.9	64.1	69.9	64.1	66.9	72.5	73.3
	Percent of candidates scoring C+ and above			30.2	24.5	24.3	27.3	29.1
TIVET		70.51	71.17	76.52	85.20	80.98	82.65	103.07
National Polytechnics	Enrollments (000)	20.2	20.5	21.3	22.9	16.5	15.8	20.3
Other TIVET institutions/ ² Youth Polytechnics	Enrollments (000)	27.4	27.7	30.2	32.6	33.2	33.8	48.9
	Enrollments (000)	22.9	23.0	25.0	29.7	31.3	33.1	35.0
University		92.32	112.23	118.24	122.85	177.74	177.62	198.26
Private universities	Enrollments (000)	10.6	20.9	21.1	22.2	35.2	27.8	40.3
Public universities	Enrollments (000)	81.7	91.3	97.1	100.6	142.6	139.8	157.9

Source: Various Economic Surveys

Notes: (i) ¹/includes both private and public ²/includes technical training institutes and institutes of technology (ii) GER is Gross Enrolment Rate, NER is Net Enrolment Rate and GPI is Gender Parity Index

Compared to other countries at a similar level of development, Kenya has done well in terms of enrolments, and relative levels of educational attainment and literacy.

Kenya's primary Net Enrolment Rate (NER) is at par with Uganda (92.2 percent) and higher than South Africa (84.7 percent), Ghana (75.9 percent) and the Sub-Saharan African average (75.1 percent). Kenya enjoyed a more educated youth population as at 2009, with its youth literacy rates being higher compared to its peers such as South Africa, Ghana, Uganda and Tanzania. However, Kenya needs to improve in other aspects of

education, such as reducing the percentage of learners who fail to complete primary education; addressing enrolment rates which have now started to stagnate or fall; and increasing the ratio of girls' enrolment.

Budgetary resources devoted to the education sector in Kenya are high compared to other countries in the region.

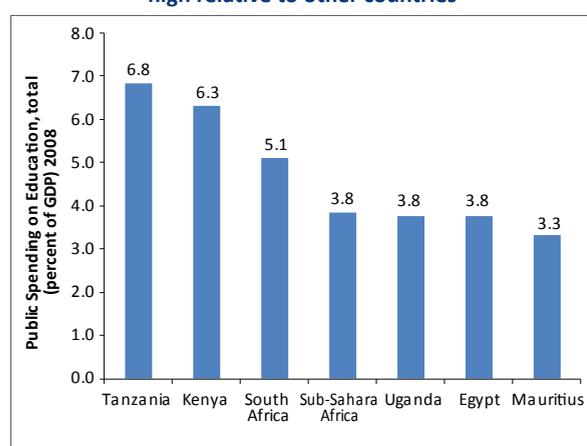
Spending on education for the last eight years has been growing in real terms, maintained at 20 percent share of the national budget and about 6.5 percent of GDP. The total government education budget is estimated

at slightly over KES 200 billion (about 6.6 percent of GDP) in 2011/12, from a low base of KES 74.6 billion in 2003/04 (see Table 3.2). This is well above the Sub-Saharan African average of 3.8 percent, and the investment is higher as a share of the economy than in South Africa, Uganda or Egypt (see Figure 3.2). Spending has shifted towards secondary and higher education, although primary education still takes the largest share. The increased spending in primary education has generally been pro-poor, and it has proportionately benefited the poor. The government needs to sustain the increase in

spending at secondary and higher education levels (while ensuring that the poor benefit most), since higher education increases translates to higher employability and higher wages.¹

The highest spending goes to staff compensation, which is mostly for teachers' salaries. Spending on staff compensation (including wages and salaries, allowances and benefits) constituted almost 60 percent of total spending in 2011/12, and is bound to increase further, due to recent teachers' strike which forced the government to put 18,000 contract teachers on permanent terms and harmonize teachers' salaries. The decision to change the status of contract teachers is somewhat contentious, since previous impact evaluation work in Kenya has pointed to the positive impact that contract teachers had on learning outcomes (see Box 3.1). These positive results may partly be attributed to the recruitment of additional teachers in the foundational year of schooling (first grade), targeted instruction, and teacher monitoring. The policy question going forward is how to contain the wage bill as the government deals with the fiscal challenges associated with devolution.

Figure 3.2: Education sector in Kenya are high relative to other countries



Source: World development indicators

Table 3.2: Spending on education maintained at about 6.5 percent of GDP

	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9	2009/10	2010/11 Budget Estimate	2011/12 Budget
Total Expenditure	74.6	83.4	96.2	108.6	126.2	141.6	166.1	201.1	216.6
Central Government	74.1	81.0	92.6	103.8	121.3	137.0	161.9	194.1	208.1
Devolved (CDF and LA)	0.6	2.4	3.5	4.8	4.9	4.6	4.2	7.0	8.5
Expenditure (2003/04 prices)	74.6	77.9	85.6	89.6	99.1	98.3	98.6	106.6	109.4
Central Government	74.1	75.7	82.4	85.7	95.3	95.2	96.1	102.9	105.1
Devolved (CDF and LATF)	0.6	2.2	3.2	4.0	3.9	3.2	2.5	3.7	4.3
Total Expenditure (percent of GDP)	6.2	6.2	6.3	6.3	6.4	6.3	6.8	7.2	6.6
Total Expenditure (% of Government spending)	19.8	22.0	22.2	21.3	19.0	20.4	20.6	20.0	22.1

Source: Various Economic Surveys

Notes: (i) 1/includes both private and public 2/includes technical training institutes and institutes of technology (ii) GER is Gross Enrolment Rate, NER is Net Enrolment Rate and GPI is Gender Parity Index

¹See work by Manda, Mwabu and Kimenyi, 2002.

Box 3.1: Studies in Kenya show positive effects of contract teachers on learning outcomes

A study by Kremer et al (2011) employed a randomized evaluation method to examine the effect of contract teachers and parental school monitoring on learners' performance, as measured by test scores. It is based on a program implemented by International Child Support, which provided funds to 140 schools (randomly selected from a pool of 210 schools in Western Kenya) to hire an extra teacher for first grade classes. Results from the study show that providing school committees with funds to hire a contract teacher had a generally positive effect on learning: higher tests scores were observed in 140 schools (treatment) relative to the 70 schools (comparison). The biggest gains come when local school committees are empowered to effectively monitor these teachers and when extra classes are structured so as to target instruction to pupils' initial achievement level.

Per capita spending has been increasing, but not at the same pace as enrolment rates. Spending per learner at both primary and secondary levels has increased in real terms by 57 and 64 percent respectively from 2004 to 2010. However, since 2004, net enrolment rates at both primary and secondary levels show declining rates, against steady increases in per capita spending, indicating a possible decrease in return on public spending in the education sector (see Figure 3.3).

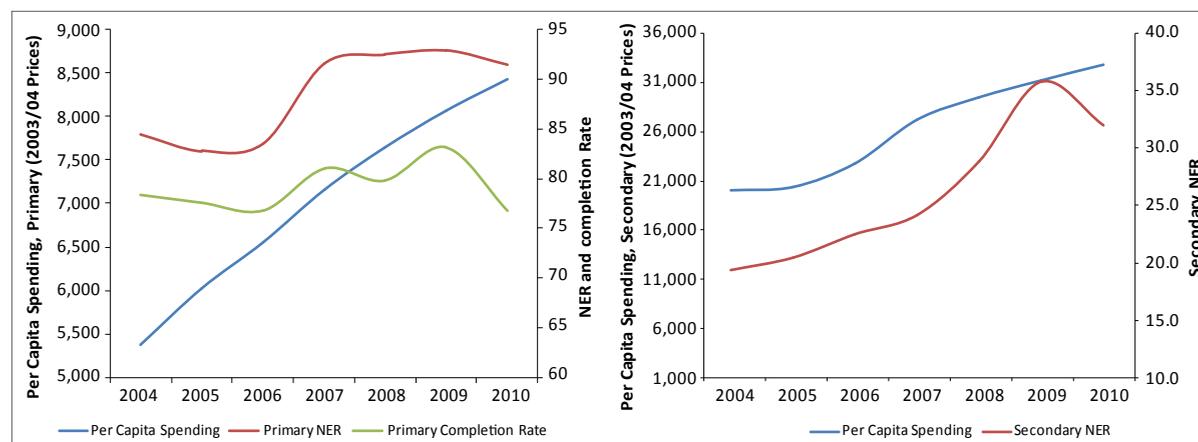
KEY CHALLENGES

The increase in enrolment following the elimination of user fees has been accompanied by a decrease in resources and increased concern over access and equity. As a direct result of FPE, primary schools saw a large increase in enrollment. However, learners have struggled to stay enrolled in school (primary completion rates

have reduced from 81 percent in 2005 to 74.6 percent in 2011), owing to unfavorable learning environments and decreasing quality. During the 2010/11 academic year, over 400,000 learners did not complete grade 8, and from tracking learners who began primary school in 2003 (the year when FPE started) has shown that only 59 percent completed. Schools struggle to provide space, classrooms, books and notebooks, while in some areas teachers face huge class sizes.

Access issues at primary level are compounded by even more challenging access issues at ECD and secondary levels. Lack of integration of ECD into the primary school system has stagnated access at this level. The NER at ECD is relatively low, at 52.4 percent in 2011 (albeit increasing from 32.9 percent in 2004), which means that 47.6 percent of children of ECD school-going age

Figure 3.3: Increase in sector spending has not kept pace with enrolment rates



Source: Appropriation accounts (for spending data) and Ministry of Education

(3-5 years) do not enroll in ECD centers. This is a missed opportunity, since ECD provides for the development of the learner's brain, which is most rapid during the first five years of life. In addition, this stage provides for the emotional, cognitive, social and physical development of the learner. Secondary school NERs in Kenya are low at 32.7 percent in 2011, albeit increasing from 20.5 percent in 2005.

The key concerns with secondary school access revolve around the process of student selection and costs. First, the Kenya Certificate of Primary Education (KCPE) plays a key role in controlling access, because if students fail the examination, they either drop out or repeat the final year of primary school. Second, when KCPE results are released, three selection rounds follow in sequence: national schools first, then provincial schools, and finally district schools. This only perpetuates the system of hierarchy: national schools begin the selection, thus eliminating many opportunities from the lower schools to receive the higher test-performing students. The government waived tuition fees in 2008 with the FDSE program, but this resulted in a drastic increase in boarding costs—in fact secondary education is still actually far from free. Since it takes both the public and private sector to cater for the increased numbers in primary school, private primary school graduates generally reach higher levels of attainment. This makes competition for secondary school places contentious, a struggle between wealthy and poor students.

Kenya also experiences huge regional variations in education opportunities and outcomes, which threatens to erode the gains made. Almost two-thirds of Kenya's counties have primary school NERs above 80 percent. However, there is a significant gap in enrollment ratios between the highest and the lowest: enrollment in Murang'a

County is 93 percent, while in Turkana it is 25 percent. In every aspect, arid regions lag behind. Primary NERs fall behind the Millennium Development Goals target in counties located in arid regions, with net enrolments of less than 50 percent. At the secondary level, county NERs range from 5 to 10 percent in the arid regions, to around 50 percent in Kiambu and Nairobi counties. Children in arid regions have lower skills, are absent from school more often, and benefit from fewer teachers and poor facilities. Data from the Afrobarometer survey also show that wealthier households have access to better education services (better facilities, teachers and quality of teaching) than those from poor households.

More children attend schools but they are not necessarily achieving the desired learning outcomes. According to the Kenya National Examinations Council's report of the 2011 KCPE results, some candidates could hardly construct a sentence in either English or Kiswahili. The 2011 *Uwezo* literacy and numeracy survey² revealed that nationally, 7 out of 10 children in Class 3 cannot do Class 2 work. Also, 12 percent and 14 percent of Standard 7 learners failed to reach Standard 2 numeracy and English tests respectively. Educational attainment is often not sufficient to enable students to proceed to higher education: only 24 percent of Kenya Certificate of Secondary Education (KCSE) examination-takers obtain grade C+, rendering them eligible for university admission.

However, the quality of education and training in Kenya seems to be better than for most of Sub-Saharan Africa, as Kenyan learners perform well on comparable standard competency tests. The results from the Southern and Eastern Africa Consortium for Monitoring Educational Quality (SAQMEQ) III survey in 2010 revealed

²Uwezo, 2011 'Are our children learning? Annual Learning Assessment Report for Kenya 2011', Uwezo Nairobi.

that Kenyan learners in Standard 6 (aged 11 years) generally perform well on both reading and mathematics tests, compared to their counterparts in 15 countries in Sub-Saharan Africa.

While the 2006 ECD Policy is sound, the implementation of ECD struggles and is not yet well developed to respond to the needs of children at this level, especially regarding trained teachers, adequate nutrition, and classroom environment. The ECD curriculum is guided by the policy, which emphasized holistic development. In practice however, public pre-primary schools do not have well-developed early-childhood services for children under the age of five. Teaching is focused on literacy and numeracy skills meant for early primary education centers—partly due to pressure from parents, who view ECD as early schooling. Child-centered pedagogical methods, which would provide a better basis for learning, exist in only a few private centers in urban areas. Learning from the global empirical evidence on the importance of early childhood learning shows that the quality of such care in Kenyan public schools inadequately takes account of the need for early cognitive stimulation and better nutrition (Box 3.2).

The deteriorating quality of education is partly due to fundamental systemic problems in the 8-4-4 system of education.

At the school level, the curriculum is quite broad: there is extensive subject selection, and it is too focused on passing examinations. Due to the pressure to attain high grades, teaching revolves around passing tests, and extra classes are mandated under the pretext of completing the bulky syllabus. Excessive emphasis on standardized national testing has led to test score inflation and examination cheating scandals, thereby compromising the ability to instil the values of integrity, honesty, respect for others and hard work. Often, resources are diverted to preparatory testing, and learning time is lost as students spend weeks preparing for the tests. This type of pedagogy is not conducive to enhancing the capacity for critical thinking and complex reasoning, essential for the attainment of Vision 2030, which relies on the presence of an abundance of creativity and innovation, especially among the youth.

There is a disconnect between the curriculum and quality of teaching at higher education levels and the emerging needs of the labor market. The task force on the re-alignment of the education sector to the 2010 Constitution

Box 3.2: Evidence of early childhood development impact

There is emerging evidence internationally of the higher returns to early childhood investments. Delays in children's cognitive and overall development can lead to future public health and education sector costs because these children lose out on significant brain development in the first years—including prior to birth. The greatest window of opportunity for brain development is mostly in the last trimester through to 2-4 years of age, and is dependent on sufficient nutrition and early sensory and cognitive stimulation. Children who start behind tend to stay behind (Schulman and Barnett, 2005), and the ability to change brain function decreases over time (Levitt, 2009). Empirical evidence points to the strong cross-sectoral links between education, health and social protection interventions. For example, (i) for children to be prepared to learn and to stay in school, they need to be nourished, free of worms, and healthy; (ii) brain development and cognitive ability are critically affected by nutrition and early stimulation, especially during the prenatal to 2 year growth period; and, (iii) poor families often need interventions such as cash transfers to access basic education and health facilities. This will require county governments to coordinate closely with national social protection schemes such as the orphans and vulnerable children cash transfer scheme, and with the county primary health programs.

has identified a number of challenges facing university education. According to the report, there is a general mismatch between what universities teach and the demands of industry. The high number of students enrolling in universities, mainly as a result of parallel degree programs, continues to overstretch the capability of staff to deliver on the teaching/learning programs. The new culture of part-time teaching in universities, due to the shortage of lecturers and tutors, compromises the quality of education. There is an increasing number of private commercial universities that have sprung up, and maintaining the expected standards remains a challenge to these institutions too.

The TIVET subsector faces similar quality and relevance challenges. According to a study by Onsomu *et al* (2009), the TIVET sector suffers from fragmented programs, limited integration into the formal education system, weak linkages with labor markets, insufficient financing, inadequate monitoring, poor wage employment opportunities for its graduates and limited alignment with technological innovation in the local and global markets.

The number of pre-primary and primary teacher training colleges has increased, estimated to have reached 105 and 89 respectively, but enforcing quality and standards for these colleges remains a challenge.

Teachers are struggling to teach, some are not reporting to school, and others are not maximizing their learning time within classrooms. On average, it is estimated that on any given day, 13 out of 100 teachers are not in school.³ Teachers also face pedagogical challenges. A 2011 survey by *Uwezo* shows that nationally, 1 in every 4 teachers do not follow the timetable, and the USAID-funded Primary Math and Reading initiative shows

that teachers in Kenya need to be trained further to teach core fundamental early reading and mathematics skills⁴. Teachers and other school administrators also need to be trained in leadership and monitoring to ensure attainment of high standards and to enhance their interface with students, parents, and other stakeholders, as emphasized in the report of the task force on education, and as catered for by the Kenya Education Management Institute.

Areas to target for efficiency improvement in the sector include reviewing teacher distribution and utilization. The Ministry of Education estimates that Kenya is short of 80,000 teachers for both primary and secondary schools to effectively provide instruction to 11.3 million students in public primary and secondary schools. The norm for Pupil Teacher Ratio (PTR) for primary is 40, but before addressing this gap, there is need to address the current poor distribution of teachers. For instance, in north eastern Kenya a teacher handles 25 children more than does a teacher in the central region of the country. Data (for public schools) on enrolment and teacher distribution from Teachers Service Commission shows that in 2011 there were counties with almost the same levels of enrolment, but with different numbers of teachers. Furthermore, there are counties with less than the recommended primary PTR of 40. Demographic trends also show that some regions are experiencing higher growth in school-age populations than others. At secondary level, there is no clear norm for PTR. It is based on the curriculum-based establishment system, where teachers are trained to teach only one or two subjects for individual subjects, and most schools offer a large range of optional subjects, some with low demand, resulting in average low class sizes.

³ *Uwezo, 2011 'Are our children learning? Annual Learning Assessment Report for Kenya 2011', Uwezo Nairobi.*

⁴ *USAID, GoK, 2012, Primary Math and Reading (PRIMR) Initiative Baseline Report.*

The potential to start new schools, funded through devolved funds and the community, further threatens the efficient use of resources in the sector. There have been efforts to improve the quality of school infrastructure and also to start new schools, mainly through Constituency Development Funds and community support financing. But new unplanned school facilities continue to put a strain on available inputs, especially teachers. There is need to ensure that devolved funds are not used to start schools that are too small, which causes further inefficiencies in the system, but for the most over-crowded schools. Achieving national objectives with decentralized funds remains a challenge.

Systematic quality assurance and policy impact evaluation is lacking. There are limited systematic school visits. Apart from the annual school surveys, schools are not obliged to prepare school plans, or performance and accountability reports. Poor and/or inadequate quality assurance services are due to the shortage of quality assurance and standards officers; inadequate resources such as vehicles and budgetary allocations for carrying out the work; and inadequate training on the subject. However, several new initiatives show that greater attention is being paid to ensuring that the performance of the sector improves. One example is the 2012/13 Public Expenditure Tracking and Service Delivery Indicator Survey of 300 primary schools, that provides a base-line against which to benchmark future primary school performance improvement.

The sector does not have up-to-date, consistent or reliable data system critical for planning, oversight and accountability. There is limited reliable information capable of providing policy-makers, parents or school managers with the school-level information they require. Such information includes enrolments, school inputs, financial flows and

school performance. Data are held by multiple agencies in the sector and they are not compatible between them, thus precluding proper comparisons and sharing best practice. However, an initiative is currently underway to develop a national integrated education information management system, which will address this challenge.

The sector also faces accountability issues. It is highly centrally managed, with pervasive powers at ministry headquarters and little management oversight from the bottom, in particular at the community level. The sector has had public financial management concerns, and an internal audit review in 2010 found that significant amounts of public and donor resources did not benefit the intended beneficiaries. While more resources are being devolved directly to the school level for direct management, there is no explicit provision for the auditing of finances at individual primary and secondary schools. A new financial management assessment is needed to determine areas for further attention.

POLICY RECOMMENDATIONS

(i) Access

- Improve access at ECD level by integrating ECD into Free Primary Education policy.
- Adopt a more targeted 'no child left behind' strategy for children, particularly girls in arid areas. The strategies should address the cultural, social and economic barriers to children entering school in counties that are lagging behind.
- At secondary level, address the current low enrolments by scaling up the current Free Day Secondary Education program, including alleviating the cost burden on students from poor households through bursaries and other targeted forms of financial support. This will increase the current low secondary enrolment rates.
- At TIVET and university, encourage more private sector participation.

(ii) Quality

- Improve ECD implementation through possible public-private partnerships which can focus better on physical, cognitive, linguistic and socio-emotional development (4-5 year olds); and school health and nutrition programs.
- At primary and secondary levels, focus on core service delivery activities to retain students and increase learning. These are the top school related areas to be focused on for raising student learning levels:
 - (a) Review curriculum learning outcomes for relevancy and sequencing across grade levels and cycles (primary and secondary).
 - (b) Ensure there are sufficient books which focus on age-appropriate learning tasks, including early grade reading.
 - (c) Maintain regular classroom attendance by teachers, and train teachers on how to use books and how to teach (especially core fundamental early reading and mathematics skills).
 - (d) Ensure that learners spend sufficient time on learning tasks.
 - (e) Strengthen school leadership for overall school management as well as instructional support to teachers, working more closely with parents and community, and mobilizing resources.
- Ensure life skills are incorporated in the curriculum and that teachers are trained on how to teach these skills.
- Introduce interactive e-learning, moving beyond physical books, while ensuring there is infrastructure to support this.
- At University and TIVET, focus on quality of teaching and relevance of curriculum, and this includes:
- Develop a quality assurance framework for multiple service providers to deliver relevant skills and ethical training in needed areas.

- Mainstream public private partnerships in curriculum development and in financing of higher education.
- With the upsurge in university enrollments, evaluate and adopt methods of delivery that foster high quality teaching and effective learning.
- Establish strong linkages with business, industry and community needs (and contributions).

(iii) Efficiency

- Address the current unequal teacher distribution across counties by ensuring that additional teacher recruitment is based on current distribution, which in turn may require relocating teachers from over-supplied to under-supplied counties.
- Ensure infrastructure school expansion addresses over-crowding instead of creating small under-utilized schools to be achieved through coordination between the central government, county government, CDF committees and communities.
- Ensure service delivery by integrating performance management, through performance contracting and appraisals.

(iv) Financial management, monitoring and accountability

- Handle the current data challenges by integrating and harmonizing the data in the sector, while ensuring that it is regularly updated.
- Undertake a sector financial management assessment to better prepare for a new phase of support to the sector.
- Initiate a review of the effectiveness of local authority and CDF projects and ensure that sub-national spending programs going forward are coordinated by county governments.

4. Making a healthy Kenya

By Gandham Ramana

HEALTHIER IS WEALTHIER

Good health makes the foundation for development, and societies benefit from healthy populations that are more productive and save and invest more. One extra year of life added raises the GDP by 4 percent.¹

A healthy population is critical for achieving the Vision 2030 goal. Several actions to improve the health status of the population are well grounded in the 2010 Constitution that makes health a basic right, and proposes a devolved system of service delivery, that is responsive to local needs.

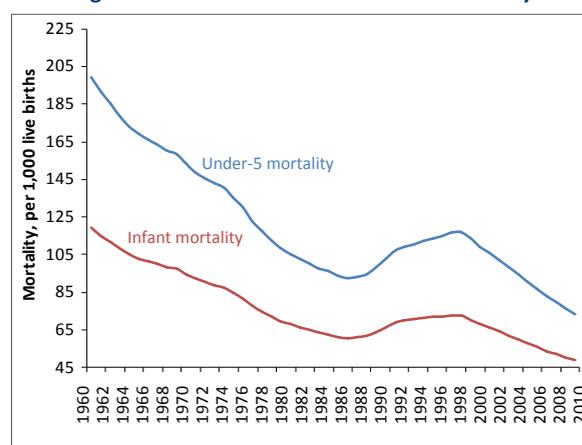
The goal of Kenya's health policy (2012-2030) is to achieve the highest possible health standards, responsive to population needs. The policy aims to achieve this goal through supporting the provision of equitable, affordable and quality health and related services to all Kenyans, at the highest attainable standards.

Kenya has shown an increasing commitment to the Sector Wide Approach (driven by the 2005 Paris Declaration on Aid Effectiveness), and stakeholder representation is now better coordinated by the Health Sector Coordinating Committee. A Code of Conduct articulates the roles and responsibilities of key players, with the government providing leadership and enabling policies; non-state actors (both for profit and not for profit) acting as implementing partners; and development partners providing finances and technical support.

Kenya has made notable progress during the past decade in reducing communicable diseases and child mortality (Figure 4.1). However, several challenges still remain,

of which the most important ones are saving the lives of mothers, and reversing the stubbornly high levels of stunting. The poor still remain highly vulnerable to health shocks caused by unforeseen health conditions, and there is an urgent need for reliable financing mechanisms that protect them. Finally, sustaining the gains made as the health system is becoming devolved, and getting ready to face the dual burden of communicable and non-communicable diseases, need priority attention.

Figure 4.1: Trends in infant and child mortality



Source: WDI 2011

HOW HEALTHY IS KENYA?

Kenya has made good progress in reducing child mortality, and the burden of communicable diseases. However, maternal mortality remains unacceptably high. Every day, nearly forty Kenyan women die due to pregnancy related complications, yet most of these deaths are preventable.

In most countries in Sub-Saharan Africa, maternal and child deaths mostly revolve around childbirth. The trends in Kenya are the same, with new born deaths contributing to two-thirds of infant mortality. Therefore, improved care during pregnancy and childbirth will be critical for making further progress in maternal and child health.

¹ Investing in Health for Africa - The Case for Strengthening Systems for Better Health Outcomes, Harmonization for Health In Africa

Nutrition is an important determinant of the health and productivity of a population.

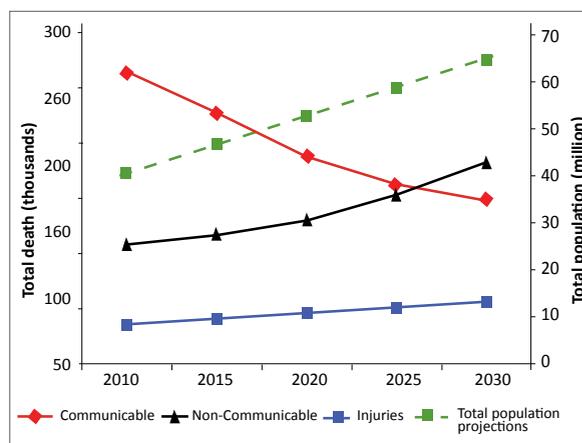
Childhood malnutrition is known to be a critical underlying cause of child mortality. Over a third of Kenyan children are stunted (DHS 2008), and more importantly, stunting has remained more or less at the same levels since the early 1990s. Even among the richest households 25 percent of children are stunted, suggesting the negative influence of child-caring and feeding practices. Kenya is estimated to lose US\$ 2.8 billion of its GDP annually as a result of childhood malnutrition (World Bank 2009).

Kenya demonstrated several gains in the control of communicable diseases, especially in reducing the burden of tuberculosis, HIV/AIDS and malaria. Kenya was also able to reverse the adverse trends in basic health service coverage which steeply declined in 2008, and if current trends are maintained, it may be able to achieve the Millennium Development Goals (MDGs) for HIV/AIDS. However, Kenya may not achieve most health MDGs, especially those related to child and maternal health (MDG 4 and 5).

The burden of non-communicable diseases is rapidly increasing in Kenya. Kenya has higher mortality rates due to non-communicable diseases compared to the global average (624 vs. 573 deaths per 100,000).² Over 50 percent of hospital admissions in Kenya are due to non-communicable diseases (Figure 4.2), and include cardiovascular diseases, diabetes, cancers and chronic respiratory diseases. The causes of chronic disease epidemics are well established and include unhealthy diet, physical inactivity, obesity, and tobacco use, as well as excessive alcohol consumption. Cardio-vascular diseases accounted for 12 percent of deaths and cancers 5 percent in 2005 and are projected to contribute to 17 percent and 8 percent of deaths respectively

by 2030.³ Injuries are estimated to be the third leading cause of deaths, and again the share of deaths due to injuries is higher in Kenya compared to the global average (116 vs. 78 deaths per 100,000). The most productive young populations, especially males, suffer a disproportionately higher number of deaths due to accidents.

Figure 4.2: Projected trends in mortality by cause groups



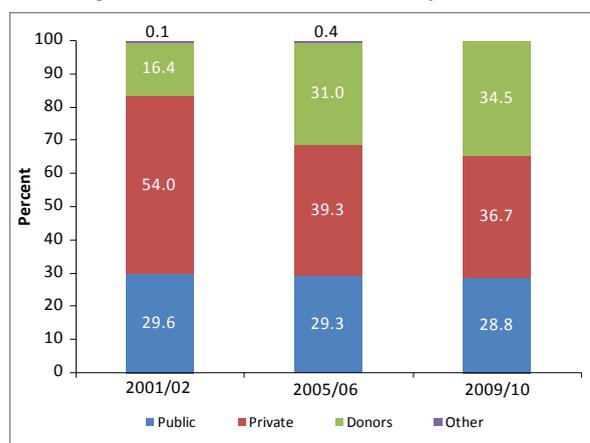
Source: Comprehensive National Health Policy Framework; Ministry of Medical Services and Ministry of Public Health and Sanitation 2011

IS KENYA GETTING BETTER HEALTH FOR MONIES BEING SPENT?

It is estimated that annually, over one million Kenyans slip into poverty due to health-related expenditure. Total health expenditure has remained at a constant 5 percent of GDP since 2001/02, with private expenditure and donor support still contributing over two-thirds of the total healthcare expenditure (Figure 4.3). Total health expenditure increased by nearly 50 percent in absolute terms, from KES 82.2 billion (US\$ 1,046 million) in 2001 to KES 122.9 billion (US\$ 1,620 million) by 2009. However, government expenditure on healthcare as a share of total expenditure has declined from 8 percent in 2001/02 to 4.6 percent in 2009/10. The estimated total per capita expenditure of KES 3,203 (US\$ 42) in 2009 is

² World Health Statistics, 2011.

³ Health Situation Trends and Distribution: 1994-2010 and projections for 2011-2030, Ministry of Public Health and Sanitation and Ministry of Medical Services, Government of Kenya.

Figure 4.3: Trends in total health expenditure

Source: Kenya National Health accounts 2009/10

more than the resource needs estimated for providing a basic package of health services, by the Commission for Macro Economics and Health.

However, Kenya is still not able to get the best value from the resources being spent on health, due to several factors. While low government spending on healthcare remains an important concern, the available resources are not being optimally used due to inequitable resource allocation (favoring hospitals and curative care); inefficiencies in the public health system that adversely affect the poor; huge out-of-pocket expenditure; significant off-budget support from partners focusing on a small number of diseases; and the inability of social safety-nets to provide risk-pooling for indigent populations. In general:

- **Access to affordable and quality healthcare remains a major challenge for most Kenyans**, with 40 percent of total health expenditure paid through household out of pocket payments.
- **The poor benefit far less from government subsidies of healthcare.** Ill-health is concentrated among the poor, but the poorest 20 percent lay claim to just 14 percent of government healthcare expenditure, compared to 27 percent of the benefit received by the richest 20

percent. In the absence of effective risk-pooling, a catastrophic illness can push the poor to even deeper poverty.

- **The National Hospital Insurance Fund (NHIF) currently covers about a fifth of Kenyans, but coverage of the non-formal sector and among indigents remains low.** Ongoing efforts to increase coverage for indigent populations resulted in adverse selection, with enrollment by those who need hospital care rather than risk-pooling. NHIF benefits are limited to hospital care, and reimbursement to those treated by the private sector is limited to bed charges. About half of the premiums go towards funding administration, partly due to the fact that premiums have not been adjusted since 1990.

Income and geographic inequalities are still predominate in accessing and using health services, with low utilization of essential services among the poor and those residing in arid and semi-arid areas. Nearly 90 percent of women in Nairobi deliver at health facilities, in sharp contrast to only 17 percent in north eastern Kenya (Figure 4.4). Only 20 percent of women belonging to the poorest households are delivered by a skilled provider, compared to 81 percent belonging to the richest ones (Figure 4.5).

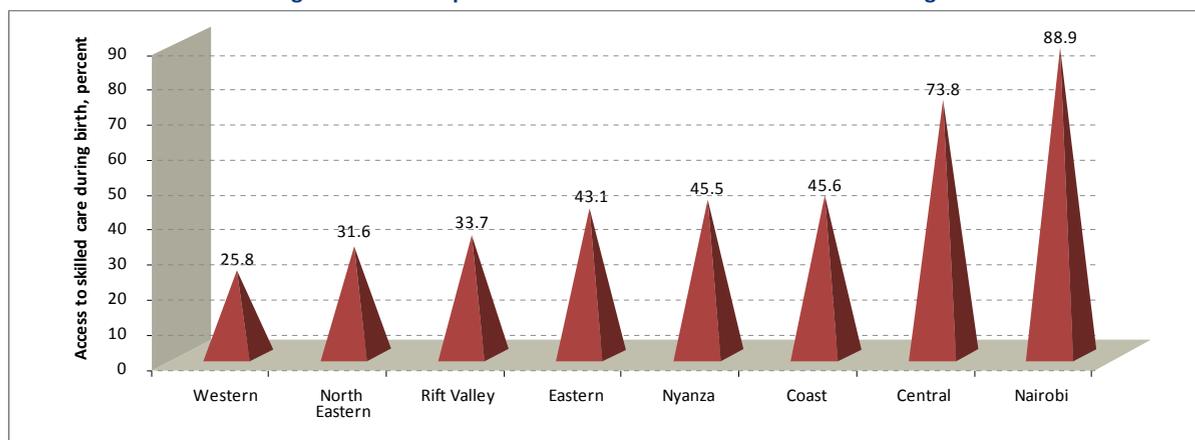
Both the quality and efficiency of public health services remain low. While many guidelines and policies exist, there is no systematic approach to assessing, monitoring and improving the performance of health services, and in any case, not according to consistent defined standards.

Health workers are unevenly distributed across the country, with greater numbers in hospitals and in urban and non-arid areas.⁴ Further, there is a general decline in the number of health workers in all provinces⁵. The overall availability of medical staff is

⁴ In 2006 only 15 percent of the workforce worked in health centers while 70 percent worked in hospitals.

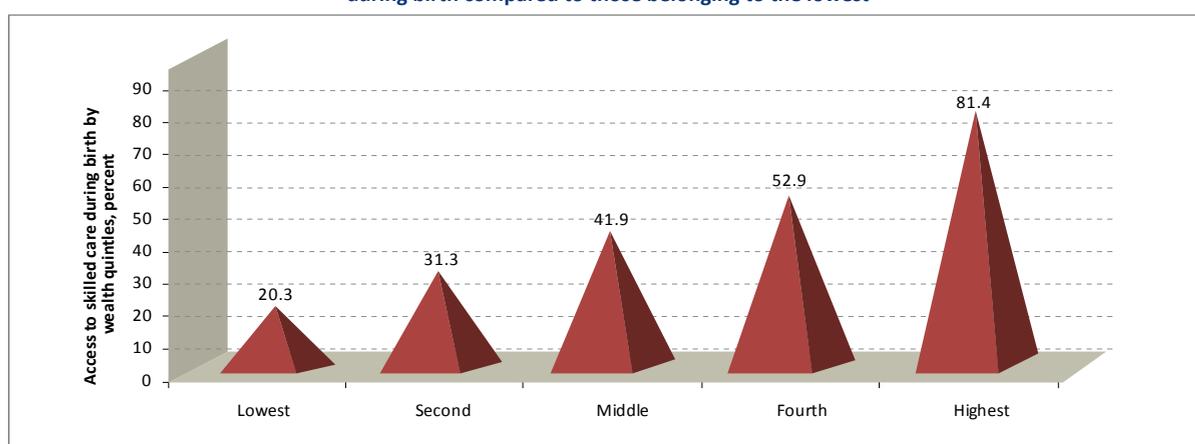
⁵ Health Situation trends and distribution 1994-2010 and Projects for 2011-2030.

Figure 4.4: Women in Nairobi and Central regions are three times likely to use skilled care during childbirth compared to those in Western and North Eastern regions



Source: Kenya DHS, 2008

Figure 4.5: Women belonging to highest wealth quintile are four times more likely to use skilled care during birth compared to those belonging to the lowest



Source: Kenya DHS, 2008

still low, estimated to be just over 5 per 10,000 of the population. Policies to attract health workers to underserved areas mostly remain ineffective. It is still not clear how the status of the nearly 3,000 staff recruited under the economic stimulus package will be regularized. The ongoing devolution will also have implications on human resources with some Counties inheriting a large number of staff, due to historical advantages of having more facilities.

The for-profit private sector plays a critical role, especially for specialized clinical services and for primary care in urban areas. Private pharmacies remain an important

source of supply for essential medicines, while traditional herbalists are well integrated in their communities, and serve as an important first port-of-call for advice and support. Faith-based organizations also constitute an important component of the healthcare system, and provide essential health services to populations in underserved areas, especially the northern arid and semi-arid regions.

Several key reforms launched by the government focus on improving access, service delivery and quality. The most important among these initiatives include exempting fee payments for basic maternal

and child health care services; the 10/20 policy for cost sharing, that limits user fees to KES 10 and 20 for accessing care at public dispensaries and health centers respectively; the Health Sector Services Fund and Hospital Services Fund that provide direct cash transfers to facility committees; and the demand-driven procurement and distribution of essential medicines and medical supplies through the “pull system” of supply.

Despite recent reforms in the Kenya Medical Supplies Agency (KEMSA) and scaling-up of the pull system, stock-outs of essential medicines and supplies are frequent. The overall government allocation for pharmaceuticals remains low and this, coupled with poor supply chain management and irrational use, forces facilities to buy medicines and medical supplies locally, paying higher prices and with a lack of effective oversight on quality.

The health sector still faces governance challenges. Accountability needs to improve at all levels of the health system, in terms of both service delivery and financial management. Community ownership and involvement in the planning and monitoring of health services have improved, following the establishment of community and health facility management committees, but the complaint redress mechanisms that give voice to citizens remain weak, lacking efficiency and transparency.

Despite the increasing mix of health service providers, there is no comprehensive and systematic engagement of non-state actors. These non-state actors play a critical role in the delivery of healthcare in Kenya, but their engagement, though higher than before, remains low. This is occasioned by fragmented legal and regulatory frameworks, and a lack of efficient and transparent institutional mechanisms.

WHAT WILL BE THE IMPACT OF DEVOLUTION ON HEALTH?

The 2010 Constitution devolves the responsibility of delivering essential health services to the counties, while the national Ministry of Health will provide policy support and technical guidance to priority national programs. The proposed devolution, with changes in roles and responsibilities and use of equitable resource allocation criteria, has great potential to improve services for the poor and underserved populations, to enhance accountability. But it also faces potential implementation challenges that include:

- **Providing more equitable health services: devolution aims for equitably distribution of resources.** However, the share of the future allocation that the counties will need to provide for the health sector out of the allocation received from national revenue—based on the County Revenue Allocation (CRA) formula—will differ significantly, ranging from 4 percent to over 40 percent. Thus, there will be some “cash-rich” and some “cash-poor” counties, and urgent technical support is required to help them optimize the devolved resources for delivering essential health services.
- **Building county health systems.** There will be a 3-year transition period during which counties can apply for the transfer of functions and funding. There is still no clear guidance on county health systems and the building of their capacity, to take over their challenging new roles.
- **Managing the Human Resource transition.** The ratio of health workers to population varies considerably across Counties. There is also an uneven distribution of workers within a county between different levels of care, with understaffing at lower level (rural) facilities, and relative overstaffing at higher level (urban) hospitals at district, provincial and national levels.

Responsibility for a large number of staff (about 43,500) will be transferred to counties, which constitutes a major human resource transition, and will require very careful management.

MAKING KENYA HEALTHY

(i) Improve the delivery and quality of Kenya's essential package of health and nutrition services.

(a) ***A "one size fits all" approach to health service delivery will not work for Kenya, due to huge diversities in health needs, population densities, and cultural practices.*** An effective community strategy is necessary to improve service delivery in northern Kenya, while facility-based services could still be an option in central Kenya, due to its high population density and the historical existence of several health facilities. The Ministry of Health needs to develop appropriate menus for different settings, to help counties to effectively plan and implement the delivery of the essential package of health services, with a strong focus on maternal and new born health.

(b) ***The scourge of stunting requires well-targeted evidence-based interventions, and a cross-sectoral approach.*** The health sector needs to urgently take action to improve the abysmally low coverage for iron folic acid supplementation during pregnancy, and scale-up the recently introduced policies such as for the use of therapeutic Zinc supplements for diarrhea management and multiple micro-nutrient supplements for children. Cross-sectoral action is equally important to reduce stunting, especially in partnership with the Ministry of Agriculture to ensure household food security, increasing access to safe drinking water, and promoting household hygienic behaviors. The Ministry of Health needs to spearhead such cross-sectoral action, benefiting

from the recent commitment of Kenya to the global Scale Up for Nutrition (SUN) initiative.

(c) ***Improve life-style changes and early detection and management of non-communicable diseases, at the primary care level.*** Early detection and effective management of hypertension and diabetes at the primary health care level, coupled with relevant policies to address risk factors such as tobacco taxation, will help to reduce the burden.

(ii) **Get better value for money from expenditure on health.**

(a) ***Scaling up output-based approaches would enable disadvantaged groups to access healthcare from preferred institutions, as recommended by Vision 2030.*** There is need to build on successful innovations, addressing both demand-side and supply-side barriers affecting access to healthcare. Kenya has successfully piloted, and is currently scaling-up the Reproductive Health Voucher scheme under the output-based aid. The results suggest a significant increase in facility-based deliveries and skilled birth attendance. Similarly, the direct cash transfers to health facilities need to be sustained and further strengthened by including non-state actors, and linking financing to results. Both vouchers and results-based financing help to strengthen the accountability of providers to their clients and enhance quality of care, thus helping in shifting the role of the government from provider of health services to purchaser of health results.

(b) ***Competent and well-motivated personnel are critical in reducing inequities and improving the quality of care.*** A strong national commitment is required to support counties in addressing the unequal distribution of human resources.

Carrot-and-stick approaches such as compulsory public service for all newly trained medical staff before licensing, and hardship allowances or performance bonuses, need to be introduced to improve the availability of skilled health staff in underserved areas. It is also important to ensure that an enabling work and social environment is created for health staff posted in undeserved areas.

(c) **Health services cannot be delivered without commodities.** There is need for sustained focus on commodity supply, by scaling up the “pull system”. This involves building on the economic and efficiency benefits of centralized procurement, while improving efficient facility-level commodity management and rational use, led by county health management teams. To achieve this, the voice of counties should be strengthened in the KEMSA Board, and which should be made accountable to counties through performance contracts. Partnerships with non-state actors are also important for ensuring commodity security, especially with the Mission for Essential Drugs and Supplies (MEDS) the procurement and distribution agency for the faith based sector, and private distribution networks with whom KEMSA is already partnering with.

(d) **Further deepen ongoing reforms to enhance citizens’ role in health service delivery, through active participation in planning, facility management, complaint redress and validation of reported results.** Transparency in sharing information on services offered through the payment of user fees for different services and inputs provided by government (both in cash and kind) need to improve. Kenya’s strategic leadership in ICT in the region needs to be effectively harnessed to apply a technology-driven

approach to complaint redress, and to facilitate information sharing with citizens. This will build on initiatives already being implemented by the health ministries to use mobile technology, such as weekly disease surveillance reporting, and tracking of essential medical supplies.

(iii) **Develop and implement a time-bound action plan for county healthcare systems strengthening.**

(a) **Clear and transparent criteria for assessing the capacity of county health systems need to be established through a consultative process involving county governments.** A traffic-light approach could be considered for objectively ranking counties, based on their capacity (for example, green for good; amber for adequate; and red for unsatisfactory) to perform critical service delivery and management functions. Comparing county’s performance using simple score-cards will help in learning and sharing lessons from good performers, and target capacity building efforts.

(b) **Using conditional grants to counties to ensure focus on national and global priorities.** By using conditional grants, the Ministry of Health could ensure focus on systems, services and results to meet national and global priorities including MDGs. The criteria for such conditional cash transfers could be: (i) providing adequate county funds for health services; (ii) adopting national health policies; and (c) meeting basic minimum service delivery standards.

(iv) **Improve universal health coverage with targeted subsidies to indigent populations.**

(a) **Introduce effective risk-pooling to ensure financial protection for the indigent populations.** The proposed initiative to

provide an insurance scheme targeting the indigent populations in a phased manner, will be critical for more informed decisions to be made on universal coverage. While additional funding is required for such an initiative, it is important to improve the efficiency of the health system. Currently, over 50 percent of government subsidies are spent on outpatient care at public hospitals. Instead of paying for inputs, the government can engage in a more strategic purchasing of hospital services, especially from the national referral hospitals and the private sector. Similarly, counties facing challenges in delivering basic health services first need to explore opportunities for contracting existing facilities operated by faith-based organizations.

(b) ***The role of the National Hospital Insurance fund (NHIF) requires redefining.*** NHIF is the largest social health insurance provider in Kenya, covering about a fifth of the country's population. Its reimbursements currently contributes an important share of public hospital revenues, and with the proposed addition of out-patient services, primary care facilities can also receive reimbursements. The potential for NHIF linking reimbursements to improve equity and quality of care needs to be explored, among other measures to improve efficiency.

(v) **Engage non-state actors to improve health outcomes through strategic purchase of services.**

(a) ***Ensure a level playing field and harmonized regulatory frameworks, building on the existing roadmap for Public Private Partnerships.*** Performance-based contracting with faith-based organizations can enhance access to basic healthcare services in the northern arid and semi-arid areas, while the services of for-profit private providers can be purchased for primary healthcare delivery, for the urban poor and for specialized services.

(b) ***The role of the private sector is no longer limited to the delivery of healthcare services.*** There are several new areas where effective collaboration is possible and desirable. These include organizing mobile money transfers to remote health facilities, decentralized warehousing for KEMSA, and the use of private pharmacies in disease control programs. The Affordable Medicine Facility for malaria has contributed to more than a tenfold decline in the price of life-saving Artemisinin Combination Therapy in Kenya. Similarly, the private sector can improve the efficiency of ambulance services, and partnerships can be used for operating common effluent treatment facilities to effectively manage bio-medical waste.

(c) ***Kenya also has a thriving pharmaceutical industry which is beginning to achieve global quality standards,*** and there is great potential for making the country a major pharmaceutical hub in the region. Such a move will benefit Kenyans by improving access to affordable medicines.

5. Protecting the vulnerable

By Sarah Coll-Black, Michael Munavu and William Wiseman

INTRODUCTION

The policy context for social protection in Kenya is changing in response to the Kenyan Constitution and the recently approved National Social Protection Policy. The 2010 Kenyan Constitution, specifically Chapter 4 on the 2010 Bill of Rights, commits the state to progressively realize the right to social security, including social assistance for people unable to support themselves and their dependents.¹ The National Social Protection Policy (NSPP) of 2012 aims to progressively expand coverage of social security in line with the government's constitutional commitment. To this end, the policy proposes to extend social assistance to various specified target populations, with the ultimate goals of providing universal access to social assistance to the vulnerable throughout their lifecycle, establishing comprehensive social security arrangements that will extend legal coverage to all workers and their dependents, whether in the formal or informal sectors and implementing a comprehensive national health insurance scheme, which covers all Kenyans, and to which those who can afford contribute.

Under Vision 2030, a comprehensive social protection program is regarded as one of the sufficient requirements for improved productivity and industrial competitiveness. Social protection is crucial for workers, as it covers family benefits and health care and provides income security in the event of such contingencies as sickness, unemployment, old age, disability, accidents, maternity and loss of the breadwinner. To address the challenge of low coverage of the social security systems, the National Social Security

Fund (NSSF) Act is being reviewed to provide for conversion from a provident fund to a pension scheme. This will facilitate expanded coverage and provide for the requirements of the people in the informal and other sectors. The fund is in the process of exploring various ways of enhancing contributions base by encouraging voluntary contributions and setting a minimum contributory level. The fund will also continue to play a significant role in national development, by providing affordable housing projects for workers.

Kenya has a long history of investing in social protection. Kenya has established social security, social health insurance and social assistance (safety net) programs, but their coverage has tended to be low and their effectiveness limited. The main form of safety net support offered to poor and vulnerable populations has been humanitarian relief (often in form of food aid), which had been mobilized by the government and the international community in response to crises, such as drought and floods. In many parts of the country, most notably Arid and Semi-Arid Lands (ASALs), this type of response has become common, with emergency food relief being provided year-on-year to chronically poor food insecure populations. Concurrently, the long-established NSSF and National Hospital Insurance Fund (NHIF) have been providing social security and health insurance support, albeit to formal sector workers only—roughly 8 percent of the labor force.

This has occurred against a backdrop of rapidly rising investments in social protection since 2005. Between 2005 and 2010, social protection expenditure in Kenya rose from KES 33.4 billion to 57.1 billion, which was equivalent to 2.28 percent of Gross Domestic Product (GDP) in 2010.² This overall growth in social protection spending was due

¹ Article 43(3) of the Constitution states that: "The State shall provide appropriate social security to persons who are unable to support themselves and their dependents."

² This analysis is from the Kenya Social Protection Review, 2012.

to increases in spending on the contributory programs, the civil service pension, and safety nets. Spending on contributory programs rose by roughly 53 percent between 2005 and 2010, while spending on the civil service pension increased by 70 percent and spending on safety nets doubled. On average, between 2005 and 2010, the civil service pension accounted for 48.4 percent of total social protection spending, as compared to 30 percent on safety nets and 22 percent on contributory schemes.

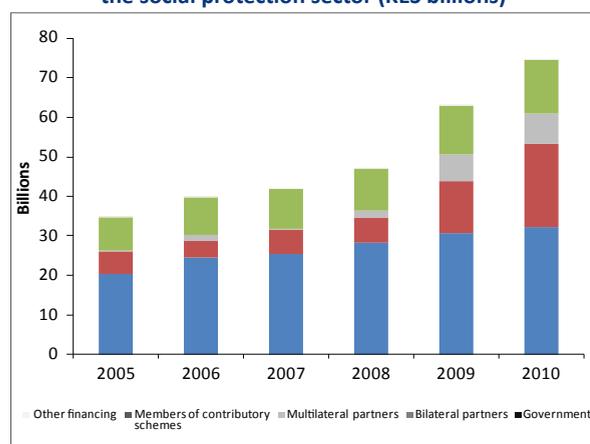
The government is the largest source of financing to social protection in Kenya (55 percent), followed by development partners (22 percent) and members of contributory schemes (22 percent). However, these sources of financing, shown in Figure 5.1 are each concentrated on different parts of the sector. Firstly, 88 percent of total government spending on social protection is channeled to the civil service pension, with the remaining government financing being allocated to safety nets, mostly and increasingly to social cash transfers. Secondly, funding from development partners (both bilateral and multilateral) was allocated entirely to safety nets, the majority of which went to relief and recovery programs (that is, emergency food

aid and supplementary feeding). Considering the funding sources to safety nets only, these programs are largely financed by development partners (71 percent).³ The notable exception to this broad trend is social cash transfers; in 2011, 42 percent of financing to social cash transfers was from the government.⁴

Despite the investments noted above, and a broad range of initiatives to promote poverty reduction and economic growth, poverty and vulnerability remain high in Kenya. In 2005/06 the overall rate of poverty in Kenya was 47 percent, with the rates being markedly higher in rural areas (50 percent) than in urban ones (34 percent). Rates of poverty also tended to be higher for households with Orphans and Vulnerable Children (OVC, 54 percent), older people (53 percent), and people with disabilities (63 percent for children with disabilities and 53 percent for adults) than for the general population.

At the same time, there is growing evidence that social protection does directly reduce poverty and promotes inclusive economic growth. An evaluation of Kenya's Cash Transfer Program for Orphans and Vulnerable Children (CT-OVC) found that it had a significant positive impact on the consumption, school enrolment levels and health outcomes of beneficiaries. The program has also resulted in an increase in the productive assets owned by recipient households. Similar results were reported for Kenya's Urban Food Subsidy Program (UFSP) and its Food for Assets Program (FAP), while there is some indication that school feeding programs appear to be improving educational outcomes. The CT-OVC also appears to be stimulating demand for locally produced goods and services, a finding observed in the Hunger Safety Net Program

Figure 5.1: Sources of financing for the social protection sector (KES billions)



Source: Kenya Social Protection Review (2012)

³ Contributory programs are financed completely by members and the civil service pension by government.

⁴ This increases to 65 percent if multilateral loans are included under government financing.

(HSNP) as well. These effects are leading to lower poverty rates among beneficiary households. The national-level gains of such impacts are potentially significant, as evidenced internationally (see Box 5.1).

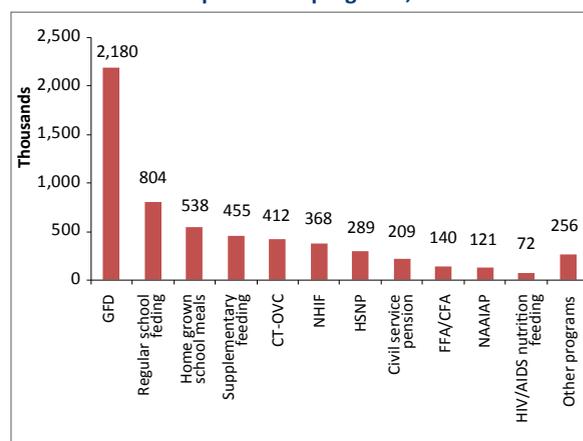
KEY FACTS AND TRENDS

- Social protection spending has increased steadily from 2005 to 2010, amounting to KES 57.1 billion in 2010. This was equivalent to 2.28 percent of GDP.
- The government is the main financier of social protection in Kenya, although 88 percent of government financing is directed to the civil service pension. Development partner financing amounts to 71 percent of all resources to social assistance.
- However, contributory and social assistance programs covered 13 percent of the population, on average, from 2005 to 2010.
- Currently, less than 7 percent of any vulnerable group is covered by social assistance, with the exception of OVC among which coverage is 28 percent.
- Progressively increasing financing to safety nets could achieve comprehensive coverage of poor, vulnerable groups in nine years.
- Increasing coverage to all poor people in selected vulnerable groups would cost between 0.35 and 3.83 percent of GDP.
- Reforms are underway to improve the financial sustainability of the NHIF and NSSF and the civil service pension.

Social assistance in Kenya is currently delivered through a large number of safety net programs, although there is limited information on their relative effectiveness.

Figure 5.2 shows the range and coverage of the main social assistance programs in Kenya. In 2010, relief and recovery programs were the most common form of safety net, providing support to 55 percent of all safety net beneficiaries, followed by safety nets in the education sector (26 percent) and then social cash transfers (14 percent). While evidence of the relative impact of these programs in Kenya is limited, international experience suggests that the use of such

Figure 5.2: Number of recipients in the largest social protection programs, 2010



Source: Kenya Social Protection Review (2012)

Notes: Social cash transfers refer to the five main cash transfer programs, that is CT-OVC, HSNP, Disability Grant, Older Persons Cash Transfer (OPCT) and UFSP. Relief and recovery refers to programs such as emergency food aid and supplemental feeding. Education refers to regular school feeding programs. Health refers to feeding programs and vouchers for primary health services. Agriculture refers programs that provide inputs and small grants to farmers groups. GFD is the General Food Distribution program

Box 5.1: International examples of the national-level impacts of safety nets

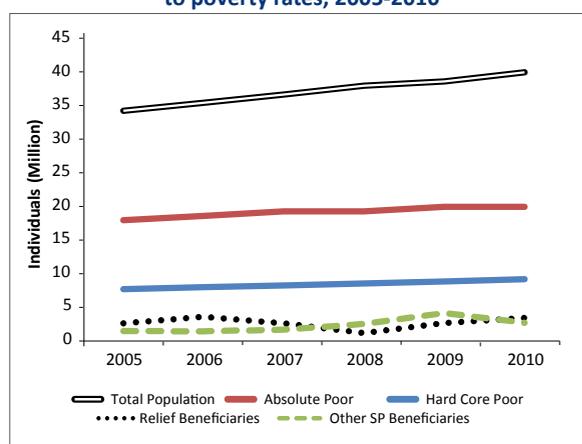
International evidence shows that targeted social protection interventions directly reduce poverty and inequality. Old age pensions in South Africa have reduced the poverty gap ratio between the richest and the poorest citizens by 13 percent. At the same time, the country's comprehensive system of cash transfers has doubled the share of national income that the poorest 20 percent of the population receives. In one of the most notable examples globally, Brazil has experienced a remarkable reduction in inequality-driven largely by a reduction in extreme poverty. Studies have found that Bolsa Familia, the largest conditional cash transfer program in the world, was responsible for 21 percent of this decline in national inequality, while having no negative impact on economic growth. Most recently, the Rwanda government has attributed the fall in poverty from 57 percent in 2006 to 45 percent in 2011 to the Vision 2020 Umurenge Program of public works and cash transfers, along with two other key development programs.

emergency food aid to respond to chronic poverty tends to be inefficient. This is because, while it can save lives in the short run, it tends to be unable to halt the population's downward spiral into destitution, as livelihoods are continually eroded.⁵ Similarly, school feeding programs do not tend to be an effective means of providing basic income support to poor households⁶, although these programs can increase school enrolment. In contrast, there is a robust and growing body of evidence on the impact of social cash transfers on consumption, health and education outcomes in Kenya (as discussed in the previous paragraphs and in Box 5.1).

Increasing investments in social protection have expanded the coverage of these programs, but overall coverage remains low in comparison with the population in need. By the end of 2010, safety nets covered almost 14 percent of the population, and in spite of rapid growth, contributory schemes covered only an estimated 1 percent. Safety nets cover a fraction of the poor population (a maximum of 27 percent—see Figure 5.3) and of vulnerable groups (ranging from an estimated 28 percent of poor households with OVCs to 0.38 percent of poor households with a member who is disabled). At the same time, members of contributory schemes are still largely drawn from formal sector workers and, as the formal sector constitutes only 8 percent of the labor force, only a fraction of the population is currently benefiting from these schemes.

Operationally, there have been a number of important advancements in the sector. Safety net programs tend to be well targeted to poor counties and locations, although the relative share of safety net beneficiaries in each location does not appear to reflect

Figure 5.3: Recipients of relief and recovery and other social protection programs compared to poverty rates, 2005-2010



Source: Kenya Social Protection Review (2012)

Notes: Poverty rates are assumed to be constant over this period

the poverty rates in that location.⁷ Safety nets currently use a range of methods to identify those households that are eligible for the program, such as categorical targeting, community-based targeting, and proxy means tests. To date, the relative effectiveness of these different methods has not been evaluated. But there is some suggestion that categorical targeting can be easier for communities to understand and less costly in terms of data requirements.

Social protection programs, particularly safety nets, have established fairly robust accountability mechanisms to ensure fiduciary control and upwards accountability of program staff to program managers and parliamentarians. These include the use of monitoring and evaluation systems, financial management reviews and audits, among other mechanisms. Many safety nets have also established strong systems to create downwards accountability to beneficiaries and communities, most commonly by using community-level organizations to monitor implementation progress and advocate for beneficiaries' rights.

⁵ There are currently no rigorous impact evaluations of emergency food aid in Kenya.

⁶ School feeding programs do not provide direct income support to households and are often not as well targeted as cash transfer programs (see the World Bank's Africa Social Protection Strategy: 2012/22).

⁷ This finding is based on an assessment of school feeding programs, the relief and recovery programs and social cash transfers. Source: Kenya Social Protection Review 2012.

Some notable advances in this area include:

(i) providing information to communities and beneficiaries through *barazas* and service charters; (ii) making public audit reports, evaluations, and other program reviews; (iii) establishing committees to represent beneficiaries; (iv) involving local people in program processes and decision-making, for example, in program targeting; and, (v) creating complaints and appeals procedures for beneficiary feedback. While this strategy appears to be effective in many ways, it has raised questions about the sustainability of programs that depend heavily on voluntary labor at the local level.

Social protection programs are leveraging advances in Information and Communications Technology (ICT) to enhance their efficiency and effectiveness.

A number of programs have well established Management Information Systems (MIS). The MIS for the five cash transfer programs are currently being upgraded based on the open-source model employed by the HSNP. At present, 29 percent of safety net benefits are channeled through banks, 6 percent through banking agents, and 4 percent through ewallet.⁸ Contributory schemes are similarly looking to use ICT to streamline aspects of their payment systems, with greater use of online submission of claims and payment through *M-Pesa*. The increasing use of these systems will make it significantly easier to exercise fiduciary oversight over the payment process even in hard-to-reach areas, as demonstrated in the case of the HSNP.

Yet these advances are uneven among types of programs and operational areas.

The innovative use of technology to strengthen program governance is currently limited to a few programs, although there are indications that these systems are being replicated across the sector. For example, the MIS of social cash transfer programs are

being upgraded and contributory schemes are looking to make greater use of *M-Pesa* to streamline the payment process. More generally, registration systems tend to be manual and slow.

There continues to be delays in some cash payments, largely arising from the lengthy process of moving funds through government systems for safety nets, and settling claims for contributory schemes.

In addition, monitoring and evaluation of social protection programs in Kenya is weak; even basic data on program implementation are often scarce, making it challenging to undertake a comprehensive assessment of the sector's performance. As a result, it is almost impossible for policymakers to get an accurate picture of the beneficiaries of these programs.

KEY CHALLENGES

Despite a slow move towards the provision of predictable safety nets to chronically poor and vulnerable populations, emergency food aid remains the most common type of support.

The five main cash transfer programs⁹ have collectively increased their coverage over ten-fold since 2005, and currently provide regular support to 1.5 million people or 8 percent of the poor population. But cash transfer programs are still only about half the size of the emergency response, particularly *ad hoc* emergency food aid. As a result, safety net support in Kenya remains dominated by relief and recovery programs, with the second most common form of safety net support being provided through school feeding programs. As previously discussed, international evidence suggests that these types of programs are not an effective means of providing regular income-support to poor households, but can be an important means of achieving other policy objectives. In contrast, there is a well-established body of evidence on the positive

⁸ *E-wallet* refers to the 'agency banking model' in which a biometric smart-card is used, and mobile networkplatforms, such as *M-Pesa*.

⁹ *OPCT, CT-OVC, HSNP, UFSP and the Disability Grant.*

impact that social cash transfers can have on the welfare of poor households.

Cash transfer programs tend to be small and do not yet provide reliable support to all beneficiary households. There are a number of cash transfer programs in Kenya but, given their small size, they cover only a fraction of the population in need, as previously discussed. Yet there is emerging geographic overlap that is set to increase as programs continue to grow (see Figure 5.4). At the same time, no cash transfer program is able to expand coverage in response to shocks, although some programs have increased the value of the cash transfer to existing beneficiaries during emergencies. This limitation undermines the effectiveness of such support to chronically poor and vulnerable populations. Finally, the adequacy of the support provided to households is variable, as the value of cash transfers is irregularly adjusted for inflation and rarely reflects household size or other factors. In spite of these shortcomings, cash transfer programs are widely assessed to be a more effective form of safety net support than emergency food aid.

Safety net programs—including cash transfers—are fragmented and uncoordinated. There are currently over 19 of these programs in Kenya, implemented by over a dozen different agencies. These different implementation arrangements lead to a high degree of fragmentation, with missed opportunities for efficiency gains. Such duplication of effort and parallel implementation structures do not optimize limited implementation capacity or support a coherent approach to capacity building across the sector. The planned expansion of programs into the same geographic areas has the potential to exacerbate this situation. The Social Protection Secretariat, as mandated by the NSPP, aims to address some of these

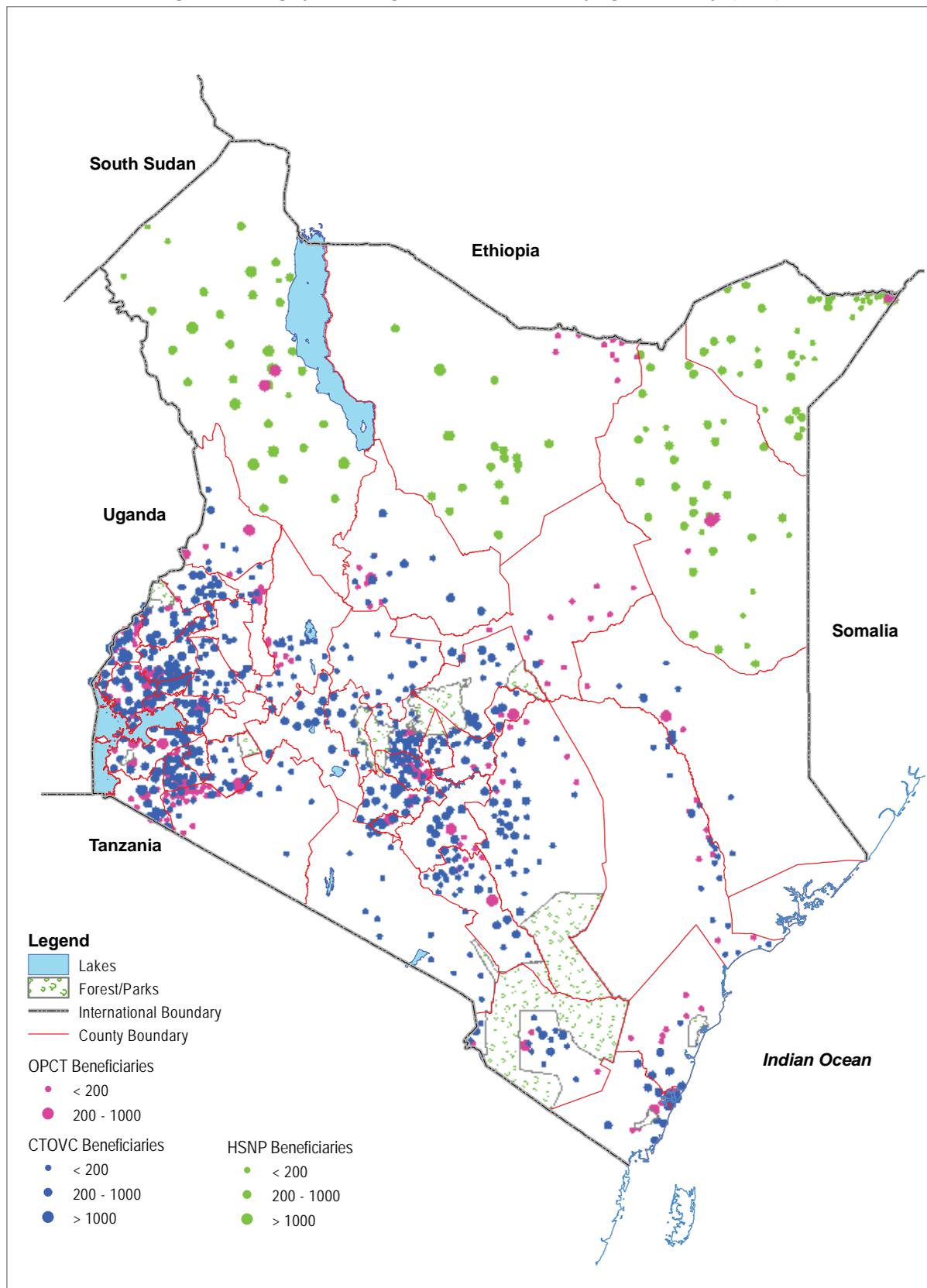
weaknesses, by providing sector-wide oversight and coordination.

The Kenyan population does not yet enjoy effective protection against poverty in old age, and access to health insurance remains limited and inequitable, despite the presence of NSSF and the NHIF. Historically, NSSF has had low rates of coverage as well as of contributions. This, together with poor investment returns, has resulted in low benefit levels for members. NSSF is currently structured as a provident fund, meaning that beneficiaries are paid only once (in a lump sum) upon retirement. Overheads are high, and the fund has not, until recently, been compliant with Retirement Benefit Authority (RBA) regulations concerning fund governance and asset management. In addition, the public's confidence in the fund's ability to deliver on its mandate is generally low.

However, NSSF has started to implement some reforms in order to address some of these issues. For example, it is trying to increase the returns on its investments, to ensure its compliance with the RBA by employing asset managers and custodians to oversee its assets, and to reduce overheads, while also changing from a provident fund into a pension fund. Like NSSF, coverage of NHIF has been low, although it has increased rapidly since 2004, and now stands at almost 17 percent of the population.

NHIF contributions have not been changed since 1990, as the current initiative to adjust contributions is on hold pending consultation with the wider stakeholder group. Contributions are based on a worker's income up to a predefined ceiling, with the contributions from informal sector members being set at 50 percent of the rate for formal sector workers. However, many informal sector members are inactive and thus are

Figure 5.4: Geographic coverage of social cash transfer programs in Kenya (2010)



Source: Programme administrative data

not making regular contributions to the fund. This, together with the fact that informal sector workers join on a voluntary basis, suggests that there is some adverse selection into the fund, with only those informal sector workers who are in need of health care participating. Indeed, in 2010, 33 percent of all benefits were paid to informal sector members, who paid only 5 percent of all contributions.

Against this backdrop, the government is considering a range of reforms. One key proposal is to increase contribution rates, which would make the fund more financially sustainable and create an opportunity to increase benefits. However, this would need to happen against a backdrop of improved governance.

The civil service pension dominates government financing to the social protection sector (and indeed all financing to the sector). The civil service pension is currently a pay-as-you-go benefit scheme, financed from the government's general revenue. However, a bill is currently before parliament that would turn it into a fully funded defined contribution scheme with the government (as the employer) financing the equivalent of 15.5 percent of the workers' salaries and employees contributing 7.5 percent of their salaries to the scheme. If passed, this bill would significantly increase the fiscal sustainability of the pension scheme, and would reduce future fiscal liabilities.

POLICY RECOMMENDATIONS

The government's overriding objective in this sector is to progressively realize the right to social security. The NSPP provides a vision for extending the coverage of social protection programs, while addressing the current operational weaknesses in the sector. The section which follows identifies a set of short term actions that the government

should take to significantly advance this agenda.

Improve the effectiveness of social assistance programs

Article 43(3) of the 2010 Constitution states that "The state shall provide appropriate social security to persons who are unable to support themselves and their dependents." To progressively realize this right to social assistance for those in need, the government must define an appropriate mix of programs based on the country's medium-term objectives and fiscal considerations. Yet, because social assistance programs currently have a range of different objectives, and there is generally limited information on their effectiveness in delivering on the country's stated policy goals, it is difficult to determine the exact form that social assistance should take. In recognition of these limitations, there are a number of steps the government can take to improve the effectiveness of the support.

(i) Provide predictable income support for chronically poor and vulnerable populations through cash transfers instead of food aid. Emergency food aid continues to dominate safety net spending, accounting for 53.2 percent of all safety net spending. While this kind of support is an important way of responding to emergency situations such as floods or droughts, it is often used to provide food aid to populations that are chronically poor, such as those in the ASALs, but not in any systematic way. Therefore, the government could consider reallocating resources from emergency food aid to a transfer program that will provide these groups with more predictable support. This could be done by expanding the coverage of the HSNP, which targets poor and vulnerable populations in ASALs. This would capitalize on existing implementation capacity and experience,

while avoiding further fragmentation and duplication among programs.

(ii) Expand the coverage of cash transfer programs. Cash transfer programs currently provide regular support to 1.5 million beneficiaries, or an estimated 8 percent of the poor population. There is a need to scale-up coverage significantly, to respond to the needs of the poor and vulnerable population. While there are competing priorities for government revenue, public financing to safety nets accounts for only 0.6 percent of total government expenditure (with social cash transfers a fraction of this) compared with the 19.8 percent spent on education and 5.5 percent spent on health. Economic growth of 6 percent per year would generate an estimated additional KES 100 billion in annual government revenue. If a small proportion of this increasing fiscal space were gradually allocated to social cash transfers, substantial increases in coverage could be achieved in a short time. More specifically, comprehensive coverage of poor households with members who are vulnerable, for example OVCs, the elderly, the disabled or chronically ill, and People Living with HIV and AIDS (PLWHA)—in nine years. An annual increase of this magnitude would lead to comprehensive coverage of poor households with OVCs in two years, or provide support to all poor households with elderly members in five years.¹⁰

(iii) Build the capacity for cash transfers to respond to shocks. International experience shows that scaling up established safety net programs is the most effective way of protecting households from the negative effects of shocks, because it is faster, more effective, and cheaper than emergency assistance. At present, only those emergency response programs have such capacity. This

limitation undermines the effectiveness of cash transfer programs to respond to chronic and transitory poverty, and misses out on important efficiency gains in the sector. As a result, there is need to build the capacity of cash transfer programs to scale-up in responding to shocks in a coordinated manner. The National Drought Management Authority (NDMA) and the National Contingency Fund (NCF) provide a foundation for this approach, including the established early warning system and local contingency plans. To this end, the government could establish a window in the NCF that can be accessed when an agreed set of early warning indicators are met, so as to scale-up cash transfer support to populations affected by a shock.

(iv) Harmonize safety net programs to reduce fragmentation and duplication.

Safety net programs in Kenya tend to be small, with emerging geographic overlaps, despite some similarities in their objectives and implementation modalities. Stronger coordination in the sector could significantly improve the effectiveness of safety net support. To initiate this reform agenda, the government should have a roadmap, as well as harmonize the five main cash transfer programs. This would consist of:

- (a) Formulating a nation-wide scale up strategy to ensure equity in coverage, and to reconcile the fact that some programs currently cover specific geographic areas (such as ASALs or urban slums), while others aim for national coverage of specific vulnerable groups (such as OVCs or the elderly);
- (b) Create a harmonizing framework through the adoption of: (i) a single monitoring and evaluation framework for cash transfer programs; (ii) a common mechanism to adjust the value of the cash transfer; and, (iii) sharing of best practices across programs (Box 5.2).

¹⁰ Source: Kenya Social Protection Review, 2012.

Box 5.2: The potential benefits of a single beneficiary registry

The NSPP advocates the establishment of a universal registry of all beneficiaries enrolled in existing social assistance programs. The single registry would enable the various programs to use the same information system, which would eliminate the need for and the costs of designing such systems for individual programs. The registry would be a source of timely and consolidated information from various programs that policymakers could use to inform their decision-making. Importantly, the registry could be the foundation for the creation of other common systems (for example, a common payment system), which would further reduce the costs associated with delivering benefits.

Operationally, the registry would reduce “double dipping”, where individuals benefit from more than one program, and would make it easier for beneficiaries to move between programs. Having a single registry of beneficiaries would also facilitate more effective responses to emergencies as many of the poor and vulnerable would already be registered, making it easier to rapidly scale up existing programs in response to short-term and unforeseen shocks. Finally, linking the registry to the broader national registration system would enable program staff to verify beneficiary identities, thereby ensuring that the safety net is accurately targeting the poor and vulnerable.

Address the adequacy of benefit levels and the financial sustainability of contributory programs

Going forward, the priority actions for NSSF include increasing contribution levels and extending coverage, while continuing to bring down overheads. The priority actions should include:

(a) The draft NSSF Conversion Bill, which will reform NSSF into a pension fund, needs to be passed by parliament, as it will strengthen its ability to protect members against poverty in old age. However, careful consideration of the parameters of the new fund is needed to ensure

affordability and sustainability, and the proposal should see consultation with a broad range of stakeholders;

- (b) NSSF should realize administrative efficiencies by, for example, adopting more modern and streamlined collection and payment systems;
- (c) Concerted outreach to the informal sector is also needed to increase coverage of workers there. NSSF will need to adopt flexible voluntary savings schemes similar to the *Mbao* Pension Plan (Box 5.3), which is already gaining attraction in Kenya, in order to effectively respond to the needs of informal sector workers.

Box 5.3: The *Mbao* Pension plan: extending pensions to the informal sector

The *Mbao* Pension Plan is a voluntary savings program to help its members save for retirement. It was started by the medium and small micro-enterprises sector to help members of different Jua Kali Associations (associations of informal sector enterprises) to save regularly towards a long-term and reliable income when they retire. The scheme has since been opened to the public. As of November 2011, there were 9,408 active contributors to *Mbao*.

Members pay a KES 100 registration fee and commit to saving at least KES 100 per week. They make their contributions electronically using M-Pesa or Airtel Money. The contributions are managed and invested by service providers appointed by the *Mbao* Trustees and approved by RBA. Upon retirement, members receive the value of their accumulated contributions plus interest. When they die, a refund of accumulated contributions plus interest is paid to their nominated beneficiaries. Both of these payments are made in a lump sum.

Significant reforms to NHIF are needed to better protect the population from health shocks. These changes should include measures to:

- (i) Increase the long-term financial sustainability of the fund by increasing contributions and returns on investments, and continuing to reduce operating expenditures.
- (ii) Continue to increase membership, both in terms of overall coverage and encouraging members to remain active, particularly among those from the informal sector.
- (iii) Enhance the benefits available to members by changing the way in which it contracts with health providers to deliver services¹¹.
- (iv) Focus on recruiting new members from the informal sector as the formal sector's compliance rate is estimated to be close to 100 percent.

However, there are a number of challenges associated with reaching out to informal sector workers which include, designing appropriate policies, effectively marketing and distributing the products, efficiently collecting contributions, and addressing gaps in health services in rural areas. Even if these challenges were addressed, additional measures would be needed to reach the poorest people. This is recognized in ongoing discussions in the health sector, as a result of which there is a proposal to create an equity and access fund that would subsidize the cost of health insurance to the poorest citizens.

Moving forward with these proposed reforms would significantly improve the efficiency and effectiveness of social security, social health insurance and social assistance programs. These reforms will also contribute towards the establishment

of a social protection system, a vision that is articulated in the NSPP. However, for this longer term vision to materialize, a system-wide approach to social protection needs to be adopted to reinforce the fact that social assistance, social security and social health insurance, work together to protect the population from a wide range of risks throughout their lifecycle.

Because of this, to advance any part of the social protection sector (whether social assistance, social security, or health insurance), there is need to ensure that progress in reforms is being made in each of the other sectors/areas. In the long term, this will improve the effectiveness of the overall social protection, thereby reducing the need for social assistance (graduating from poverty) and at the same time, ensuring a well-functioning social security and social health insurance schemes, that protect households from falling into poverty.

6. Promoting a sustainable Kenya

By Christian Peter, Halla Maher Qaddumi and Gutavo Saltiel

INTRODUCTION

Kenya aims to be a nation that has a clean, secure and sustainable environment by 2030. Under the social pillar of Kenya Vision 2030, Kenya's journey towards prosperity involves the building of a just and cohesive society that enjoys equitable social development in a clean and secure environment. This is the case because about 42 percent of Gross Domestic Product (GDP) is derived from the natural resource-based sectors of agriculture, forestry, tourism, mining, water and energy, that are closely related to the state of the environment. At

¹¹ NHIF is mandated to provide both in and outpatient medical healthcare but largely provides in-patient care. The NHIF should "continue to pursue roll out of the outpatient care" (*Strategic Review of the National Hospital Insurance Fund-Kenya* October 2011: 156).

the same time, droughts and floods cost Kenya 2.4 percent of GDP per year, since the key drivers of the economy are climate sensitive.

Future projections of temperature and rainfall variability and change suggest that major challenges will be presented to the economy, human life and the environment.

Thus, sound environmental conservation measures that result in the preservation of natural resources, as well as proactive management of the environment, are important as they pre-empt serious calamities and occurrences, such as drought, floods and global warming that would otherwise take up extensive resources to deal with.

The development activities planned under Vision 2030 will have different impacts on the environment, some of which could lead to increased pollution levels and more waste.

Activities in the manufacturing sector are expected to give rise to an increase in effluents discharged, which will also require effective management. In line with the country's commitment to the sustainable development objective, targeted Vision 2030 socio-economic development initiatives must take into account environmental considerations.

Water is an environmental resource necessary not only to support life but also to sustain economic activities—and across different sectors.

The country's water endowment is low, and Kenya is classified as a water-scarce country. Sanitation and waste management are closely related to human health, and the challenges of addressing sanitation and waste management have been compounded by rising population, improvements in the standard of living, and the high rural-urban migration, which is responsible for the development of densely populated informal settlements in urban and peri-urban areas, that suffer from poor

sanitation facilities. Pollution and waste management are exacerbated by the dumping of waste into rivers, streams and other water bodies, and inadequate strategies to deal with these issues, have resulted in serious health implications.

Conservation, sustainable exploitation and management of the environment and natural resources, continue to pose major challenges to the government.

Goals to address these challenges include, increasing the forest cover from less than 3 percent in 2008 to 4 percent in 2012 and 10 percent by 2030, and lessening by half all environment-related diseases. The specific strategies involve promoting environmental conservation, in order to provide better support to the various flagship projects and also for achieving the Millennium Development Goals.

Improvement of pollution and waste management is to be effected through the design and application of economic incentives and the commissioning of Public-Private Partnerships, for improved efficiency in water and sanitation delivery.

Kenya should also enhance disaster preparedness in all disaster-prone areas, and improve the capacity of adapting to global climatic change. In addition, the country should harmonize environment-related laws, for better environmental planning and governance. This will be in line with protecting the environment as a national asset, and conserving it for the benefit of future generations and the wider international community.

In order to address the current and future environmental challenges, the Ministry of Environment and Mineral Resources has developed the climate change action plan, supported by a multi-sectoral taskforce.

It has also been shaped by a countrywide series of county consultations, given that the impacts of climate change affects planning at community, county and national

levels. Besides, the Bill of Rights in the 2010 Constitution states that “every person has the right to a clean and healthy environment”, and so it is the responsibility of every Kenyan to protect and care for the environment.

This holistic plan will guide policy makers, as well as civil society and the private sector, in implementing the 2010 Constitution and the 2010 National Climate Change Response Strategy. It has been designed to address sustainable development and climate change, with the objective of achieving Vision 2030, through people-centered development.

KEY FACTS AND TRENDS

Kenya covers an area of about 587,000 square kilometers, of which 11,000 are water. Extreme poverty affects about half of Kenya’s population, with around 80 percent of the poor living in rural areas that depend on agriculture. Approximately 80 percent of the overall population is directly involved in, and is dependent on agriculture (crops, livestock and fisheries) for their livelihoods.

Agriculture is a key sector, directly contributing to 24 percent to GDP, as well as contributing indirectly through its links to other sectors. In addition to its multiplier effects, the sector provides 62 percent of formal employment, 60 percent of exports, and 45 percent of government revenue. Land is the main asset in agricultural production, but its productivity is reliant on a number of factors, including rainfall and/or access to supplemental water supplies. Over 80 percent of the country is Arid and Semi-Arid Lands (ASALs) and so unsuitable for rain-fed farming, due to low and erratic rainfall. At the same time, rising population pressure has led not only to the progressive sub-division of land (and consequently to smaller and less productive farms), but also to encroachment into critical and/or less productive land, such as water catchments and steep slopes prone to soil erosion.

Both spatially and temporally, Kenya experiences wide climate and rainfall fluctuations, primarily due to *El Niño-La Niña* events, that usually manifest as severe flooding followed by drought. Rainfall is highly variable, and varies year-to-year by up to 30 percent above or below the long-term average. In ASALs, the variation is even more significant, with variations from the mean of between +35 percent and –70 percent. The country experiences either a drought or a flood (with a greater than 20 percent deviation from the mean) on average, every third year. Major floods affecting much of the country are becoming increasingly frequent (for example in 1961, 1997, 1998 and 2003). The spatial variability of rainfall is also considerable, varying from 250 mm in ASALs to 2,000 mm in high mountain ecosystems. The Lake Basin receives the greatest rainfall over a small area, while the much larger Ewaso N’giro North basin receives the least, and 66 percent of the country receives less than 500 mm of rainfall annually.

Warming over continental Africa is projected to be greater than the global mean over the 21st century, and there is likely to be an increase in rainfall over East Africa, and most of Kenya by the end of the 21st century. While mean annual rainfall is projected to increase, climate conditions in general and rainfall in particular are expected to become more variable, which means that the frequency of extreme events, including floods and droughts, will be likely to increase.

Kenya is already classified as a chronically water-scarce country, in both absolute and relative terms, and water availability can be highly sensitive to relatively small changes in rainfall and temperature. Even if rainfall remains constant or increases, water availability may decline as a result of climate change because of higher temperatures and if warming is of a significant magnitude.

Kenya is also highly exposed to sea level rise and related coastal hazards, due to its extensive low-lying coastal areas. In addition, the increase in forest cover over the years (as shown in Table 1.6a) has been and remains low, compared to other African countries.

KEY ISSUES

Climate variability and change (and attendant climate-related risks) pose a number of challenges to the realization of Kenya's development goals. Close to 80 percent of Kenya's population is rural and dependent on agriculture for basic livelihoods. This makes the country highly vulnerable to climate change and variability, since 98 percent of the country's agriculture is rain-fed, hence, highly sensitive to climatic fluctuations. Moreover, arable land constitutes only 17 percent of the total land mass, with the bulk of the land mass considered to be arid or semi-arid. Kenya is also a water-scarce country, where the natural endowment of freshwater is low, and water resources are unevenly distributed. Population pressures and rapid urbanization are also impacting the country's natural resources. In addition, Kenya's strong tourism industry is sensitive to climate risk, as important habitats, including coral reefs and wildlife corridors and reserves, are directly affected by climate variability and rising temperatures.

The combination of these factors increases Kenya's vulnerability to climate change. Therefore, mitigating the expected impacts of climate change and related uncertainties will require careful planning. Addressing climate change requires taking measures aimed at tackling both the causes of climate change (greenhouse gas emissions) and adapting measures to support the country's capacity to cope with its impacts.

Similar climate-related challenges include, increases in the incidence of waterborne and water-related diseases, crop failure, and

escalation of pests, as well as of crop and livestock diseases. Other impacts include water scarcity, which may foment natural resources conflict, food insecurity and malnutrition. The continued annual burden of these extreme climatic events could cost the economy as much as US\$ 500 million a year, which is equivalent to approximately 2 percent of the country's GDP, and is likely to stunt long-term growth.

Reports indicate that the 2009-2011 drought may have led to an economic loss of about US\$ 2.8 billion, resulting from the loss of crops and livestock, forest fires, damage to fisheries and reduced hydropower generation and industrial activity. As for the 1997/98 floods, they are estimated to have affected about 1 million people, and may have cost the economy between US\$ 0.8 and US\$ 1.2 billion, related to damage to infrastructure (roads, buildings and communication systems); public health effects (including fatalities); and loss of crops. Other losses amounting to US\$ 9 million may have arisen from flooding, property destruction, soil erosion, mudslides and landslides, surface and groundwater pollution, and sedimentation of dams and water reservoirs.

Climate variability and change, and the inability of Kenya to deal effectively with their impact, jeopardize stable economic growth, and provide a volatile environment for the implementation of macroeconomic reforms and development programs. Kenya's economy is highly vulnerable to hydro-climatic shocks such as droughts and floods that impact the general economy, and disproportionately affect the poor. For example, it is estimated that about half the population lacks access to adequate food, and even the little it has, is of poor nutritional quality. The incidence and prevalence of food insecurity is more extreme in ASALs, largely due to the regular recurrence of hydro-

climatic hazards—particularly droughts and floods that have repeatedly led to massive crop/livestock failure, and in the worst cases, to severe famine.

Consequently, the poor have been forced to rely on food relief provided by the government, bilateral and multilateral agencies, and Non-Governmental Organizations, at high cost to the country. For example, for the 2005/2006 financial year, the government budgeted US\$ 194 million through reallocation and additional allocation, to cover the anticipated fiscal requirements of drought. But by February 2006, it had already spent US\$ 124 million.

Kenya is also highly exposed to sea level rise and related coastal hazards, due to its extensive low-lying coastal areas. Climate change is projected to have quite severe impacts on the coastal areas. Kenya's coastal plain is 4 to 6 kilometers wide and it is between sea level and 45 meters above sea level, as a result of which it is highly vulnerable. In addition to the risk of submergence from sea level rise, it is also possible that large areas may be rendered uninhabitable or could no longer be exploited for agriculture, due to water logging and salt stress, particularly in peri-urban areas, where most of the agriculture is practiced. Sandy beaches, together with historical and cultural monuments, beach hotels, industrial sites, the port and human settlements, could all be negatively affected by sea level rise.

Other potential impacts of sea level rise include increased vulnerability to coastal storm damage and flooding, seashore erosion, salt water intrusion into estuaries, freshwater aquifers and springs, changes in sedimentation patterns, decreased light penetration to benthic organisms (leading to loss of food for various marine fauna), loss of coral reefs (leading in to reduced biodiversity,

fisheries and recreational opportunities) and, increased height of waves.

Kenya is in the bottom 8 percent of countries classified as a chronically water-scarce globally) and water stress could increase with climate change. The natural endowment of renewable freshwater is currently 552 cubic meters per capita per year, less than 10 percent of the regional average—which is 5,720 cubic meters/person/year. Severe degradation of the country's key water catchment areas (known as “water towers”), mainly caused by deforestation and unsuitable agricultural management practices, has exacerbated this situation (see Box 6.1).

In addition, high population growth adds pressure to this limited resource, and by 2025 Kenya is projected to have a renewable freshwater supply of only 235 cubic meters per capita per year. In terms of vulnerability to increasing water stress (measured by the proportion of people with access to improved water sources), Kenya is in the middle range of Sub-Saharan African countries (61 percent, compared to Gabon, the highest at 88 percent, and Ethiopia, the lowest at 22 percent).

Kenya's vulnerability to climate variability and change is very high when taken in a global context. Along with about half of the countries in Sub-Saharan Africa, Kenya has a score of 4 out of 5 in the overall Climate Vulnerability Index. No country in the region scores below 3, and a number of countries score 5 (indicating maximum vulnerability). Although Kenya is in the middle range, it is important to note that Sub-Saharan Africa exhibits systemic vulnerability to climate variability and change, which means that climate risks for Kenya are very high within a global context.

Box 6.1: Environmental degradation is not helping climate change pressures in Kenya

Serious environmental/catchment degradation has increased challenges related to climatic variability and change, putting additional pressures on an already fragile natural resource base. The effects of water resource degradation are not always as apparent as those of rainfall variability. This is partly because of their incremental nature and partly due to the effects that are often felt at a distance, both in time and space, from the source of the degradation. Mogaka *et al.* (2006) names the following principal causes of water resource degradation in Kenya: (i) excess abstraction of surface and groundwater; (ii) soil erosion, causing turbidity and siltation; (iii) high nutrient levels, causing eutrophication of lakes and pans; and, (iv) toxic chemicals, including agricultural pesticides, and heavy metals, which are toxic to water-dependent biota. Water resource degradation also exacerbates the costs arising from rainfall variability. Poorly managed catchments shed their runoff quickly into rivers and streams, thereby increasing the size of flood peaks during moderate to large storms. Forests and agricultural catchments with good ground cover slow down the runoff and reduce the size of the flood peak. Adaptation options therefore need to address both the natural assets (protection of catchments, wetlands, lakes and aquifers), as well as built assets (dams, irrigation systems, hydropower plants and water supply systems).

Additionally, in terms of extreme events, Kenya has a history of greater disaster risk, particularly of droughts and floods, than the majority of Sub-Saharan African countries—when assessed over the past 30 years.

Vulnerability to coastal hazards, measured in terms of the percentage of the national population living in the low-elevation coastal zone, is relatively low at 0.91 percent (as measured by the Global Rural Urban Mapping Project dataset), and there are significant threats associated with sea level rise, as previously discussed.

There are a number of ongoing initiatives in Kenya to address current and potentially increasing climate vulnerability, but these efforts do not meet the scale of the challenge and there is significant and growing adaptation deficit.

It is critical to move towards a more comprehensive and systemic approach, whereby the risks and opportunities presented by climate variability and change are fully understood and integrated, and measures are taken across all key sectors, including health, infrastructure, energy and agriculture, to mitigate risks and realize opportunities. The Kenyan economy urgently needs the buffering capacity to address the hydro-climatic shocks that could be exacerbated by a changing climate. As

previously noted, while mean annual rainfall is projected to increase, climatic conditions are expected to become more variable, which means that the frequency of extreme events will likely increase.

Floods and droughts already cost Kenya an estimated 2.4 percent of GDP per year.

Flood risk is often exacerbated by the use of drainage channels for settlement as rubbish dumps, and also by unplanned development, including for agriculture. Lake levels are also highly sensitive to climate: for example, Lake Victoria rose by about 1.7 meters after the 1997 floods. Positive or negative lake level fluctuations may have significant societal impacts associated with flooding, and the availability of water for agricultural and other uses.

Kenya currently lacks the capacity to buffer against climate shocks, which are already so severe, that years of investments in infrastructure for economic growth can be undone. For example, the floods of 1997-98 caused transport infrastructure damage and destruction, whose replacement cost was US\$ 777 million (World Bank 2004). A recently completed post disaster needs assessment established that the overall cost of the 2008 to 2011 drought was estimated at US\$ 12.1

billion, which includes US\$ 805.6 million for destruction of physical and durable assets, and US\$ 11.3 billion for losses in the economy across all sectors.

Climate change and energy sources. Climatic variability and change have potentially serious implications to the viability and reliability of hydro-electric power generation, the supply of which may become more erratic as rainfall becomes more variable and unpredictable. The Seven Forks hydropower station situated in the lower Tana catchment, provides nearly 58 percent of the total national electric power generated. However, such catchment areas have undergone intensive environmental degradation, resulting in the siltation of rivers, reservoirs and irrigation canals, which in turn exacerbates flooding in the lower parts of the basin. Thus, along with climate change investments, proper management and conservation of the catchment areas are a key strategic requirement for Kenya's sustained economic growth.

Climate change and water resources. As in much of Africa, some of the most significant impacts of climate change on development in Kenya are likely to result from its impacts on water availability. As previously noted, rainfall is projected to increase over East Africa, and a study published in 2005 projected increases in surface runoff of 5 to 50 percent across Kenya by the middle of the 21st century. Nonetheless, surface runoff can be highly sensitive to relatively small changes in rainfall and temperature. For example, a study of the potential impact of elevated temperatures in Morocco, concluded that an increase in average temperature of just one degree centigrade over the catchment of the country's largest dam, would result in a 10 percent reduction in surface runoff—equivalent to losing one dam a year, if extrapolated to the entire country.

Projections of increased runoff and soil moisture must therefore be treated with caution. Any increase in rainfall may be offset by increased evaporative losses associated with atmospheric warming, and even if rainfall remains constant or increases, water availability may decline as a result of climate change, due to high temperatures and if warming is of a sufficient magnitude. Increased climatic variability may result in greater variation in water availability over time, with extreme water stress during times of drought, exacerbated either by greater variability in rainfall (and greater rainfall deficits) and/or higher extreme temperatures.

Other risks to water resources include the intrusion of saltwater into coastal aquifers, and the loss of mountain snow and ice, associated melt-water. Saltwater intrusion is likely to result from higher sea levels, and might be exacerbated by the abstraction of groundwater for coastal development, or by a reduction in surface runoff resulting from either reduced rainfall or increased evaporative losses, due to higher temperatures. Mount Kenya and Mount Kilimanjaro are reported to have lost over 60 percent of their ice cover over the past century.

The factors contributing to this loss are the subject of intense debate, and they are not simply a result of atmospheric warming. Nonetheless, if current climatic conditions persist, the ice fields on Mount Kilimanjaro are predicted to disappear between 2015 and 2020. While Kenya may experience increased rainfall, greater than projected rates and magnitudes of climate change, changes in variability, and factors such as saltwater intrusion at the coast and the loss of mountain melt-water, are likely to increase water stress. The development and

implementation of strategies to increase the efficiency of water usage, expand the capture and storage of surface runoff and conserve soil moisture, are therefore all necessary.

Climate change and agriculture. Climate variability already poses considerable challenges to agriculture, particularly in form of droughts, which recur every few years. These could be exacerbated by climate change. Crucially, agricultural planning cannot assume that current or historical climatic and hydrological conditions will hold in the future. As discussed earlier, climate change will result in reduced water availability, hence, in a shift in the geographic ranges viable for key crops. The length of growing seasons may also alter due to changes in temperature and rainfall, with seasons becoming longer in some areas and shorter in others.

Crop responses to climate change will vary with location, topography and local climatic conditions, with potentially positive impacts on crop yields in some areas and negative impacts in others. In medium to high-altitude locations where water availability is not a limiting factor, crop yields may increase if climate change results in higher mean and minimum temperatures. However, in low-lying semi-arid areas higher mean and maximum temperatures are likely to result in increased evaporative water losses and physiological stress, thereby decreasing yields. Trends in yields are not necessarily consistent over time, so there is significant uncertainty as to future crop performance (for example, some areas in central Kenya and in the Kilimanjaro region have registered unchanged or decreased maize yields that subsequently increased).

Climate change, coastal development and tourism. Kenya's coastal population, cities and infrastructure are at a risk from potential sea level rise, and from related

hazards such as storms, erosion, saltwater intrusion, ecosystem change and permanent inundation. Within the timescale of Vision 2030, the impact of climate change on coastal settlements, infrastructure, ecosystems, livelihoods and tourism, could be quite significant.

A study of climate change risks to Mombasa district established that around 17 percent of the city's area could be submerged by a 0.3 meter rise in sealevel, which is plausible within the next few decades, based on studies of sea level rise. Such an increase in sealevel would also make many areas uninhabitable, due to periodic flooding, water logging and salt stress. While the estimated proportion of Kenya's population living in the low-elevation coastal zone is less than 1 percent, Mombasa county houses over 2 percent of the country's population, as well as vital infrastructure (including the port and the refinery) and economic activities.

Key economic sectors such as tourism are highly vulnerable to the potential impact of climate change. Beach erosion and the degradation of beaches and coral reefs may make coastal areas less attractive to tourists. Coastal erosion is likely to result in the loss of beaches, loss or migration inland of coastal wetlands and ecosystems such as mangroves, and the permanent inundation of some land areas. The economic losses resulting from the inundation of areas used for producing mangoes, coconuts and cashews resulting from a one meter rise in sea level, have been estimated at up to US\$ 500 million.

Higher ocean temperatures and ocean acidification, combined with other natural and human stresses, are likely to lead to a widespread loss of corals, with an impact on fisheries, livelihoods and tourism. Changes in water depth, temperature, salinity, acidity and turbidity may also affect key species such

as sea grasses, which are at the foundation of marine ecosystems. Threats from climate change and other stresses are already apparent in locations such as Kiunga Marine National Reserve, where bleaching and other threats have led to the establishment of a partnership between a number of national and international bodies, to monitor the health of corals and integrate climate resilience principles into the management of marine ecosystems.

POLICY RECOMMENDATIONS

Water resources

Climate variability and change present an opportunity to invest heavily in appropriate water infrastructure, and to better manage existing water investments. Kenya has not invested adequately in the storage of water and further existing storage capacity has not been properly maintained in the face of siltation, general depreciation and episodic damage from floods. Generally, the water investment gap—from small scale storage to irrigation and water supply—is substantial, estimated in various studies to be between US\$ 5-7 billion.

The government has planned a large scale water investment program to address this challenge. Vision 2030's 'flagship projects' in the water sector, include building large-and-medium sized multipurpose water storage facilities, upgrading the hydro-meteorological network, and rehabilitating and expanding major irrigation schemes and urban water supply and sanitation in key satellite towns. Such investments—and more generally measures to capture and store surface water runoff, conserve soil moisture, and make better use of groundwater resources—will go a long way towards building climate resilience, so as to lift Kenya out of a history of food insecurity, low productivity and constrained growth.

The priority is to increase investment readiness by advancing and improving the quality of investment preparation. Investment must balance productivity and climate resilience, by avoiding unsustainable development in marginal or otherwise sensitive areas. Investments—and settlement—in catchments or flood-prone areas need to be approached with extreme care, in order to avoid/minimize losses from potential floods and to protect the natural functioning of catchments. Beyond water investments, there is need to build an enabling institutional foundation— one that is fully aligned with the Constitution—and a solid, scientifically-founded knowledge base and analytical tools to ensure that water investments are sustainably planned, developed and maintained for long-term prosperity.

Agriculture

Agricultural policies must be informed by scientific information on emerging and potential future changes in productivity. They must be based on observed and projected changes in rainfall, temperature, and the incidence of key pests and diseases, in order to target investment in areas with the greatest potential for yield improvement. In addition, investment must be made in land rehabilitation and land conservation measures, to arrest erosion-induced declining land productivity.

In addition, existing subsistence strategies such as pastoralism that promote climate resilience in the face of climatic uncertainty, variability and marginality should be complemented by new measures such as efficient irrigation; new crop varieties that are drought and disease tolerant and grow fast; erosion controls to address more intense rainfall events; water conservation measures; and the dissemination of climate information such as seasonal forecasts and long-term trends.

Natural resources management

Efforts to build resilience must focus on investment in natural resource management more broadly, given the reliance of Kenya's economy on the health of its natural resource base. Natural resource management cuts across strategic sectors and themes, including crop and livestock production, surface and groundwater resources, forestry, tourism, and coastal zone management.

Natural resource management is central to issues of conflict in Kenya over forest, water, and productive land, and as such, their resolution is critical. Watershed management is one strategy that provides a platform for balancing these competing interests, and should be highly prioritized. For example, it is widely known that Nairobi and high-value irrigated crop land such as Mwea, a critical rice-producing area, depend on the health of forested water towers upstream. The water from Cherangany Hills drains into the western part of the country, e.g. Nzoia and Lake Victoria. Nairobi and Mwea depend mainly on water from Mt. Kenya and the Aberdares.

The new generation of large-scale water infrastructure that is being planned as previously discussed, requires that watershed planning and management should accompany the investments in order to prolong their useful life. The government's target to expand forest cover from a current 6 percent to 10 percent is in line with the need to protect key catchments from degradation. Yet to accomplish this, it is critical that local forest-dependent communities and downstream communities partner in watershed planning, to help secure a shared vision on the sustainable use of forest, water and land resources. In the absence of this approach, climate risks will persist and amplify over time.

Other integrated approaches look promising. For example, rotational planned

grazing should be further promoted as a policy strategy, as herders can triple stocking capacity in drylands as an explicit land restoration strategy that recharges water tables and stores massive amounts of carbon. This approach has been proven in a number of settings, from Zimbabwe to western United States, and deserves further exploration on its suitability in Kenya.

Investment in coastal development

This must take climate risks into account: Kenya's Coast Region is highly vulnerable to multiple climate impacts. As such, coastal development must be carefully directed. Kenya's draft Integrated Coastal Zone Management Policy (July 2010) sets forth guiding principles to promote integrated planning in the sensitive coastal region. Efforts to support spatial planning and integrated development, are likely to result in significant cost savings in the long-term.

In parallel, given that the Coastal economy is highly dependent on sensitive natural resources, including beach-based tourism, fisheries and agriculture, efforts to strengthen natural resource management will lead to increased resilience of local communities. In coastal areas, support for enhanced community co-management of fisheries and other marine resources provide important development and climate co-benefits. Improved management of fish stocks, both in marine and inland waters, will provide an important sustainable source of revenue and livelihood. No-regrets measures include improved research and monitoring capacity.

Similarly, strengthening Kenya's world-class conservation efforts, including protection and management of marine and terrestrial parks and other sensitive habitats (e.g. mangroves and corals), represent an important long-term strategy for adaptation, as ensuring sufficient connecting habitats

for high-value tourism species and other biodiversity will provide a sustainable long-term source of revenue for Kenyans. These efforts should be complemented by investment to promote pro-poor tourism, through supporting policies, and activities to ensure tourism benefits extend far along the value chain.

Public awareness and communication

Given that climate change is a serious challenge requiring the active participation of all members of the society, creating public awareness and communicating climate change information in a structured manner, would catalyse an appropriate response to the phenomenon. In addition, climate change issues should be integrated into Kenya's education system. All efforts should be made to achieve critical levels of expertise in climate change-related topics in all areas of learning, and effort must be made to ensure that opportunities that arise as a result of climate changes initiatives are harnessed. For effectiveness, climate change courses need to be common units of study, and compulsory for all learners. This should be done through a multi-disciplinary approach, whereby climate change course contents are infused and integrated into other subjects of learning, and applied across the different levels of learning.

Mainstreaming

The actions will need to be mainstreamed into Vision 2030 through the 2013-17 Medium Term Plan, and into sector strategies and government workplans. It is also crucial that these climate change actions are incorporated into the Medium Term Expenditure Framework, and that a climate change budget code is developed, to enable the tracking of the flow of climate change funds. In addition, there is need for

monitoring and evaluating environmental trends, and for harmonization of data collection methodologies, storage and access in the entire area of environment, and natural resources.

Climate variability and change present not only risks, but importantly, opportunities for Kenya's development. In order to achieve the aspirations of Vision 2030, it is important that investments and other activities are designed to manage and mitigate climate risks, while capturing the opportunities presented. A number of government projects (including those supported by development partners), focus on building climate resilience through disaster mitigation and longer-term adaptation to climate threats.

These include initiatives to more carefully manage the natural resource base, on which a vast majority of the Kenyan population and its economy depend on, such as improving forestry and water resource management, reducing food insecurity through increased use of irrigation, and buffering shocks and improving the productivity of water resources in water dependent sectors, through the development of multi-purpose water storage facilities.

Climate Change therefore must be addressed through a coordinated approach and must be dealt with countrywide, and across all sectors of the economy. In addition, climate change must be mainstreamed into national planning. Indeed, integrated environmental planning must be adopted, because the current planning approach is largely sector-based and neglects the essential economic and social values associated with the environment. This way, the economic and social benefits arising from sound environmental management will be demonstrated, and delivered to Kenyans.



Growth and Competitiveness

7. Rebalancing Kenya's economy¹

By John Randa

SUMMARY

Kenya's economic performance has been below its potential and below what has been envisaged under Vision 2030. Kenya's annual GDP growth over the past decade averaged 3.8 percent, which was lower than the average for Sub-Saharan Africa (SSA) of 5.5 percent, and far from the 10 percent target of Vision 2030. Exogenous factors, such as rising food and oil prices, as well as the global economic crisis, somewhat contributed to the weak economic performance. Nevertheless, the main reasons for the low growth are to be found in Kenya.

The structure of Kenya's economy and its growth trajectory are incompatible with high and sustainable growth rates. GDP growth has been driven mainly by consumption, while the contribution of investment has been low, and that of net exports has been largely negative. Consumption has been fueled by increased public spending (on

recurrent items), rising credit to the private sector, and continued flows of foreign short term capital. Investment has been low as a result of low saving, both private and public, as well as low foreign direct investment. Net exports have had a negative contribution to GDP growth in practically all years, owing to poor export growth and rising imports. This poor performance has been a result of various constraints to production and exports, as well as an appreciating shilling (in real terms) which in turn favors imports.

To achieve the objective of becoming an African success story with shared prosperity, the authorities would need to change the policy mix in order to balance out the economy and unleash its potential. This would require prompt action on multiple fronts. First, macroeconomic policy would need to stimulate more private and public investment. Second, the exchange rate should support exports and make domestic goods more competitive vis-à-vis imports. Finally, measures to reduce Kenya's susceptibility to exogenous shocks are necessary to build a positive growth momentum and deal with possible external shocks.

¹ The author would like to thank Celestin Monga and Paolo Zacchia for very extensive, valuable and insightful comments on the initial drafts.

INTRODUCTION

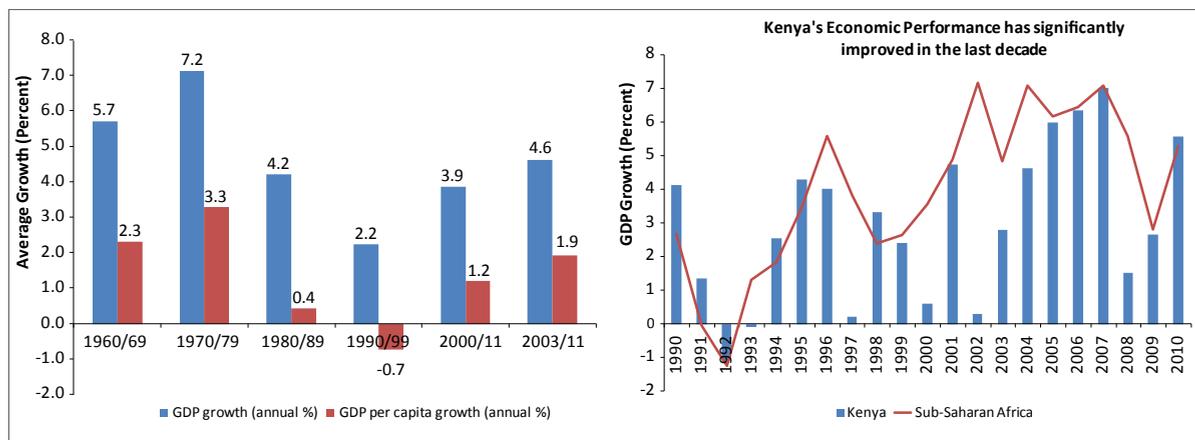
The Kenyan economy has the potential to be one of the strongest in SSA, but it has been underperforming. Hills and valleys with no sustainable growth pattern characterize Kenya's GDP growth trajectory. Kenya's GDP growth accelerated from 0.5 percent in 2002, to 7 percent in 2007. It then plummeted to 1.6 percent in 2008, as a result of external and internal shocks, before taking off again. Kenya's average GDP growth has picked up since 2000 after falling drastically in the 1990s (see Figure 7.1). However, when compared with others, including countries in SSA, Kenya's GDP growth has lagged behind as shown in Figure 7.1. From 2000-2010, Kenya grew at an average annual rate of 3.8 percent, compared with SSA growth rates averaging 5.5 percent. Kenya's growth over this period was also less than that for newly industrialized Asian economies (4.6 percent) and for all emerging economies (6.2 percent). GDP per capita increased from US\$ 397 in 2003 to US\$ 772 in 2011.

Compared to its peers, Kenya is punching below its weight. Even though Kenya has seen improved growth performance in the decade of 2000, it can perform much better given its potential. GDP per capita has increased from US\$ 450 (constant 2000 US\$) in 1990, to US\$

478 in 2011 representing a 6 percent growth rate over a period of two decades. This is disappointing performance, especially when compared to its African peers and other "role" models countries like Ghana, whose GDP per capita increased by 82 percent in the same period, Ethiopia (79 percent), Tanzania (55.6 percent), and Uganda (111.1 percent). This poor performance is even more pronounced when Kenya is compared to some of the East Asian countries, which Kenya wants to emulate. For example, Malaysia's GDP per capita in constant dollar terms increased by 106.2 percent, Thailand (94 percent) and Vietnam (232.9 percent).

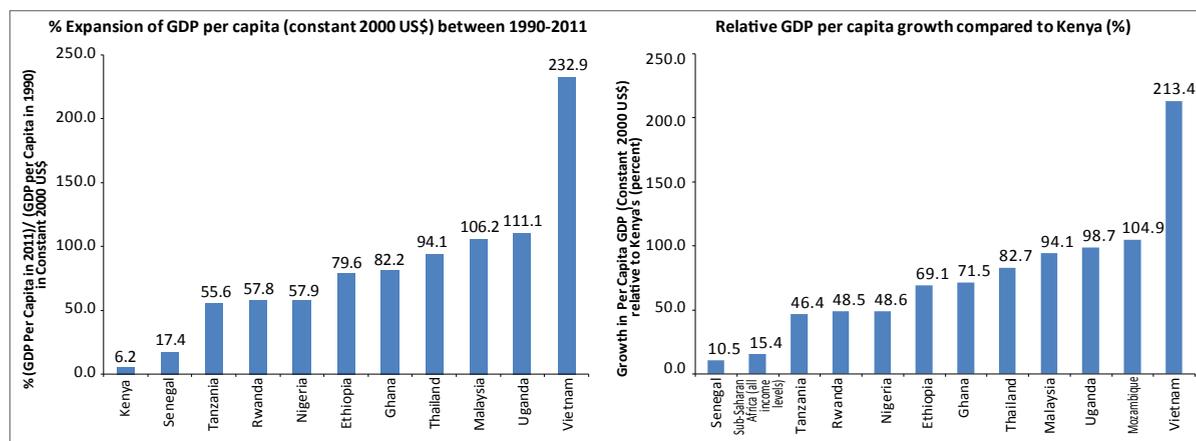
Because of slower growth, other SSA countries are catching up with Kenya. Most African countries whose GDP per capita was below Kenya's in 1980, including some of its neighbor's, are rapidly catching up with it and some (Nigeria) have overtaken it. In 1990, Ethiopia's GDP per capita was 28 percent that of Kenya, in 2011 was 48 percent. Relative to Kenya's GDP per capita, a number of countries have had their economies expand: Ethiopia (69 percent), Ghana (71 percent) Mozambique (104 percent), Tanzania (46 percent), Uganda (98 percent), Malaysia (94 percent), Thailand (82 percent) and Vietnam (213 percent) (see Figure 7.2).

Figure 7.1: Kenya's GDP growth is picking up but still remains low compared to SSA and early post-independence period



Source: World Bank, WDI

Figure 7.2: Kenya’s GDP per capita is growing at a slower rate relative to its peers



Source: World Bank, WDI

$$* \text{Relative GDP per capita growth compared to Kenya} = \left(\frac{\text{Country X GDPPC}_{2011}}{\text{Kenya GDPPC}_{2011}} \right) \div \left(\frac{\text{Country X GDPPC}_{1990}}{\text{Kenya GDPPC}_{1990}} \right)$$

Aggregate demand has powered Kenya’s recent growth. Growth in domestic demand drove the strong growth Kenya experienced in 2003-2011, which averaged 4.6 percent annually, with private consumption and private fixed investment contributing positively to the headline figure. Foreign demand, on the other hand, has been weak. As shown in Table 7.1, consumption expenditure is the major engine of Kenya’s GDP growth. Analyzing Kenya’s growth pattern reveals some interesting insights. When the 4.6 percent rate of GDP growth is decomposed, it shows that 78 percent of it emanated from private consumption expenditure, 15 percent from government final consumption, and 21 percent from domestic investment, while

net exports (exports minus imports) was a drag on economic growth by a negative 14 percent. This finding supports the World Bank’s position in the 2011 Kenya Economic Update that showed Kenya’s economy as running on one engine (consumption) and needs other engines (investment and exports) to substantially kick-in for Kenya to achieve a stable economic growth pattern.

The macroeconomic outcomes indicate that the Kenyan economy is out of balance. In 2005, gross domestic savings were sufficient to cover domestic investment financing requirements. However, savings have not been increasing as fast as investment needs. The savings-investment gap increased from

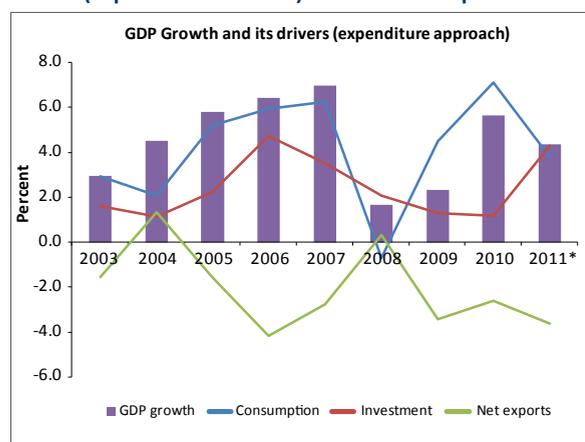
Table 7.1: Contribution to GDP growth 2003-2011 (expenditure method): constant 2001 prices

	2003%	2004%	2005%	2006%	2007%	2008%	2009%	2010%	2011%
Govt final consumption expenditure [1]	1.0	0.1	-0.1	0.3	0.5	0.3	0.5	1.3	1.6
Private final consumption expenditure[2]	1.8	1.9	5.0	6.2	5.8	-1.0	4.0	5.8	2.2
Net fixed capital formation [3]	1.6	1.2	2.3	4.5	3.5	2.1	1.3	1.2	4.3
Gross domestic expenditure[4=1+2+3]	4.3	3.2	7.2	11.0	9.8	1.4	5.8	8.3	8.1
Net exports[5]	-1.7	-1.7	-1.2	-5.3	-2.8	0.3	-3.5	-2.6	3.7
GDP Growth [6=4+5]*	2.9	5.1	5.9	6.3	7.0	1.6	2.6	5.6	4.4

Source: KNBS Economic Survey—various issues

* Numbers may not add up due to statistical discrepancy in the national accounts

Figure 7.3: Contribution to GDP growth 2003-2011 (expenditure method): constant 2001 prices



Source: KNBS Economic Survey—various issues

near zero in 2005, to a deficit equivalent to 8.9 percent in 2011. On the fiscal side, the story is not any better. The fiscal deficit including grants has deteriorated from 1.8 percent of GDP to 5.4 percent. The saving-investment gap and the deterioration in the fiscal balance have spilled over into Kenya's external account. The balance of trade deficit has almost doubled increasing from 11.4 percent

of GDP in 2005 to 21.5 percent in 2011, while the current account deficit increased from 1.5 percent of GDP to 10.6 percent in 2011. Kenya's main macroeconomic outcomes are summarized in Table 7.2.

Savings and investment levels are lower than those underpinning the first Medium Term Plan (MTP) and Vision 2030. Kenya's savings and investment rates are well below those desired in the MTP and Vision 2030. The MTP envisages Kenya's gross savings for 2008-2011 averaging 18.7 percent and investment equaling 24.6 percent. However, the outturn for actual gross savings was 14.4 percent, while gross investment averaged 21.3 percent (Kenya's annual saving and investment rates for 2005-2011 are shown in Table 7.2). Kenya also lags behind SSA countries and others in terms of savings and investment (see Figure 7.4). For a country with Kenya's investment opportunities, the low levels of domestic savings are acting to constrain investment.

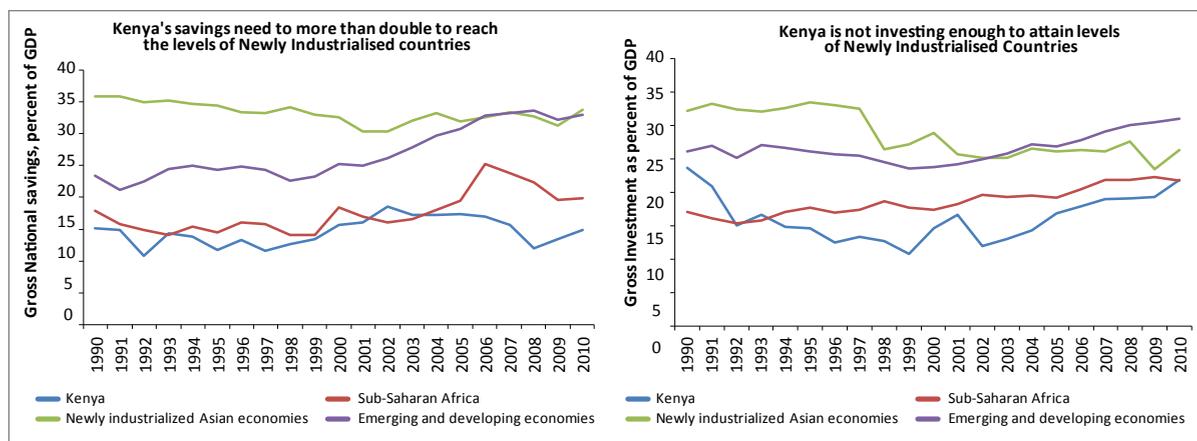
Table 7.2: Selected macroeconomic outcomes (percent of GDP)

	2005	2006	2007	2008	2009	2010	2011
Savings – Investment							
Investment	16.9	17.9	19.1	19.5	19.4	21.5	24.7
Savings	17.2	16.8	15.5	13	13.3	15.6	15.8
Government							
Government Expenditure	24.3	24.7	26.2	27.6	27.9	31.2	31.4
Government Revenue	21.2	21.1	22	22.1	21.9	24.2	24.8
Fiscal Balance (grants)	-1.8	-2.5	-3.1	-4.3	-5.2	-6	-5.4
Fiscal Balance (W/grants)	-3.1	-3.6	-4.2	-5.4	-6	-7	-6.7
External Sector							
Imports	36	36.3	37.1	41.8	37.2	41.1	44.5
Exports	28.5	26.6	26	27.6	24.1	26.9	28.8
Balance of Trade	-11.4	-14.5	-15.7	-18.8	-16.9	-19.7	-21.5
Current account	-1.5	-2.3	-4.0	-6.6	-5.8	-6.5	-10.6
S-I	0.3	-1.1	-3.6	-6.5	-6.1	-5.9	-8.9
T-G	-3.1	-3.6	-4.2	-5.5	-6	-7	-6.6
X-M	-7.5	-9.7	-11.1	-14.2	-13.1	-14.2	-15.7
Current Account	-1.5	-2.3	-4.0	-6.6	-5.8	-6.5	-10.6

Source: KNBS Economic Survey—various issues

* Numbers may not add up due to statistical discrepancy in the national accounts

Figure 7.4: Kenya's savings and investment rates below its peers



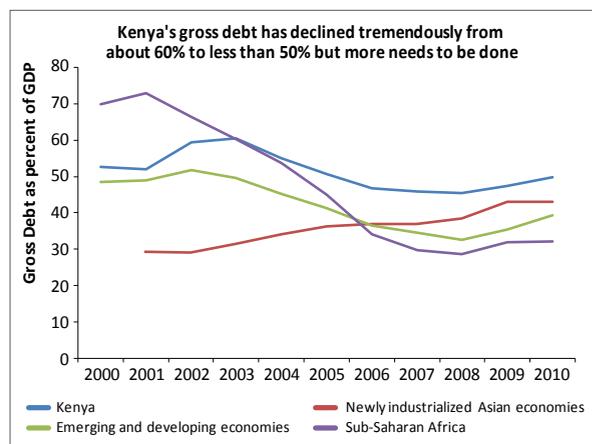
Source: IMF WEO database 2012

The responsive and responsible nature of Kenya's fiscal management is one of Kenya's signature achievements. The government has been able to mobilize domestic revenue to finance its spending, and as such, Kenya is one of the very few countries in SSA, whose budget is not dependent on development assistance. Kenya has not sought debt relief under the Heavily Indebted Poor Countries (HIPC) initiative, and has managed to maintain reasonable debt levels. The government's recurrent spending is 100 percent financed by domestic resources while development assistance finances part of the development budget. Under the recent Kibaki administration (2002 – 2013), significant resources were directed to finance infrastructure projects, as well as programs in health and education.

Public debt as a share of GDP is within tolerable levels, but a reduction of this debt ratio is important if the government is going to improve confidence levels in the financial markets, and expand the fiscal space to ride out any future shocks. Public debt declined from over 60 percent of GDP in 2003 to just below 45 percent in 2011-2012. This is a major achievement for an economy that has not been a recipient of HIPC assistance. However, Kenya's debt levels are still high, compared to debt levels in emerging economies and

newly industrialized economies (see Figure 7.5). Experience has shown that the economy is prone to external and exogenous shocks brought by such developments as spikes in international oil prices or downturns in the Euro zone, a major trading partner. The government has resorted to the external market at times, to smooth the impact of the various shocks that the economy has experienced.

Figure 7.5: Kenya's debt levels in comparison with others



Source: IMF WEO database 2012

Kenya's conduct of monetary policy has contributed to macroeconomic stability, the development of money and capital markets, and in keeping the exchange rate stable. As a result of Kenya's prudent monetary and financial policy, it now has the third largest financial system in SSA, in terms of assets.

Kenya's money and capital market are among Africa's most vibrant.

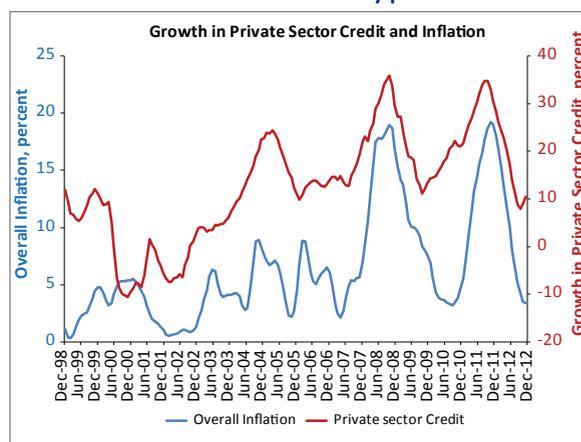
Kenya has experienced relatively low inflation, averaging below 10 percent annually since 2000, with spikes driven mostly by swings in food and international oil prices. The Central Bank's prudent monetary policy has kept core inflation within targeted range, but sub-optimal official food policies and strategies have led to spikes during drought periods. Since food accounts for 36 percent of the consumer price index, spikes in food prices have a strong impact on inflation. In addition, sharp movements in international oil prices are passed through to domestic prices leading to inflationary pressure. The economy relies heavily on hydro power, whose supply fluctuates with the amount of rainfall Kenya receives. During droughts, expensive diesel fuel is imported to power engines for supplemental energy.

Access to private sector credit has spurred an increase in domestic consumption, and GDP has also added to inflationary pressure.

Kenya has seen tremendous growth in private sector credit since 2003, as the government reduced its reliance on borrowing from the domestic market. With less crowding out by the government, there was a sharp increase in financial savings, leading to lower interest rates and increased lending. In addition, a more accommodative monetary policy encouraged a boom in borrowing by the private sector in 2008-2010. However, high credit growth is associated with inflationary pressure as shown in Figure 7.6.

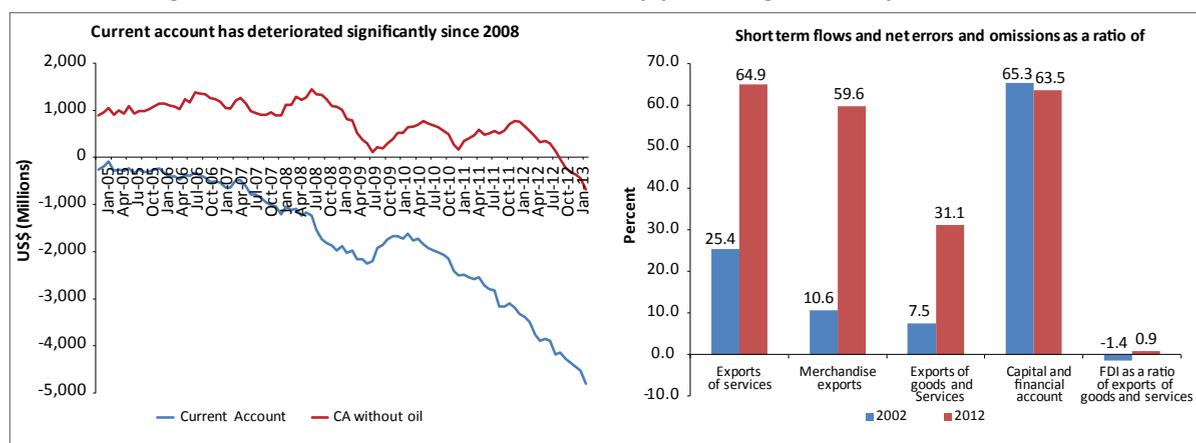
Kenya's current account and balance of trade deficit has deteriorated sharply, as exports have stagnated while imports increased. The share of Kenya's exports in GDP has remained constant since 2005, while the share of Kenya's imports has increased. Exports marginally increased from 28.5

Figure 7.6: High growth in private sector credit has increased inflationary pressure



Source: CBK database

percent in 2005, to 28.8 percent of GDP in 2011. At the same time imports as share of GDP increased from 36 percent to 44.5 percent. Though a significant portion of the increase of imports can be attributed to the oil bill and increased imports of machinery, transport goods and other intermediate goods, the appreciation in the real exchange (to be discussed hereafter) has contributed to the problem. The current account deficit deteriorated from 1.5 percent in 2005 to over 10 percent in 2012 (see Figure 7.7). When Kenya runs a current account deficit, it builds up liabilities to the rest of the world that are financed by flows in the financial account. However, if the imports are mainly composed of consumption goods, i.e. spending that yields no long term productive gains, then Kenya's ability to repay might come into question. Kenya's large appetite for imported goods has not only led to deterioration in the current account, but has also contributed to a reduction in the consumption of domestically produced goods. This in turn has reduced the demand for local labor, contributing to the existing imbalance between new entrants to the job market and job prospects. About 800,000 Kenyans enter the job market annually, but the economy, on average, generates only 50,000 modern sector wage jobs.

Figure 7.7: Current account has deteriorated sharply and being financed by short term flows

Source: Balance of payments data, CBK database

The financial account has been financing the current account. Remittances have increased significantly in the last 5 years, surpassing the US\$ 1 billion mark in 2012, from US\$ 300m in 2006. Large amounts of remittances find their way into real estate, building and construction activities, which has increased the demand and prices in the non-tradable sector. The high differential between yields in Kenya and international market (USA and Euro area) both in fixed income securities and equities market has attracted short term inflows into the financial markets.

The short term flows have heavily influenced Kenya's exchange rate which has appreciated by 34 percent since 2000 in real terms. The appreciation of the real exchange rate is reflected in the deterioration of the current account (weaker export growth and strong import growth) and strong private sector credit growth. The short terms flows have financed the current account deficit, and have managed to shore up the strength of the Kenyan shilling since 2003. The strong shilling has boosted the consumption of imports, benefiting businesses such as those in the construction industry, that import significant levels of specialized materials and finished products. China and India account for an increasing amount of construction-related

imports, as do Turkey and Dubai. Commercial banks organize trips for businessmen and women to attend trade fairs in China, Singapore, Malaysia and Turkey. These trips often lead to orders for new imports. Overall, the reinforcing nature of the nexus of strong short term flows (both legitimate and illegitimate), and an appreciated exchange rate which discourages exports, acts as a drag on economic growth. As such, Kenya needs to rethink its macroeconomic policy mix which is currently only being driven by consumption.

Kenya's capital account, which remains the least controlled in the region, has become an attractive destination for short term flows, some of which may be of questionable origin. Short term flows (including errors and omissions, have increased dramatically in the last decade. Compared to earnings of exports of goods and services, short term flows, which were the equivalent to 7.5 percent of GDP in 2002, increased to 29.4 percent in 2011—and now constituted 70 percent of Kenya's Capital and financial account

Exchange rate policy remains the key pillar to macroeconomic management. Although the real exchange rate has appreciated, nominal bilateral exchange rates have been stable with

a minimal bias towards depreciation in the last decade.^{2,3} The shilling has depreciated by 36 percent cumulatively between 2000 and 2012, representing an annual depreciation of about 3 percent. Given the higher price differences between Kenya and its trading partners, the shilling should have a higher nominal depreciation. The good news is that exchange rates are market determined with no interferences from the Central Bank. The forex market in Kenya remains very thin with few market participants, and as such, susceptible to large volatility in both intraday markets and within any month. The average daily market trading averaged only about US\$ 300-500 million, a relatively small amount. Large purchases of forex, for example, to buy fertilizer or petroleum, subject the shilling to large swings on the days the deal is completed. Since Kenya has an open capital account, volatility in the international currency markets and geopolitical disturbances, are passed through into the domestic currency market. In addition, the trade weighted exchange rate, shown in Figure 7.8 indicates that despite the nominal depreciation of the exchange

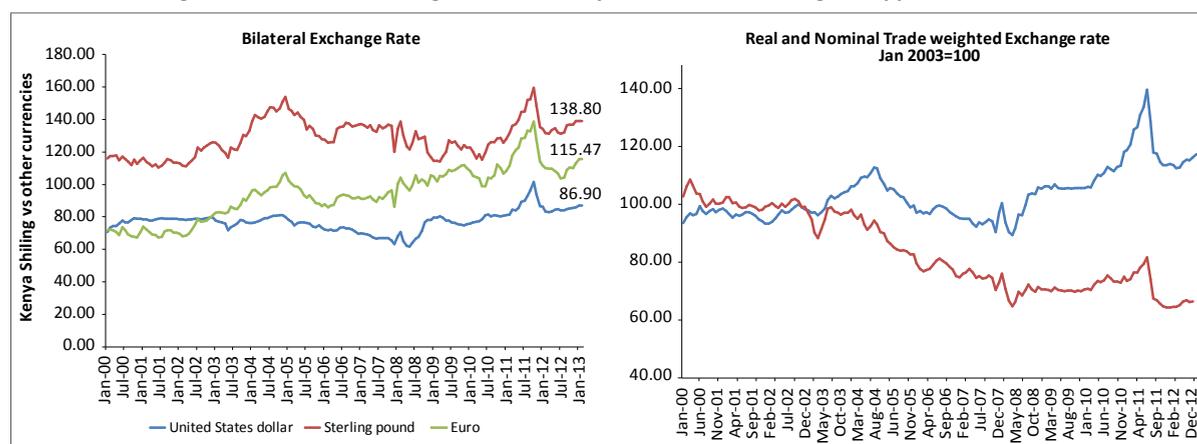
rate since 2008, Kenya's competitiveness has deteriorated by 30 percent since 2003.

KEY CHALLENGES

Kenya's below par economic performance over the past ten years can be attributed to a policy mix which has not always been optimal. The current policy mix has led to an overvalued exchange rate, discouraged exports, encouraged short term flows, and has failed to attract enough FDI to power GDP growth. As a result of the policy mix:

- (i) *Growth has been unbalanced:* growth has mainly been driven by consumption, while investment and exports have yet to be the major factors determining growth;
- (ii) *Growth has not been sustainable:* growth has not been sustainable with high growth episodes followed by low growth;
- (iii) *The external account has deteriorated as the result of the unbalanced and unsustainable nature of Kenya's growth.* Weak exports and high import demand in an environment of an appreciating real effective exchange rate resulted in Kenya's external account deteriorating significantly since 2003; and,

Figure 7.8: Bilateral exchange rates relatively stable but the shilling has appreciated in real



Source: CBK Database

² Nominal exchange rate can be defined as the amount of Kenya shillings that can purchase a unit of a given foreign currency. A decrease in this variable is termed nominal appreciation of the currency while an increase is termed nominal depreciation of the currency. Real exchange rates are nominal exchange rate that has been adjusted for the different rates of inflation between Kenya shillings and a foreign currency. In practice, changes of the real exchange rate rather than its absolute level are important. An increase in the real exchange rate is termed depreciation while a decrease is depreciation. The importance stems from the fact that it can be used as an indicator of competitiveness in the foreign trade of a country.

³ Long-run equilibrium real exchange rate is the real rate that, for given values of "economic fundamentals" (openness, productivity differentials, terms of trade, public expenditure, direct foreign investment, international interest rates, etc.) is compatible with simultaneous achievement of internal and external equilibrium. For methods to estimate long-run real equilibrium exchange rate, see Hinkle and others 1999.

(iv) **The open capital account has attracted significant inflows of short term funds**, some of which, including those from troubled countries within the region, are of questionable origin.

Kenya is able to finance its current account deficit because capital flows are coming in and this contributes to the exchange rate's appreciation. Most of the inflows that come in are short term and speculative in nature, drawn because of attractive interest rates, the strength of the Kenyan financial sector and the relatively stable political and economic environment. Exchange rate appreciation in turn weakens exports incentives. In addition, Kenya is not saving enough as the economy consumes more than what it produces, further putting pressure on the current account.

While fiscal programs have been adequate, Kenya will require more resources if it is to attain its major developmental objectives—becoming a Middle Income and newly industrialized country by 2030. Kenya is already mobilizing over 20 percent of its budget from taxation. It will need more resources to finance its development agenda. Considerable scope exists to increase tax revenue, by simplifying the tax codes, closing the loopholes for tax evasion, reducing tax exemptions, and bringing significantly more people within the formal taxation system.

Foreign direct investment and development assistance will be critical in helping Kenya to finance its development agenda. Kenya needs to provide reliable energy to its industrial sector at competitive rates. It needs roads to connect its cities with both domestic and international markets, and it needs more fiber optic connections to facilitate commerce. These are huge investments which need large injections of capital into the economy. Government funds

are constrained, and cannot be relied upon to deliver such costly investments.

Even though public debt has decreased to within tolerable levels, a debt level below 40 percent of GDP would provide a comfortable cushion to improve confidence levels in the financial markets and expand the fiscal space to ride out any future shocks. Kenya's debt levels are still high compared to debt levels in emerging and newly industrialized economies. Experience has shown that the economy is prone to both external and exogenous shocks, brought on by such developments as spikes in international oil prices, negative spillovers from Kenya's trading partners, and drought. The government should aim to keep the rate of growth of its debt accumulation below the rate at which the economy grows.

Economic development is a continuous process of industrial and technological development that also changes the institutional and social settings. Kenya's government has underperformed in the past because it has not taken a systematic and comprehensive approach to managing all aspects of the economy. As it begins to readjust Kenya's economic strategy, the incoming National Treasury team should try to answer the following questions:

- How to move resources (human and physical) from low-to high-productivity activities?⁴
- How will the process of moving into higher quality goods and services happen within agriculture, services or industry?
- Why are some firms able to move into export markets and start producing new goods competitively, while others languish, yet they all face the same business environment constraints?
- Why is there a high firm mortality in the manufacturing export market?
- How could the economy move up the value

⁴ This does not necessarily mean from low-to high-value added activities

chain without government distortions getting in the way and creating artificial and unsustainable growth spurs, that eventually lead to a middle-income trap?

- What are the appropriate roles for the Kenyan government and the country's vibrant private sector in setting the country on a sustainable growth path?

MOVING TOWARDS A BETTER POLICY MIX FOR KENYA

Kenya's developmental goals envisioned in Vision 2030, will need an adjustment to its policy mix to help deliver better macroeconomic outcomes (outlined earlier). To achieve its developmental goals: (i) Kenya's sources of growth must expand and be broad-based, powered by exports and investment; (ii) the economy needs to create more jobs than the current 50,000 or so to accommodate the roughly 800,000 job entrants that come into the job market every year; and, (iii) policy makers need to re-evaluate macro fundamentals to assess their viability to deliver the projected growth trajectory and outcomes in the Vision 2030 document.

Kenya can grow faster. With GDP per capita just above US\$ 800 (half of SSA's average), yet with all the ingredients for much stronger performance, Kenya should be aiming for double-digit growth. It is projected that the country will only reach a very modest GDP per capita of about US\$ 1,000 in 2018—that is less than half of Congo's GDP per capita today. The current growth trajectory of 6 percent in the medium term is not ambitious enough, especially given the country's incredible potential and challenges. With high income inequality and nearly half the population below the international poverty lines of US\$ 1.25 per day, the new administration of President Uhuru Kenyatta needs to aim for much higher goals.

Jumpstarting the manufacturing sector is a key pillar for any medium term economic strategy. The most important strategic decision which Kenya's new administration needs to make, is to renew its commitment to the manufacturing sector and exports, as part of the broader agenda to diversify the economy.

- ***Diversification of the economy is important for Kenya's development.***

Countries that have been able to achieve a higher level of economic development have done so through the diversification of their economy. An effective industrial policy is key for an economy to diversify over time. Diversification which involves the manufacturing sector, creates new sources of income and has positive spillover effects for society, such as knowledge acquisition that allow for other capacities to be developed. Furthermore, empirical evidence shows that as countries increase their level of diversification, the level of economic output also increases. In other words, no country has been able to achieve positive growth over many years, based on a single sector or on a few activities.

- ***The philosophy behind the new strategy is to give a focused thrust to economic growth and employment intensive initiatives.*** The manufacturing sector in general and manufacturing exports in particular, can be viewed not only in terms of their economic contribution, but as a means of generating gainful employment. This can be done by: encouraging domestic manufacturing to produce inputs for the export industry, reducing their dependence on imports; promoting technological upgrading of exports to retain a competitive edge in global markets;⁵ endeavoring to reduce transaction costs through procedural simplifications, encouraging and

⁵ While innovation is the driver of productivity enhancement everywhere, it should mean different things for developing and developed countries. For advanced economies, innovation generally implies invention, because technologies and industries there are on the global frontier. For developing countries such as Kenya, innovation could be mostly imitation because their technology/industries are most likely to be within the global frontier. At its current low level of development, Kenya could sustain very high growth rates by just doing imitation.

promoting a strong market diversification strategy to hedge the risks against global uncertainty; and encouraging investment in export-oriented business in and around Kenya's coastal shipping zones, which themselves need to be made more efficient, if Kenya is to improve its international competitiveness.

- **Exports incentives could include supporting exporters to access new markets by helping the exporters to offset high freight costs and other externalities to select international markets.** In addition, Kenya could encourage new export products, which have high employment intensity outside Nairobi, so as to offset infrastructure inefficiencies and other associated costs involved in marketing of these products. Kenya could also support its exporters to reach out to new markets by supporting buyer-seller meeting exhibitions abroad based on a careful consideration of products and countries to be targeted.

Macro-Financing Framework. For Kenya to achieve a high annual growth rate of 10 percent or higher, greater levels of investments will be needed. Kenya's relatively low savings rate, only 13 percent in 2012, might be seen as an impediment to higher growth. However, low savings are a typical feature of poor countries—few economies with GDP per capita of US\$ 800 have much higher saving rates. Moreover, the low domestic saving rate can be compensated by higher levels of foreign savings, provided that they are channeled into a credible development strategy that generates economic surplus, in the form of profits and salaries, and higher savings. Kenya urgently needs high-quality infrastructures, at least in certain key sectors and key geographical areas. The country currently has the fiscal space and credibility to attract more FDI and even to use more foreign debt to sustain its economic

development—provided that the funds are used to finance productive infrastructure (i.e., those with positive rates of return) and to support competitive industries. The important questions are not whether savings are too low or whether the fiscal and current account deficits are too high, but how the country's resources are being used, how the deficits are being financed and whether their financing is sustainable.

Foreign Direct Investment is key to Kenya's development agenda. Since domestic savings are low, attracting FDI would supplement domestic savings in financing Kenya's growth agenda. Kenya should aggressively seek more productivity enhancing FDI to diversify its economy and develop its private sector, and encourage technology transfer, to sharpen its competitive edge in the external market. Kenya needs strong institutions like the judiciary to resolve conflicts, enforce contract disputes, and ensure a level playing field for investors. Political stability is also an important factor in attracting FDI, and in providing longer term investment horizons.

RE-EVALUATING KENYA'S EXCHANGE RATE POLICY

Kenya's real effective exchange rate has appreciated by over 30 percent since 2003, thereby hurting its export competitiveness. Given that Kenya has a floating exchange rate regime policy, the real appreciation has been driven by massive short term inflows, which dominate its financial account. The short term flows which stand at 70 percent of the financial account include, portfolio flows flowing into the money market mostly into the bond and equities market. Kenya might be attracting the illicit flows from fragile states of Somalia, South Sudan and others, given the stability of its financial sector and the proximity to these countries. A peculiar characteristic of Kenya's securities market is the thinness of the market, with a daily turnover of US\$ 300-500m with about

five to six main market players. As such the forex market has exhibited high short term exchange rate volatility and medium term swings that are only weakly related to economic fundamentals. This is largely explained by the fact that the exchange rate is also an asset price influenced strongly by short term financial flows, which are subject to speculation, manias, panics, herding, and contagion.

The size, peculiar nature and the outcome of the forex market has called into question its efficiency, and appropriateness of the current exchange rate policy. Because of the thinness of the forex market, short term inflows are able to move the market. The exchange rate is therefore sustained by artificial reasons not real fundamentals. Central Bank of Kenya's reaction of mopping off excess liquidity to sterilize the inflows through open market operations ends up keeping domestic interest rates high which typically results in the attraction of even greater capital inflows. Second, given the relatively small size of the domestic financial market compared with international capital flows, sterilization tends to become less effective over time. As capital inflows increase, tension will likely develop between the authorities' desire, on the one hand, to contain inflation and, on the other, to maintain a stable (and competitive) exchange rate (see Caramazza and Aziz, 1998).

The government needs to have an idea of where the real exchange rate should be, to ensure that the national economy is competitive. For any exchange rate regime to maintain a stable and competitive real exchange rate, it requires a supportive policy environment which would include prudent macroeconomic policies, a strong financial sector, and credible institutions (Yagci 2001). Monetary policy should be consistent with exchange rate objectives. Failure to establish

fiscal discipline would lead a country to crisis under any exchange rate regime. Typically, the longrun equilibrium real exchange rate is estimated based on the economic fundamentals of the country, and a variety of policy and institutional arrangements are made to keep the actual rate sufficiently close to it over the medium-term. If Kenya could embark on active management of the exchange rate, this would provide policymakers with an additional strong policy tool, to correct misalignment and to influence the balance of payments, trade flows, investment, and production (Yagci 2001).

The current exchange rate policy has helped Kenya to override shocks. With its current exchange rate policy, the economy has been able to absorb the impact of adverse external and domestic shocks (deterioration in terms of trade, contraction in world demand as experienced during the global financial crisis, etc), and avoid large costs to the real economy. These shocks usually necessitate an adjustment in the real exchange rate. Because domestic prices move slowly, it is both faster and less costly to have the nominal exchange rate respond to a shock.

Kenya's exchange rate policy needs to be calibrated to maintain a stable and competitive real rate consistent with the economic fundamentals. This might to involve consciously moving from a free float to managed float exchange rate policy, to correct Kenya's misalignment and to influence the balance of payments, trade flows, investment and production in the medium term.⁶ The current exchange rate policy stance has exhibited short term exchange rate volatility and medium term swings, that are only weakly related to economic fundamentals. This is largely explained by the fact that exchange rate is also an asset price

⁶ Long-run equilibrium real exchange rate is the real rate that, for given values of "economic fundamentals" (openness, productivity differentials, terms of trade, public expenditure, direct foreign investment, international interest rates, etc.) is compatible with simultaneous achievement of internal and external equilibrium.

influenced strongly by short term financial flows, which are subject to speculation and herding behavior (Yagci 2001). Determined in this manner, exchange rates may develop their own short term and medium-term dynamics that overwhelm the goods and services market transactions.

A managed float exchange rate policy will provide scope for setting an appropriate balance between exchange rate stability and flexibility. When supported by sound macroeconomic policies, such a policy measure can keep the variations in the exchange rate within reasonable bounds, dampening the degree of uncertainty, while permitting enough flexibility to adjust the parity to economic fundamentals.⁷ If the Central Bank of Kenya can manage the exchange rate to be consistent with economic fundamentals and the markets is convinced by the government of Kenya's macroeconomic policies, Kenya can achieve and maintain stable and competitive exchange rates.⁸

Kenya could adopt some selective capital controls to discourage highly volatile short term flows, but facilitate the longer term capital inflows.⁹ These controls would reduce Kenya's vulnerability to external shocks, and help to ease the real appreciation of the shilling which has averaged about 3 percent annually in the last 10 years. Any selective measures chosen should complement GOK macroeconomic policies and aim to: (i) limit short term speculative flows; (ii) reduce the vulnerability of the shilling from domestic and external shocks; and, (iii) help insulate the real economy from excessive movements in the exchange rate. A policy of selective capital controls should be limited to short term speculative inflows, which pose particular risks to the shilling's stability, and

should not include capital outflows, longer term inflows and direct investment, that help to ease downward pressures on the exchange rate.

8. Unleashing Kenya's export potential – regionally and globally

By Ganesh Rasagam, Yira Mascaro, John Randa and Ravi Ruparel

OVERVIEW

Kenya's export performance has been characterized by:

- an over-reliance on traditional exports (tea, coffee and horticulture), which still account for 35 percent of goods exports, but are losing share in traditional markets in Europe and failing to penetrate into potential emerging markets;
- an under-performing services export sector dominated by tourism;
- low value addition and lack of differentiation in traditional and non-traditional exports; and,
- lack of an integrated national framework for export development across key industries and institutions.

To achieve the aspirations of Vision 2030, a fragmented approach to export development is no longer appropriate, and will not lead to enhanced competitiveness, hence, sustainable improvement in Kenya's export performance. Experience in countries that achieved sustained rapid growth since the 1960s indicates that such growth has typically been accompanied by a sharp increase in the share of exports in GDP, and in most cases, in the share of manufacturing in exports and GDP¹, although a few have managed to grow through revenues from services.

⁷ See also Yagci 2001.

⁸ A policy of managed float exchange rate policy would still allow Kenya's exchange rate to remain flexible and absorb an important part of the shocks. The shock absorption capacity of the regime would depend on the width of the band.

⁹ This can take three forms (i) unremunerated reserve requirement on bank deposits designed to discourage the short-term inflows (ii) a minimum holding period of one year for equity investment (iii) taxing short term inflows.

¹ See Eichengreen, 2008.

Kenya shares some important features with these high export economies, including labor abundance, a coastal location, and macroeconomic stability. But while it has performed moderately well in services, its manufacturing sector has lagged behind significantly. The new government needs to comprehensively address issues constraining export development by: addressing the competitiveness of Kenya's products abroad; removing impediments to competitiveness within the export sector; allocating scarce resources to priority industries, and business support services—that enable current exporters to export more, potential exporters to begin exporting—and aspiring exporters to move from idea to execution.

While Kenya's trade participation has expanded over the last decade, its deficit has grown considerably, and despite some progress in product diversification, there remains much scope for improvement. Goods exports are still dominated by vegetables and foodstuffs, whose share expanded to over 60 percent in 2010. Outside of the goods sector, Kenya is showing buoyancy in the development of the services sector, particularly in communications services. At the same time Kenya seems to face important challenges with regard to the sophistication of its services exports.

Looking at the product composition of Kenya's export basket, there is little sign of dynamism. The most important products in the basket are, by and large, the same ones that were there a decade ago. While the EU still remains the main destination for Kenya's goods exports, higher export shares to the BRICs partially compensated for the declining share to the EU. Although export concentration of markets doesn't seem to be a serious problem now, Kenya still needs to explore alternative sources of demand, given the current crisis in the Eurozone and

the resulting demand volatilities for Kenya's exports.

The sophistication of Kenya's export basket has increased, particularly between 2006 and 2008. Nevertheless, Kenya's significant textile and clothing exports lost in relative quality between 1996-1998 and 2006-2008, which is serious, given the growing role of this sector. Moreover, Kenya's export growth was strongly affected by a decline or even extinction of old products to existing markets. The increase of new products to either new or existing markets only explains 2.8 percent of Kenya's export growth between 1998 and 2010. In order to become a more dynamic exporting country, such as Nicaragua, Cambodia and Vietnam, Kenya's export growth needs to focus more on new products, while ensuring that existing products show lower decline and extinction rates.

Kenya's share in world merchandise exports has shrunk by 75 percent since the 1960s, while its share in world manufacturing has stagnated at a very low level. Given the high level of unemployment, especially among the educated youth, and given the job creation imperative, Kenya needs to adopt concrete actions aimed at diversifying its production and export structure, and removing regulatory barriers to manufacturing exports.

Kenya could develop an export strategy that doubles merchandise exports by 2018. Such a strategy could hinge on two pillars: (i) market and product diversification; and (ii) expanding existing products with considerable growth potential.

This will require the government to address issues of capacity development and diversification, cost of doing business, export facilitation, and market access and promotion. This should include the harnessing

of Kenya's creativity and innovative spirit, including in the financial sector. However, this is not going to be easy. It will require Kenyan policymakers to make tough policy choices and renew their commitment to the manufacturing sector and to exports, as part of a broader agenda to diversify the economy. They will need to build resilience to shocks, and develop productive capacity for high and sustained economic growth.

Kenya has a comparative advantage in the export of services, but this potential has not been fully exploited. Despite the weak performance in manufacturing exports, Kenya's services sector has performed relatively well in recent years. Service exports have been growing at nearly twice the rate of service imports, and substantially faster than merchandise exports. The country has a clear comparative advantage in services within the COMESA region, and the sector has significant potential to continue this dynamic growth trend. However, regulatory barriers currently restrict growth, particularly in higher value added services sectors like banking, and professional and business services. Improving competitiveness in these key input services sectors will also be critical to underpinning a more competitive manufacturing sector.

KEY CHALLENGES

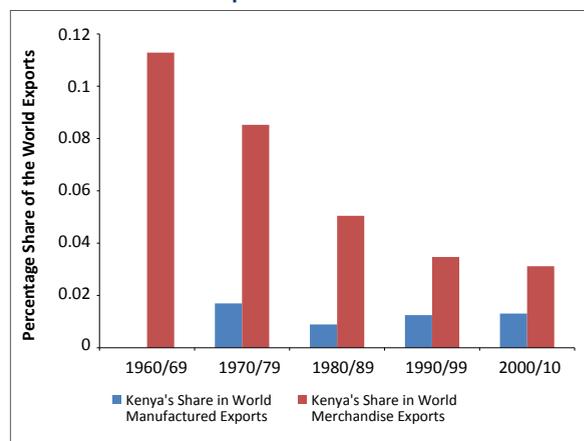
The contribution of manufacturing to GDP has stagnated at about 10 percent since 2000, and has actually been declining. The share of manufacturing in GDP has dropped from 10.1 percent in 2000, to about 9.6 percent in 2010, implying that as the size of economy expanded, the contribution of the service sector (including subsectors such as trade, transport and communication), expanded faster than that of the manufacturing sector. This seems unlike experiences from other countries, where in virtually all cases,

high rapid and sustained economic growth in modern economic development have been associated with industrialization—particularly growth in manufacturing.²

Kenya has been losing its market share of merchandise exports globally. Its share in world merchandise³ exports has shrunk significantly (by 70 percent since 1977, reaching 0.03 percent in 2010), while that of manufacturing exports has stagnated at about 0.02 percent in the last three and half decades. The only good news on exports is that the share of manufactured exports in merchandise exports has more than tripled from 10 percent in 1977 to 35 percent in 2010.

Kenya's export performance is poor compared to high growth exporters. It has had limited growth in exports over the last decade, mainly as a result of poor performance in merchandise exports. However, services exports have expanded significantly. The ratio of total exports (goods and services) to GDP has fluctuated between 22 percent and 29 percent (see Figure 8.1). In comparison, Cambodia's⁴ ratio increased from 20 percent to 60 percent over the same

Figure 8.1: Kenya's share in world merchandise exports has shrunk



Source: World Bank computation based on UN Comtrade data

² See Szirmai, 2009.

³ Manufacturing includes firms that convert raw materials into products; merchandise firms buy finished products and sell them. The latter differ from services firms in that they hold goods inventory that they sell to their customers.

⁴ Cambodia has a similar export structure as Kenya (i.e. emphasis on agricultural products and light manufacturing).

period. Merchandise exports stagnated, increasing from 14 percent in 2000 to 19 percent in 2005, then declining to 17 percent in 2011. However, service exports increased to 12 percent in 2011 from 8 percent in 2000, while service imports declined from 7.7 percent to 6.3 percent in the same period. Net service exports (exports minus imports) registered a positive balance that widened throughout the last decade (see Figure 8.2).

As of 2011, Kenya's services exports as a percentage of GDP were higher than the ratios registered by countries at similar levels of development, implying that the country's services exports are above the sample average (conditional on the level of per capita income). Kenya's services export share of world services exports expanded from 0.065 percent in 2000, to around 0.09 percent in 2010/11. Kenya shows the third largest share in world services exports after South Africa and Vietnam.

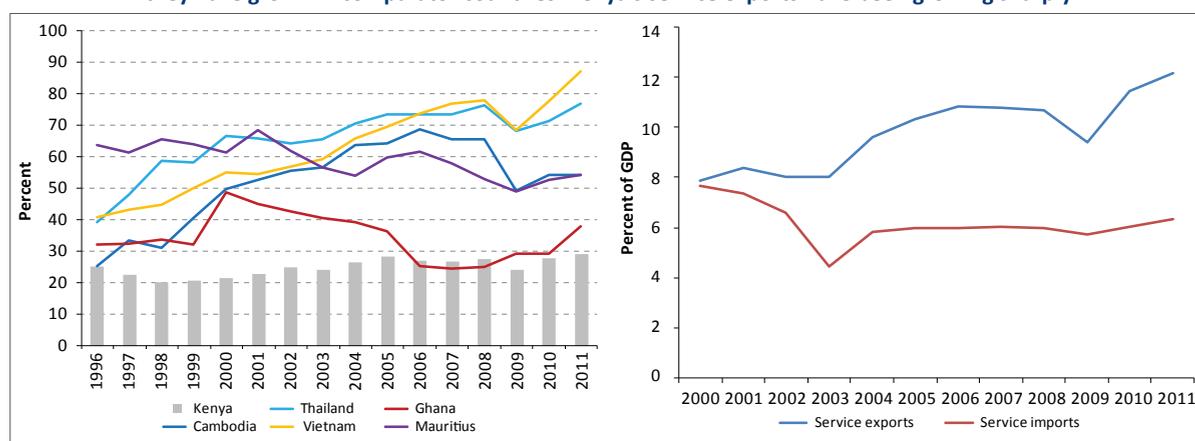
Services exports across broad sectors show that the country has slightly increased its dependence on 'other services' beyond the traditional transport and travel sectors, growing from 30.6 percent in 2000-2002 to 35.7 percent in 2010, reflecting a compound annual growth rate of 15.9 percent between

2000 and 2010. This increase mainly came at the cost of travel, whose share fell from 27.4 percent to 21.8 percent over the period. 'Other services' exports are dominated by government services, but also communication services, making up almost 10 percent of Kenya's total services exports. The export share of transport services remains high at around 42 percent. Furthermore, Kenya has potential to develop its services sector, but it faces severe regulatory barriers which restrict services—particularly in banking, and professional and business services.

There has been considerable volatility in the rate of merchandise exports growth. Kenya's export growth pattern has been rather volatile, with a few good years followed by major falls. Vietnam, a successful example of export-led growth, has had a distinct export growth trajectory with steady growth in merchandise exports year after year. In contrast, Kenya has had little positive momentum while suffering from some particularly challenging years.

The EU is the main destination for Kenya's goods exports. Nevertheless, the EU27 export share declined from almost 50 percent in 1996-1998 to 35 percent in 2006-2008, which was mainly driven by strong

Figure 8.2: Kenya's exports as a percent of GDP have remained virtually the same for a decade, while they have grown in comparator countries. Kenya's service exports have been growing sharply



Source: World Development Indicators (WDI), 2012 and KEU, edition 6

drops in exports to the UK and Germany. In 2010, the export share to the EU27 seems to have recovered, reaching 37 percent of the total export basket. The export share to Netherlands—Kenya’s major destination for cut flowers—is noteworthy, having increased from 7.1 percent to 11.4 percent between 1996-98 and 2010. Higher intra-regional exports (to the most important Sub-Saharan African and Middle East and North African markets) only partially compensated for Kenya’s reduced reliance on the EU-27 markets, rising from 28.7 percent in 1996-1998 to almost 35 percent of exports in 2006-2008. Missing data from Sudan, Rwanda, and the United Arab Emirates are likely to have reduced the reported share.

Kenya does not export much to high growth emerging markets like China, Turkey, Brazil and India. The BRICs absorbed less than 2 percent of Kenya’s exports in 1996-1998, 3.9 percent in 2006-2008 and 5.9 percent in 2010. While India was previously the dominant market among the BRICs, Russia has recently become an important export destination. Kenya’s export share to the US also slightly increased, to around 8 percent in 2006-2008 and 2010.

There is untapped potential to increase exports to countries that play an important role in global markets. The results from a bilateral gravity model, evaluating the observed bilateral trade in relation to the projected trade, indicates that Kenya’s actual exports are in line with predictions for partners such as Europe, the US and Japan, but are below the potential to some high growth countries. The results from a gravity model evaluating the observed bilateral trade in relation to the projected trade indicates that Kenya’s exports are in line with predictions for partners such as Europe, the US and Japan, but are below potential to some high growth countries, including the BRICS.

⁵ The Herfindal Index is computed as the sum of squared shares of each product (market) in total exports. A country with a perfectly diversified export portfolio in terms of products (markets) will have an index close to zero, whereas a country with only one export product (market) will show a value of 1.

Kenyan export performance has been hampered by its high costs of doing business compared to its competitors such as India, China and South Africa. Investment climate assessment studies (World Bank, 2008) have shown that selected business costs in Kenya add up to three times more than in China and almost twice as in India. The high costs of business reduce Kenya’s export profitability, thus, act as a disincentive to investment. Doing business 2012 places Kenya in the bottom quintile in terms of trading across borders (at position 141), with costs to exports and imports being twice as large as those in OCED countries, and with almost three times longer wait times to clear customs.

Kenyan firms have to bear high direct and indirect costs, because of the poor quality of the transportation infrastructure. High lead times and the unreliability of transportation services are reflected in the disproportionately high number of days of inventory held by Kenyan firms, particularly by manufacturing firms. Inland transport costs in the country are much higher than in China and India, and are among the highest in all the comparator countries. Low returns to capital appear to have their roots in an insufficient supply of complementary factors of production such as infrastructure services.

Kenya’s exports of goods have become less concentrated. Over the last decade, the index of export market penetration has increased from 14 to 25, indicating that Kenya has become better at diversifying its product portfolio across existing export markets. The Herfindal Index⁵ for products has decreased from 0.1 to 0.05, indicating reduced concentration.

Looking at another measure of export product diversification—the share of total exports accounted for by the top five HS6 products—shows that Kenya is less

concentrated in its exports than most African peer countries, but still more so than South Africa and all non-African peers. Regarding market concentration, Kenya managed to further diversify its export markets during the period. Overall, the results suggest that export concentration of products and markets is not a serious problem, but significant scope remains for further diversification of the product range.

Kenya's top ten export goods in 2010 confirm the country's strong reliance on vegetables, but also indicates the growing role of textiles. The top ten products made up more than 50 percent of the total export basket, reflecting moderate diversification at the product level. However, this share grew substantially in recent years, from only 43.5 percent in 2006-2008. Among the top ten, vegetables had the dominant share, of which black tea and cut flowers and flower buds for bouquets were the main export goods, with almost equal shares in 2006-2008. Table 8.1 reveals that the EU27 is a major export destination group for many important vegetables. Besides EU27 countries, the Middle East and Eastern Europe are major export destinations for black tea, while the US plays an important role for coffee exports.

Kenya has also improved its relative competitive position (as measured by the Revealed Comparative Advantage) in some

new product categories such as inorganic chemicals, glass/glassware, beverages/spirits, metals manufacturing, and select apparel categories.

Kenya has increased the number of export destinations and export products. In 1996-1998, Kenya exported 2813 products to 98 countries, compared to 3621 products to 129 countries one decade later. Both Kenya, and particularly Vietnam, managed to catch up with South Africa in terms of the number of countries, with Vietnam exporting more products to more countries than Kenya in 2006-2008. Other regional partners also caught up with Kenya, particularly, Tanzania, Uganda, and Ghana, while Rwanda is lagging behind.

Kenya's exporters export on average 7.6 HS6 products, the third largest number after South Africa (16.4 products) and Cambodia (8.1 products). Kenya also ranks third in terms of the average number of markets per exporter (2.5 markets), after Cambodia (5.3 markets) and South Africa (3.6 markets). The results suggest that compared to other East and West African peers the number of products is not a major issue for Kenyan exporters, while Kenya trails Cambodia and South Africa. In terms of number of markets, Kenya lags behind Cambodia, which seems to be globally more integrated.

Table 8.1: Kenya's high cost of doing business for trading across borders

	Kenya	Sub-Saharan Africa	OECD	Singapore	Malaysia	China	India
Documents to export (number)	8	8	4	4	6	8	8
Time to export (days)	26	31	10	5	17	21	16
Cost to export (US\$ per container)	2,050	1,960	1,032	456	450	500	1,095
Documents to import (number)	7	8	5	4	7	5	9
Time to import (days)	24	37	11	4	14	24	20
Cost to import (US\$ per container)	2,190	2,502	1,085	437	435	545	1,070

Source: *Doing Business 2012*

Export growth has been driven primarily by traditional products to traditional markets, with little by way of new products or new market discovery. Kenya's main exports in terms of products and markets still remain what they were two to three decades ago. Evidence also shows that the total number of both markets and products has declined since 2005, and Kenya appears to be specializing in a smaller set of merchandise exports.⁶ Export growth has mainly been driven by growth at the intensive margin (i.e. existing products and existing markets), with minimal growth at the extensive margin (i.e. existing products into new markets, new products into existing markets, and new products into new markets).

An analysis of Kenya's trade statistics for the period 2005 and 2009 reveals that export growth has been primarily at the intensive margin—with existing products in existing markets. Further, there has been little new product or new market discovery. Cumulatively, between 2005 and 2009, approximately 72 percent of export growth was at the intensive margin. At the same time, only 28 percent of the growth was at the extensive margin. The bulk of this growth was accounted for by an increase in exports of existing products to new markets. Discovery (new products exported to either new or existing markets) accounted for less than 1 percent of growth.

The technological content of Kenya's exports improved substantially between 1990 and 2010. The share of high-tech exports increased from 0.6 percent to 3.4 percent, and the share of medium-tech exports rose from 1.1 percent to 6.6 percent, driven by growth in exports of pharmaceuticals, and electronics and telecommunications equipment. Perhaps more significantly over

this period, Kenya's share of low-tech exports grew from 6.2 percent to 14 percent, driven particularly by the textiles sector. At the same time, Kenya lowered its dependence on resource-based exports from 25.4 percent to 19.5 percent of the export basket. Exports of primary products declined from 66.7 percent to 46.8 percent in 2008, but climbed back to 56.2 percent in 2010.

Kenyan exporters of business services are facing a variety of challenges. At the regional level, numerous barriers limit the mobility of professionals, and differences in regulation further segment the markets for business services in East Africa. Skills mismatches and skills shortages pose a significant challenge to many Kenyan exporters. Another factor that constrains service providers from exporting is a widespread lack of knowledge about exporting opportunities, markets, and processes, and a lack of awareness as to how to acquire such knowledge. Very often, Kenyan service providers—especially smaller ones—lack international networks and find it very difficult to obtain market intelligence on foreign markets. Finally, difficulties in penetrating foreign markets also comes from Kenya's low international brand equity as a business service provider.

In summary, Kenya's overall export competitiveness in recent years has been very weak—it has failed to maintain its competitive position in key products and markets, and perhaps more importantly, to introduce new, innovative products to the mix. On many indicators of competitiveness, Kenya does outperform its regional (East and West African) peers. However, in almost all cases, it lags badly behind South Africa and emerging dynamic global exporters like Cambodia and Vietnam.

⁶ This could be driven by a combination of higher exit rates by existing export products and lower rates of discovery and innovation at the extensive margin (new products being brought to the export market).

POLICY RECOMMENDATIONS: REVAMPING THE EXPORT ENGINE

- **Renewed momentum in the business environment reform agenda will reduce both startup and operating costs for businesses, including exporters.** Kenya's performance on business environment reforms has stagnated since 2008 (when Kenya was the top reformer in Africa in the World Bank Doing Business indicators). There is urgent need to embark on regulatory reforms, especially in business startup, licensing, tax administration and trading across borders, and this will significantly enhance the competitiveness of Kenyan firms.
- **A comprehensive action plan for enhancing exports, drafted and implemented jointly with the private sector, is urgently required.** This action plan, as part of the second Medium Term Plan, will address institutional and policy constraints across ministries and agencies, to identify priority constraints and systematically address these through a multi-year reform program. For such a program to be implemented effectively as it has been in other countries, high level government leadership and oversight are key success factors.
- **Critical to the strategy of achieving greater diversification of the export sector is firm level support in partnership with the private sector, in accessing new markets, new products and market access initiatives.** Such firm level support must be tailored to the specific needs of potential and current exporting firms, to innovate and attain higher value addition, increase the current value of non-traditional exports, grow services exports and increase penetration to existing and emerging markets.

9. Fuelling growth: energy

By Kyran O'Sullivan

INTRODUCTION

Kenya has advanced further in the reform of its power sector than most African countries. Reforms implemented to date—notably private participation in generation; commercial and technical performance contracting for the public companies; a tariff policy based on cost recovery and regulation by contract; unbundling of generation and distribution; and creation of specialized agencies for geothermal development and rural electrification—have had positive outcomes.

Further unbundling is in progress, and in time, the transmission company KETRACO will assume the mandate of an independent system operator from KPLC. The reforms have attracted considerable investments from private investors and donors, the quality of electricity supply has improved, and the number of electricity consumers has doubled in the past five years.

Kenya is now at a crossroads in its power sector reform journey. The government drafted an Energy Policy in 2012 that described the challenges in the sector, together with strategies and policies to address these, that included a detailed implementation agenda and timetable.

The draft Energy Policy sets out the overriding objectives for the power sector that will guide public policy in the medium term:

- **Ensuring adequate and reliable electricity supply.** Investment in electricity generation and transmission infrastructure needs to keep pace with demand, to ensure that there is adequate reserve margin and diversified sources of

supply. Modernization of the distribution network needs to be accelerated, to ensure that there is reliable electricity service to customers and reduction of technical losses.

- **Ensuring that electricity prices are affordable and at the same time ensuring fair returns to investors.** Stable and predictable electricity prices are necessary to underpin the competitiveness of Kenyan firms. The electricity tariff-setting mechanism will need to ensure that there is a fair return for investors, in order to sustain private investment in the sector.
- **Rapidly increasing the number of Kenya households with electricity service.** The number of households with electricity access has increased rapidly in recent years—doubling between 2008 and 2013 to 2 million customers. The electrification program can be sustained to achieve the target of 40 percent household access by 2020, from 25 percent in 2012.

The government can achieve these objectives with sensible policies that protect investors and consumers, promote competition, and protect the environment.

POLICIES TO ENSURE ELECTRICITY IS ADEQUATE AND RELIABLE

(i) The current policy of diversifying national sources of electricity supply and pursuing a regional strategy of system interconnection with neighboring countries should continue. Investments in geothermal and wind generation capacity and transmission line interconnections with neighboring countries, will reduce vulnerability to drought-prone hydropower.

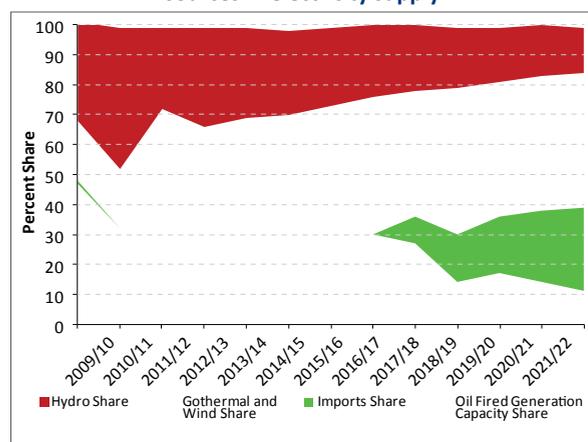
Currently, 280MW of additional geothermal capacity is being built in Olkaria, to be commissioned in 2014, and the Geothermal

Development Corporation has begun geothermal resource development in Menengai. Wind generation projects being developed by private sector sponsors, as well as thermal generation at a number of sites will add a further 400MW generation capacity by 2014.

Regional interconnections between Kenya, Uganda, Tanzania and Ethiopia will allow the countries to access lower-cost power. It will also enable countries that import power to postpone, reduce or avoid large and lumpy investments in domestic generation. For example, Kenya has contracted the purchase of 400MW of supply from Ethiopia from late 2017, after a transmission line interconnector will be commissioned. Domestic generation capacity additions and interconnections under construction will enable Kenya to achieve sufficient reserve margin (i.e. surplus available generation capacity), stable electricity supply, avoid load shedding and reduce its vulnerability to hydropower from 2014 onwards. A policy that ensures open access to transmission networks needs to be pursued, to allow agents in Kenya and neighboring countries to trade freely (purchase and sell) electricity.

The outlook of electricity supply by source based on Kenya's least cost power development plan is summarized in Figure 9.1. Kenya's considerable green energy sources of wind and geothermal are projected to provide as much as 45 per cent of electricity supply by 2022, displacing thermal plants that would otherwise be required. Imports based largely on diversified hydropower resources, are projected to provide a further 28 percent of supply by 2022. Since the proportion of national hydropower generation is also projected to fall to 20 percent by 2022, Kenya's supply of electricity will become much less vulnerable to hydropower, during drought years.

Figure 9.1: Projected percentage shares of sources in electricity supply



Source: World Bank Computation based on data from Kenya Least Cost Power Development Plan, 2011

(ii) Policies for increased competition in supply to end users should be implemented gradually, provided that a number of preconditions are put in place. The draft Energy Bill 2012 proposes that a generating entity may supply electrical energy to any consumer, i.e. the Bill envisages a competitive wholesale and retail electricity market. The proposal is made in the context of the need to ensure that there is improved reliability and reduction of losses in the distribution of electricity to consumers. There are a number of preconditions for a successful transition to a more liberalized power market. Ideally, the following characteristics are required:

- multiplicity of market players (i.e. multiple generators and buyers);
- no major transmission constraints; and
- mature steady-state power systems (i.e. which do not require significant generation capacity additions).

Experience from successful examples indicate that where reforms were introduced in wholesale markets, either one of the above conditions were already in place, or they were created as part of the reform process. In addition, wholesale power markets seem to function better when there is a comfortable margin of

spare generation capacity. Furthermore, establishing a wholesale market, with the required accompanying mechanisms (e.g. metering, balancing mechanisms, settlement of differences and ancillary services), is costly.

Even well-performing wholesale markets can fail to provide market signals to ensure optimal security of supply. The approaches successfully adopted by middle-income developing countries such as Chile, Brazil, Peru, Colombia and El Salvador in the past decade, are a reversal of the tendency to create wholesale markets that was predominant in the 1990s.

These countries have shifted their approach from “competition in the market” to “competition for the market”. Their priority is to ensure security of supply through competitive processes (auctions and others), and to sell electricity to financially viable distribution companies, through long-term PPAs.

To ensure the success of further market liberalization, the government should define a road map with specific milestones and timelines, in order to create the appropriate technical, commercial and economic conditions, to be able to introduce such reforms successfully.

(iii) Kenya can ensure security of supply through competitive processes (auctions and others) to sell electricity to financially viable distribution companies through long-term PPAs. In order to attract private investment in generation capacity, Kenya will need to continue to provide investors with a predictable and even enhanced environment. This will involve long term power purchase agreements (valid for at least 15 years) and credible off-takers; and include either take or pay clauses or payment for capacity (in order

to secure a level of cash-flow at least covering debt service obligations). It is unlikely that a private investor would be willing to build generation capacity in Kenya on the basis of a prospective portfolio of clients, who would not be prepared to make long term commitments for energy prices or demand volume.

(iv) Modernization of the electricity network is necessary. There is urgent need to modernize the electricity transmission and distribution systems, through investments in the “last mile” of the electricity network (i.e. in the distribution network up to the customer meter), and through the deployment of advanced tools for network planning, operations and maintenance in KPLC. The introduction of Smart Grid technology and other information technology applications to improve operational management processes, combined with investments in upgrading and expanding the electricity distribution grid, could initially target urban and greater peri-urban areas, that are the main zones of economic growth and development. Currently businesses incur heavy production losses and capital investment costs in self-generation, due to unreliable electricity service. By ensuring reliable electricity service in economic growth zones, existing businesses will become more productive and will be encouraged to expand, while new manufacturing and service industries will be attracted to set up operations.

(v) Effective enforcement of regulations on service quality is required. The Energy Regulatory Commission (ERC) should ensure effective implementation of a regime based on service quality, including parameters to be monitored, acceptable target values, penalties in cases of non-fulfillment and procedures for systematic monitoring. This should allow for timely access to, and the use of information provided by the management

information systems used by the utility (KPLC) to run its operations. A realistic approach to addressing this critical issue involves effective enforcement of a strict regime of service quality, and application of penalties, when mandatory standards are not met.

(vi) The efforts of industry and consumer associations to improve efficiency in the commercial and industry sectors need to be encouraged. The regulatory environment can support these efforts (the current requirement for solar water heating in new housing development is a good example), and it will need to be backed by a strong enforcement regime.

POLICIES TO ENSURE THAT ELECTRICITY PRICES ARE AFFORDABLE AND PROVIDE FAIR RETURNS TO INVESTORS

(i) The policy of maintaining full cost recovery tariffs is critical for sector sustainability and for attracting private investment to the sector. Kenya’s good track record of maintaining tariffs at cost recovery levels—even during periods of high international energy prices—has enabled it to attract large amounts of concessional financing for electricity generation, transmission and distribution infrastructure, from donor agencies, as well as financing from the private sector.

(ii) The system of regulation by contract that governs the setting of wholesale and retail tariffs since 2008 has worked well and should be maintained. The independence and capacity of the ERC and the Energy Tribunal should be safeguarded and enhanced. The existence of these bodies has been a key feature of the sector that has underpinned private sector investment in independent power generating projects, and maintained interest in projects being developed. As a wider array of public-private arrangements

are introduced, and as the sector further evolves, the competence and capacity of these bodies will need to be commensurately adapted, and enhanced with sector needs.

(iii) Diversification of the sources of electricity supply from hydropower and oil based generation will moderate price increases and reduce price volatility.

The share of oil-fired generation in electricity supply is projected to fall to about 11 per cent by 2022, as is shown in Figure 9.1, thus, reducing the weight of oil-fired generation in the bills paid by KPLC's customers. Consequently, as new generation is commissioned after 2014 (when 280MW at Olkaria I and IV are commissioned), there will be less volatility from month-to-month in the fuel component of the electricity bill. In addition fuel imports that are a heavy burden to Kenya's balance of payments, will fall as the country reduces its use of imported diesel and heavy fuel oil.

POLICIES TO INCREASE ELECTRIFICATION RAPIDLY

(i) Public policy has supported electrification as a priority development objective. This commitment will need to be sustained over the long term. Common features of a successful rural electrification planning include:

- a clearly established system to prioritize the areas to be electrified and the projects to be selected;
- a long-term (multi-year) vision aimed at coordinating grid extension and off-grid efforts, that should be supported by studies on the optimization of technology options and a grid/off-grid comparative economic analysis;
- a broad regional development approach that takes into account other conditions for rural development (access to education and health services, an adequate transport

system, acknowledgement of agricultural potential, access to markets, and the capacity of local manufacturing industry); and

- the design and effective implementation of an institutional framework that clearly establishes the roles and responsibilities of the public and private agents involved.

Achieving the targets for household electrification in Kenya (40 percent by 2020, up from 25 percent in 2012) will require more systematic planning of network reticulation using advanced GIS techniques, in order to reduce or at least contain costs.

As the draft 2012 Energy Policy points out, creating linkages with other sectors of the economy in the framework of integrated energy planning is necessary. Expanding industrial and commercial electricity loads can anchor the electrification program by enabling the distribution utility to expand the network with such nodes at the center of local reticulation schemes. Off-grid schemes will require that technical designs are optimized and institutional arrangements that are adapted to local conditions. For example, through community ownership or involvement in billing and collections.

(ii) The financial sustainability of electricity service should be guaranteed by contributions from all consumers.

The draft Energy Policy highlights the high cost of connection at between KES 17,000 and KES 35,000, a level that is beyond the reach of majority of rural households. It is unrealistic to charge new users full connection costs. Investments in rural electrification plans should comprise of all network assets needed to provide services to new users, which include the new customers' connections. Worldwide, experience shows that there is often a gap between the cost of efficient service provision, and the ability to pay of low-income consumers.

(iii) Given the magnitude of the electricity access challenge and the limited institutional and financial resources available, it is imperative for Kenya to minimize inefficiencies in the power sector.

(iv) Private sector provision of energy services in rural areas should be encouraged.

A number of factors, such as accelerating urbanization, will facilitate the achievement of electrification targets. Nevertheless, as the residual unconnected households will be progressively more dispersed and poorer, the costs of connecting them may escalate considerably. In areas of very low population density, the focus of the government should be on providing energy services and not just electricity access, since the immediate needs of rural households are for lighting, cooking, entertainment and charging mobile phones. These energy services using photovoltaic-based devices can be provided more efficiently by the private sector, than by the public sector. The role of the government should be to help private sector service providers to get established, by facilitating start-up capital and expertise development, and introducing smart subsidy schemes.

(v) The electrification program that KPLC is implementing on behalf of the government requires long term financing, to allow for extended amortization of the investments by the company and reducing the financial impact on it, and limiting the potential impact on tariffs. The electrification rate will need to increase from about 350,000 households per annum currently, to 500,000 by 2022, to be able to achieve the targeted 80 percent connectivity by 2030.

POLICY RECOMMENDATIONS

The paper endorses policies in three broad areas that the new government should consider adopting in order to meet Kenya's power requirements in the near to medium

term. These have been discussed and are summarized as follows:

(i) Policies to Ensure Affordable Electricity.

The current policy of diversifying sources of supply, and pursuing a regional strategy of system interconnection with neighboring countries should continue. Increased competition in supply to end-users should be implemented gradually, provided that a number of preconditions are put in place. Investments in transmission and distribution infrastructure need to be accompanied by effective enforcement of regulations on service quality to ensure reliable service is provided to consumers.

(ii) Policies to Ensure Adequate Electricity Supply.

The commercial orientation of the sector and the government's policy of maintaining full cost recovery tariffs, have been critical for sector sustainability and attracting private investment to the sector. This track record—even during periods of high international energy prices—has enabled Kenya to attract significant concessional financing for electricity generation, transmission and distribution infrastructure from donor agencies, as well as conventional financing from the private sector. The independence and capacity of the ERC and of the Energy Tribunal, should be safeguarded and enhanced.

(iii) Policies to Rapidly Increase Electrification.

The financial sustainability of electricity service should be guaranteed mostly by the contributions from all consumers. Pursuing a balanced approach to urban and rural electrification, can ensure financial sustainability of supply, and affordability by poor consumers. The electrification program that KPLC is implementing on behalf of the government requires long-term financing to allow for extended amortization of the investments and reducing the financial impact on KPLC and limiting the potential impact on tariffs.

10. Infrastructure for growth: priorities for transport sector

By Josphat Sasia and Solomon Waithaka

INTRODUCTION

Transport infrastructure is a central element for Kenya to reach its Vision 2030. Economic growth will only accelerate if Kenya increases its quantity and quality of infrastructure, in particular transport. The vision is to build modern, high-quality and efficient transport infrastructure facilities that would facilitate access to markets. In addition, better infrastructure is expected to boost tourism, which is one of the six priority sectors for development. Areas of emphasis in the Vision 2030 include rehabilitating the road network; upgrading the railways; transforming ports and airports to create hubs for a modern economy; and improving urban public transport.

Kenya is the dominant economy in East Africa and aspires to become a regional hub for which it has the right location and conditions. Its geographic location is critical for transportation of goods from the neighboring countries to foreign markets. Unfortunately, this potential is not fully utilized as transport costs remain high, due to inefficiencies, poor quality, and congestion of the infrastructure.

KEY FACTS AND TRENDS

Following years of neglect during the 1990s and early 2000s, the quality of Kenya's transport infrastructure and services has been improving over the last eight years. This has been a result of higher spending on infrastructure as well as thanks to institutional reforms. Recent investments have upgraded trade corridors, reduced urban traffic congestion, and modernized governance in the sector (through establishing autonomous

road authorities and a fuel levy to fund road maintenance).

Kenya's road network of 160,886 km is adequate for the needs of the densely-populated parts of the country, while insufficient for those Kenyans who live in the less populated areas. In terms of quantity of roads, Kenya compares favorably with its neighbors where many regions remain without all-weather roads.

The port of Mombasa continues to perform substantially below international standards. This is despite some recent improvements such as the deepening of the Kilindini channel, the construction of a second container terminal, and the upgrading of port security. Nevertheless, with some 900,000 containers Twenty-foot Equivalent Units (TEU) Mombasa transacts per year what Singapore handles in eight days.

The aviation sub-sector, which is critical for promoting tourism and trade, has also become a bottleneck. Kenya's main aviation gateway, Jomo Kenyatta International Airport (JKIA), is experiencing severe capacity constraint. For instance, JKIA handled over 6 million passengers in 2012 compared to its design capacity of 2.5 million. With such congestion, Kenya would not be able to reach its objective of increase foreign tourist and other visits from the current 1.5 million to 3 million. The sector has received additional resources in recent years. For example, the government is expanding the Nairobi and Kisumu airports.

The railway sector has been on a downward spiral for decades. Kenya Railways Corporation (KRC) used to be a major economic asset several decades ago. Thirty five years ago, it carried 60 percent of long distance freight traffic along the Northern Corridor linking

Mombasa, Nairobi and the Ugandan border. However, by the time the concession for railways services was signed in 2006, KRC had become a severe financial liability to the government. Today, railway's share of the throughput at the port of Mombasa is negligible—at about 4 percent—which has caused shifting of traffic onto the overloaded roads and thus reduced competition in the freight market. For comparison, KRC handled over three million tons in the 1990s, while in 2012 it handled one six hundred million tons. The poor performance of the railways adds to the congestion at the port of Mombasa.

With respect to urban transport, Kenya's cities and towns have been rapidly growing and this trend is expected to continue as the labor force out of agriculture into industry and services. The pace of growth of urban areas has far outstripped the ability of the authorities to provide infrastructure to keep parity with this growth, even if vehicle ownership had remained the same. But urbanization has been accompanied in Kenya, as in virtually all countries, with large increases in motorization rates. The pace of both population growth and motorization has led to new urban challenges, in which travel times have become long and unpredictable, particularly for the urban poor who live farthest from the city centers. For example, on an ordinary day, it takes more than one hour for commuters living less than 10 km away to reach the Central Business District of Nairobi. The cost to the Kenyan economy from these challenges is large, in terms of lost productivity, congestion, and increasing public health costs associated with poor air quality, which negates Kenya's reputation as an environmental leader.

Although increasing investments and institutional reforms over the past years have had a positive impact, the insufficient

quantity and poor quality of certain aspects of Kenya's transport infrastructure continue to present a major impediment to economic growth. Some of these key impediments could be removed in a short-period while others will take several years of investment and institutional development to change. In both instances, the pays-offs for Kenya's economy and its people outweigh, by a great margin, the time and effort needed to implement the reforms.

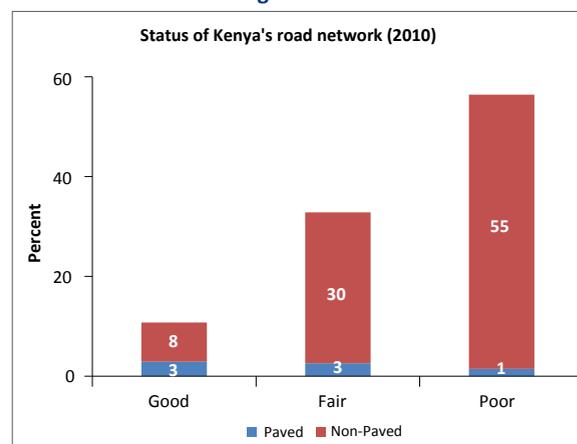
KEY CHALLENGES

Progress in improving transport infrastructure and services has been uneven across the five sub-sectors: roads, ports, aviation, rail, and urban transport. Thus, the challenges that each of the sub-sectors faces differ. The following sub-sections summarize the key challenges in each sub-sector.

(i) Roads

The main challenge here is the poor condition of the road network, which is a result of a large backlog in maintenance. More than half of Kenya's roads are in poor condition, and only 38 percent are in fair to good condition (see Figure 10.1). In recent years spending on roads has increased: US\$ 2.4 billion were spent between 2008 and 2011, of which US\$

Figure 10.1: Only 11 percent of Kenyan roads are in good condition



Source: World Bank, 2010

1.8 billion went to construction of new roads and the remainder to road maintenance and rehabilitation. Nevertheless, even this spending is inadequate to raise and maintain the quality of road network.

A second challenge facing the road sector is the completion of ongoing institutional reforms. The government introduced major institutional reforms in the road sector over the past few years which lead to substantial improvements in the efficiency of managing the road network. However, further reforms are required to anchor the sector to the constitutional changes of 2010 and to incorporate private sector in financing and management of the sector..

(ii) Ports

The port of Mombasa has suffered from years of underinvestment and is experiencing serious capacity constraints. Although it has a design capacity for only 250,000 TEUs annually, it handled a much higher amount—about 900,000 TEUs—in 2012, out of which 27 percent was destined for neighboring countries. This under capacity leads to long delays and to high handling costs at the port. Nevertheless, by international standards, the volumes handled by Mombasa port are relatively low. This creates a paradoxical situation that despite the low levels of trade, the port still suffers from substantial congestion. The total average transit time from Mombasa to Nairobi is estimated at 20 days, about the same time it would bring a container by boat from Singapore to Mombasa. Without investment in new capacity, over and above current investments, that would increase the quality of services and reduce their price, Mombasa cannot become a major transport hub for the East African region. In addition to the high congestion and handling costs created by inadequate infrastructure, there are deep-rooted interests that resist reforms,

further contributing to the poor performance of the port.

(iii) Airports

The main challenges for the aviation sector are service improvements and inadequate capacity, the latter recently addressed by investments in airports. Among other measures, improving the quality of service will depend on how the government addresses the management performance and aviation regulations. As air traffic grows, the mandate of the Kenya Civil Aviation Authority (KCAA)—i.e. to provide regulatory, safety and security oversight consistent with international conventions and protocols—becomes more demanding. KCAA has largely met the International Civil Aviation Organization standards and recommended practices, though it is yet to attain the International Aviation Safety Assessment Category 1 safety status. JKIA has attained category 1 security status from the Transportation Security Administration allowing for direct flights from Kenya to the US. Overcoming the regional security challenge will enable Kenya to access the large US market and also attract more airlines to operate from Kenyan airports.

(iv) Railways

The key challenge in railways is the dismal performance caused by a combination of dilapidated infrastructure and poor management. The legal framework is also not conducive to promoting private sector engagement which could in turn improve the management of railways. Indeed, the KRC Act works against further privatization of operations. For example, since the law is not based on an open access principle for qualified operators, it benefits the incumbent concessionaire for commuter services, the Rift Valley Railways (RVR). The firm is responsible for all rail freight operations and for the maintenance of railway infrastructure, including the track. Therefore, a newcomer

to the commuter rail market could face serious constraints, such as RVR giving its freight trains timetable priority. In addition, even if a new service provider was granted access, RVR would still have control over the maintenance priorities and, moreover, is likely to be granted the right to charge a track access fee.

(v) Urban transport

Addressing the problems of urban transport requires a holistic approach that recognizes the experience that many cities around the world have learned the hard way: it is difficult, if not impossible, for cities to “build” themselves out of congestion. Tackling complex urban transport problems such as congestion requires a more comprehensive approach, such as the internationally accepted strategy of Avoid – Shift – Improve (ASI).¹ In the case of Kenya, such an approach would entail the following elements: (i) strong investment in urban public transport, including mass transportation modes such as commuter rail and Bus Rapid Transit (BRT) systems, that provide an alternative to private car use within the major cities, complemented by bold action to develop and strengthen institutions capable of developing and managing these systems; (ii) immediate action to strengthen regulatory and planning capacities with respect to land-use and land-use control at national and county levels, in order to ensure that returns on transport investments are maximized to allow full exploitation of transport capacity created; (iii) strengthening the use of non-motorized transport, such as cycling and walking, through, for example, a Complete Streets program, with better linkages to the public transport network; (iv) managing the demand for road space through transport demand management measures, including

comprehensive parking policies and pricing, as well as temporal restrictions on freight movement in and through cities; (v) strategic application of traffic improvement measures, including physical separation / geometric improvements where appropriate, use of centralized traffic control where appropriate (e.g. central Nairobi), and development of Intelligent Transport System (ITS) infrastructure; and (vi) strategic improvements to urban road networks to support the above measures. To address the above will require concerted efforts to improve the currently weak institutional framework for urban transport and the formation of the Nairobi Metropolitan Transport Authority (NMTA) should be expedited.

(vi) Gateways

Kenya’s main trading partners are its neighbors; the EAC Customs Union signing (in 2005) saw a significant increase in trade, rising threefold in some cases during the first five years. Kenya must address significant trade facilitation challenges, including non-tariff barriers on the main corridors and on the entry and exit points. Though progress has been noted—with the number of road blocks between Mombasa and Malaba more than halved, and the crossing time reduced from 15 to about 6 hours, both in the last five years—there is scope for further reduction. The one stop border point concept adopted by the EAC will be of help once the infrastructure for it is completed and a border management system installed. In the meantime, there has been little attention to the roads linking productive areas to the border, the bulk of which are in very poor condition. In addition, Kenya has to seriously consider its links to Ethiopia, Somalia and Southern Sudan even as it continues to invest in roads leading to the traditional EAC markets.

¹ *Avoid excessive motorized travel, for example through incentivizing the use of non-motorized transport such as walking or cycling, or developing or redeveloping land-uses in a manner as to reduce the need to travel by motorized means. Shift the motorized travel that does occur toward vehicles with higher occupancy, such as well-managed, effective, and efficient public transport services, carpooling, or vanpooling. Improve the fleet of motorized vehicles which are plying the roads, by removing older, dirty vehicles, improving driving and maintenance practices, ratcheting up the environmental and safety performance requirement of new vehicles entering the market and the fuels they run on, and managing running ways to minimize stop-and-go traffic as much as possible (while maintaining the primacy of Avoid and Shift).*

KEY RECOMMENDATIONS

The cost of expanding Kenya’s infrastructure to the level needed for achieving a sustainable GDP growth rate of 10 percent is well above the resources available to government and donors. Hence, the two primary recommendations for transport infrastructure and services are to: (a) involve private sector in order to meet the large infrastructure gap and improve service quality in the non-urban sector, and (b) manage demand and improve the quantity and quality of public transport services in the urban sector.

Kenya’s transport infrastructure sector has great potential to grow and be profitable, so the government should expect high investment interest from the private sector. The interest would be strong, in particular, for Kenya’s international getaways—JKIA and the port of Mombasa—but is also likely for railways, in particular, the commuter rail service. The road network, on the other hand, is unlikely to attract strong interest, so the government would retain the primary financial responsibility for this sector.

Attracting experienced, international operators would be the best strategy for attaining services at international standards and at competitive prices. Experiences elsewhere support such a view, showing strong correlations between private investment and effective management. Air transport is a good example of successful synergy between the private and public sectors. The benefits are also evident from Kenya’s own air cargo transport; the sub-sector is managed by private firms and has achieved remarkable progress, particularly in the expansion of cargo handling facilities.

The government should seek respected international operators to manage the key gateways, which could be in the form of joint

ventures with local investors. Irrespective of the type of investor, a precondition for the success of any management or concession arrangement would be the adequacy of its governing contract, and particularly the design and supervision of it (see Box 10.1).

In addition to attracting private sector involvement in infrastructure, other reforms are needed to address the key challenges related to transport infrastructure and services. These are highlighted below.

(i) Roads

- Increase spending on road infrastructure and allocate a greater share of the budget to upgrading unpaved roads and maintenance. Costs of maintenance should be incorporated in fiscal estimates when preparing new road investments.
- Adhere to implementing the Road Sector Investment Plan (2010-2024).
- Concession the viable road sections along the Northern Corridor.
- Initiate maintenance concessions and long-term performance-based maintenance contracts for the long-haul road network.
- For national roads in and around the main cities—Mombasa, Nairobi, and Kisumu—foster strong mechanisms for land-use control and access management by local authorities to ensure that these roads retain their national function.

(ii) Ports

- Award a concession contract for Mombasa port to a private investor, ideally involving an experienced international operator. The first step of this process would be to commission a transaction adviser for the concessioning of the Mombasa container terminal, the dockyard and marine craft, and the bulk oil terminals. The next steps would be to concession the operational activities at the port and transform the Kenya Port Authority into a landlord port.

Box 10.1. Role of government in management or concession contracts

The success of management and concession contracts depends on how they are designed and implemented. In designing the concession, the management responsibility assigned to the international operator has to be very clearly defined, so as to avoid a repetition of the failed management contract at the Mombasa container terminal. The government should be careful in proposing a joint venture that includes the asset authority/landlord, whether it is the Kenya Airports Authority or the Kenya Ports Authority. Such ventures do exist elsewhere, but they raise potential conflicts of interest (the authority holds, in effect, both the interest of the landlord and of the tenant). It would be preferable to have a complete separation of roles with clear lines of responsibility.

As for implementation, even if the private sector is involved in investment and in providing services, the public sector will still retain some core functions for all transport modes. These would include:

- (a) public funding in areas where private companies cannot be attracted;
- (b) contract management, including long-term contracts (e.g. performance-based road maintenance contracts; concessions/toll roads, etc.); and,
- (c) concession monitoring where the public sector retains ownership of infrastructure assets and is responsible for several oversight functions including, ensuring terms of agreements are followed; monitoring maintenance of public assets; ensuring safety standards are kept, and monitoring service delivery performance targets.

- Enact legal changes to facilitate private sector investment and management, and strengthen the regulatory function.
 - Amend the legislation to create a competitive railway system that is anchored in a transparent contractual relationship between the government and KRC. This should be for services to be provided, directly or via concession contracts, and cover multi-annual infrastructure maintenance contracts, public service contracts and compensatory mechanisms for the procurement of passenger rolling stock.
 - Strengthen the regulatory function over the concession holder RVP.
 - Prepare plans to maximize the value of Kenya Railways' non-operational land or land that, in time, could be made non-operational as a result of the concessioning and taking into account the future expansion of the railways.
- (iii) Airports**
- Concession the international airports. The first step would be to prepare the basis for concessioning JKIA and other international airports. The JKIA concession should incorporate an investment plan to increase capacity. The next steps would be to place the major domestic airports under a management contract and transfer responsibility for the other airports/airstrips to counties.
 - Make KCAA a fully autonomous regulator by separating its responsibility to regulate air navigation services and the management of the East African School of Aviation from its responsibility to provide such services. In addition, KCAA needs to upgrade its air navigation systems.
- (iv) Railways**
- Inject additional resources to acquire modern rolling stock, and upgrade the rail track.
- (v) Urban transport**
- Scale up investment in urban public transport infrastructure and services, particularly in Mass Rapid Transit systems designed around buses and commuter rail systems, as well as in the capacity to plan and manage urban public transport.

- Scale up capacity of the private and informal sector to enable professionalized transport service delivery.
- Scale up investments in and capacity for improved traffic management in the newly created counties covering urbanized areas.
- Establish the proposed Nairobi Metropolitan Transport Authority, to plan and coordinate transport matters in Nairobi. Clarify its powers in relation to those of the National Transport Licensing Authority. Establish a Special Purpose Vehicle to immediately coordinate urban transport matters in Nairobi while the NMTA is being developed.
- Establish legal and regulatory framework for railways as well as a railways regulatory body.

(vi) Gateways

- Remove non-tariff barriers on the corridors and borders.
- Embrace the One Stop Border Concept and empower customs officials at the border points.
- Maintain roads to key border points in an acceptable condition.
- Work with other EAC countries to charge duty at the port of entries.
- Manage axle loads at the point of loading to ease congestion at weighbridges

The benefits from investment and reform of transport infrastructure and services will be maximized if actions are taken across all five sub-sectors. Many of the priority sectors for Kenya, including tourism, manufacturing, transport services, and agriculture, rely on multi-modal transport. Hence, implementation should begin immediately in each sub-sector as all of them together can fully unleash Kenya's growth potential.

11. Modernizing and boosting agriculture

By Andrew Karanja

INTRODUCCION

Kenya is still predominantly rural although it is urbanizing very fast. Seven out of ten Kenyans live in rural areas, and they are mainly engaged in agriculture.¹ The performance of the overall Kenyan economy and that of the agriculture sector are therefore closely linked, with economic growth declining whenever there is a shock in agriculture. The availability of food has also in the recent past affected inflation (and therefore the cost of living) hence, the welfare of most Kenyans; it also affects the government's budget and balance of payments.

The overall performance of agriculture has been erratic, mainly due to over-reliance on rain-fed production. Farmers also face major challenges in accessing both input and output markets, and most commodities are sold without much value addition. Nevertheless, in the recent past some subsectors such as tea, horticulture and dairy have performed well, in total contrast to the food subsector, where productivity has not been able to match the increasing demand. This contrast provides a clear indication that with better management, there exists major growth prospects in the sector, that can be exploited for the benefit of all.

Recent experience from China and other emerging economies clearly demonstrates the developmental and poverty reduction benefits from agriculture-led growth, especially involving large numbers of small holders. A distinctive feature of China's reform-driven growth has been the strong initial emphasis on the expansion of agriculture, the so called "firing from the

¹ Agriculture comprises crops, livestock, fisheries and related activities.

bottom". For Kenya there is evidence to the fact that enhancing agricultural growth could be a very powerful and effective way to induce overall economic growth and reduce poverty. The evidence suggests that agriculture-led growth is more than twice as effective at reducing poverty as industry-led growth. Agriculture as a source of overall growth has been significantly underutilized, as reflected in declining public spending on agriculture-related public goods. These findings confirm that the Vision 2030 and the Agricultural Sector Development Strategy (ASDS) are rightly focusing on agriculture as a key sector to achieve the overall national objectives of growth and poverty reduction.

There is need to focus on agriculture in particular and on rural development in general, as a major source of growth (see Box 11.1). Agriculture also contributes to improving equity, and is a viable mechanism for addressing a variety of other challenges, such as food insecurity, high food prices, unemployment and climate change. For this to happen, critical reforms and investments have to be undertaken, prioritizing interventions that benefit majority of Kenyans, while delivering quick results.

SECTOR POLICY AND PRIORITY INTERVENTIONS

The sector's priorities are articulated in the government's 2009 Agricultural Sector Development Strategy (ASDS). The ASDS investment plan is also in place. The sector policy identifies critical issues to be addressed, but there is still a need for prioritization, for an implementation schedule, and for rigorous outcome measures. The sector is also developing a food and nutrition policy to guide food security and nutrition matters, and the government is in the process of finalizing a far-reaching consolidated agriculture reform bills. While these efforts

are commendable for both the medium and long term, there is also need to focus on critical reforms and investments for the immediate future. As a matter of priority, the government should focus on three critical priorities: (i) policy, institutional and legal reforms in the sector; (ii) measures to enhance productivity and promote food security; and, (iii) measures towards commercialization of agriculture.

POLICY, INSTITUTIONAL AND LEGAL REFORMS

To unleash the potential of the sector (see challenges, Box 11.2), and to attract private sector investments and participation in the sector, in order to reduce the cost of doing business, as well as improve service delivery, comprehensive policy, institutional and legislative reforms should be put in place. In particular, there are likely to be high dividends from fast-tracking parastatal reform in the following areas:

- (i) separating the regulatory and commercial functions of the National Cereals and Produce Board (NCPB);
- (ii) privatizing the sugar factories and improving the sub-sector's competitiveness;
- (iii) implementation of institutional changes/ parastatal reforms as provided for in four legislations enacted in 2012²; and
- (iv) agricultural finance.

There is also need to prioritize the improvement and devolution of agricultural services, such as research and extension, and to enhance public private partnerships that support sector development and investment.

Maize sub-sector reforms

Maize is the most important staple food in Kenya and also more broadly in the Eastern Africa region. It is also the most widely traded of agricultural commodities. The performance of grain markets therefore

² The sector bills signed into law in January 2013 include; The Agriculture, Livestock, Fisheries and Food Authority Bill 2012; The Kenya Agricultural and Livestock Research Bill 2012; The Pyrethrum Bill 2012; and the Crop Bill 2012.

Box 11.1: Agriculture as a source of growth

Agriculture directly contributes 26 percent of the GDP annually, and another 25 percent indirectly. National economic growth is highly correlated to growth and development of the agriculture sector; and the sector is identified as a key pillar to deliver the 10 percent annual growth under vision 2030. The sector accounts for 65 percent of Kenya's total exports, and provides more than 70 percent of informal employment in the rural areas. The sector is dominated by smallholder farmers, pastoralist and fish folks (estimated at 4 million households) with small land sizes averaging one hectare.

The sector recorded a lower growth of 1.5 per cent in 2011, compared to 6.4 per cent in 2010. The slower growth in 2011 was primarily due to erratic weather conditions and high cost of agricultural production (rising farm inputs prices). All major crops registered declines in production in 2011 except for rice, cotton, pyrethrum and sisal (see Table 11.1). However, global supply constraint resulted in higher (better) prices for tea and coffee.

Table 11.1: Key Indicators of agricultural production

Commodity	2010	2011	Percent change
Tea ('000 Tonnes)	399.0	377.9	-5.3
Coffee ('000 Tonnes)	38.9	30.0	-22.9
Fresh horticultural produce ('000 Tonnes)	228.3	227.1	-0.5
Maize (million bags)	35.5	34.4	-3.9
Wheat ('000 Tonnes)	199.7	105.9	-47.0
Rice ('000 Tonnes)	72.5	80.2	10.6
Milk delivered to processors (million litres)	515.7	549.0	6.5

has a significant impact on people's welfare, particularly the poor, and it is critical to inducing pro-poor growth. Maize is widely regarded as the "sleeping giant" of Kenya's agriculture. It occupies the largest share of cultivated land in Kenya, but the lackluster performance of the maize sector has been

a drag on the country's overall agricultural performance, which in several other respects, appears to be quite vibrant. Fueled by rapid population growth and declining farm size, Kenya now suffers from a structural maize deficit, which is likely to grow in the coming years (Box 11.3).

Box 11.2: Critical agriculture challenges for Kenya

Critical challenges facing the sector include:

- Continued shocks such as drought and food deficits, and their impact on macroeconomic performance, food security and the incomes of a major proportion of the population, re-emphasizing the need to focus on agricultural productivity and competitiveness.
- High population growth rate, urbanization, regional integration, land reform and land use offer both opportunities and challenges to the growth of the agriculture sector.
- Climate variability and change are increasingly affecting agricultural productivity and food security in Kenya, as evidenced by numerous droughts in recent years, such as the 2011 Horn of Africa Crisis.
- Legal and policy reforms are required to enhance service delivery, parastatal rationalization, private sector participation and investment. Many parastatals continue to drain public funds while offering poor services and stifling private sector participation. Comprehensive legislative action is also required as the sector is currently regulated by more than 130 Acts.
- Land and land use reforms are required to provide a sound basis for investment in agriculture and access to land for the poor.

Most farmers are net buyers of staple food.

Two percent of Kenya's rural households account for over 50 percent of the marketed maize production in Kenya, and their average farm income is over seven times that of the bottom 70 percent of households. Meanwhile, 60 percent of households are net buyers of maize, and they tend to have relatively small farms, mainly concentrated among the poor. Smallholders have little to do with NCPB, and currently only 2 percent of smallholders sell to the cereals board. It is therefore clear that policies that raise prices above market levels have income distributional effects that run counter to the stated poverty reduction goals. Because the rural poor tend to be net purchasers of staples such as maize, wheat and rice, they are directly hurt by policies that raise the prices of these commodities. Higher import prices risk the food security of millions of low-income consumers, and should and indeed may change the nature of food policy debates in Kenya.

Given that maize is Kenya's major food staple, efficient maize marketing is critical to food security, poverty reduction, and producer incentives.

Marketing systems that reduce price risk and instability benefit consumers, as well as producers. But the government has intervened in maize markets in ways that have kept maize prices high and have had little impact on price stability. However, evidence clearly indicates that the current maize market interventions are generally anti-poor, in the sense that they raise prices paid to large-scale farmers at the expense of consumers—especially poor

urban households and the majority of poor rural households, who are all net buyers of maize.

At the heart of future food policy issues in Kenya is the question of how to maintain adequate maize production incentives for specific producers—both large and small scale farmers, for whom maize is a viable commercial crop—without taxing consumers and producers of other farm products through high maize prices. Solving this conundrum will involve difficult political trade-offs. In the short-run, reducing NCPB's operations will hurt large-scale maize farmers in the North Rift. Over the long-run however, the confusion and uncertainty spread throughout the maize value chain by current and past NCPB interventions, have resulted in such a high cost that reform is most likely to reduce marketing (and production) costs enough to make maize farming more competitive, even with lower prices.

Reforms must focus on transforming government and NCPB functions in the sector, and on the need to promote private sector participation. The key reform areas in NCPB and the cereal sector should include:

(a) Mandate of the NCPB. The NCPB mandate allows it to engage in commercial activity like any other private player in the industry, while at the same time, carrying out certain social duties on behalf of the government, including procuring and managing the Strategic Grain Reserve (SGR) and emergency relief

Box 11.3: Kenya's grain sub-sector

The grains sub-sector accounts for a large share of agricultural GDP, rural employment and consumption—both in terms of calorie intake and households' food budget. Cereals are estimated to contribute about 15 percent of agricultural GDP. Maize is the main cereal, with a 12 percent share in agricultural GDP. Maize consumption is estimated at 98 kilograms per person per year, which translates into a total of 30–34 million bags (2.7 to 3.1 million metric tons). However, national maize production has not kept pace with consumption. Over time, food imports and aid have bridged the gap, with a strong tendency towards increased dependence on imports. Kenya has been importing maize from Uganda and Tanzania, in addition to large offshore imports from as far away as South Africa, the US, Brazil and Argentina.

aid stock. Separating the responsibility for the SGR from NCPB will make it possible to distinguish between SGR stocks, commercial stocks and famine relief stocks. (in addition, the SGR should also be expanded to include other commodities apart from cereals.) NCPB's role in importing and distributing fertilizers deviates from its core mandate, and offers unfair competition to the private sector. If the public sector wants to continue to play a role in the fertilizer trade (which is sometimes justified by factors such as economies of scale and the oligopolistic fertilizer market structure), this function should be undertaken by a farmers' organizations. The Kenya Tea Development Agency model is a good example of how such a farmers' organization can contribute.

(b) Accountability in grain management.

Existing procedures for procuring and marketing maize are not transparent. For example, NCPB is not required to make public how much maize it has in its stores, despite the fact that it is funded by tax payers' money. The reformed NCPB should be made to publish periodic reports disclosing information on available stocks, procurements and importations, as well as allocations/beneficiaries, in order to enhance the accountability of its operations.

(c) Enhancing the private sector role. The development of private storage capacity is essential to increasing market stability and facilitating trade. To encourage the development of private storage operations, some NCPB grain silos and warehouses could be transformed into storage leasing operations. Additional storage facilities, coupled with better financing arrangements, could help the commercialized grain marketing system to weather downside price risk.

These efforts could be combined with a warehouse receipting system to help farmers and traders to gain access to formal credit markets, and improve the efficiency of the food marketing system in general. Another alternative for private storage, cereal banks, is receiving renewed attention in Kenya. To be successful, these systems must benefit from: (i) an effective system of grades and standards; (ii) sufficient integrity, hence, trustworthiness, plus quality control systems, so that there is essentially no default risk in using them; and, (iii) regulatory procedures and oversight to ensure the integrity of the system.

(d) Establishment of a Commodity Exchange.

To ensure that the warehouse receipts and cereal banks are well linked to the market and to monetize these activities, an open price discovery mechanism should be established through a commodity exchange. A review should be undertaken to determine the legal regime under which the commodity exchange could be operationalized. To enjoy economies of scale in line with East African integration, it should be structured as a regional entity.

Reforming the sugar subsector

The sugar industry in Kenya, which has heavy government involvement, is constantly embroiled in controversy. The industry is also highly inefficient, and only survives due to high tariff and non-tariff protection. Nevertheless, it remains a key economic activity in Western Kenya, where it directly supports an estimated 300,000 small-scale farmers who supply over 80 percent of the cane to the factories. Employment in the sugar factories is estimated to be around 40,000, and the Kenya Sugar Board estimates that the industry supports up to 2 million people in the country.

Kenya's annual sugar demand is estimated at 800,000 metric tonnes (mt). However, the country's domestic production has historically hovered at around 550,000 mt, leaving a net deficit that must be filled by imports of approximately 250,000 mt (see Figure 11.1). Demand is estimated to be growing at an average annual rate of 4 percent.

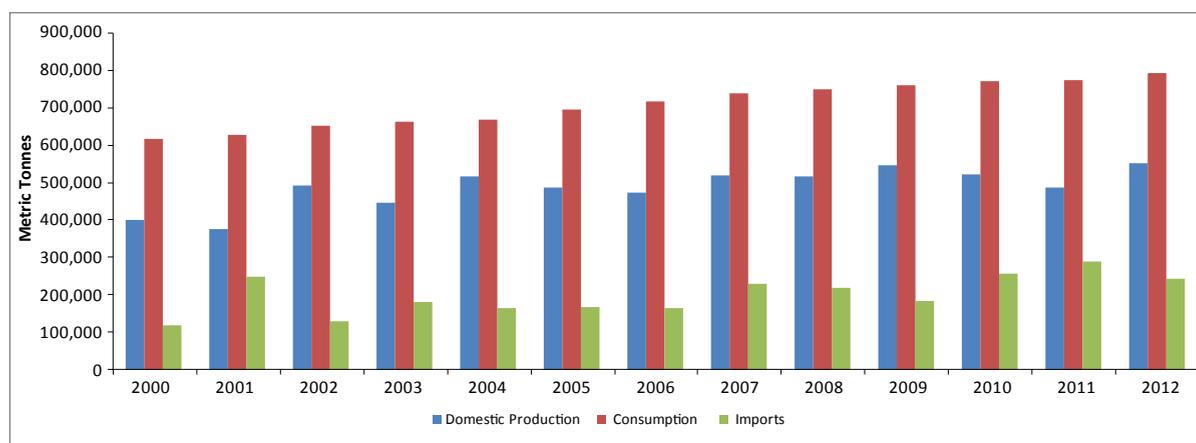
Currently, there are seven sugar companies in the country, and the government is the majority shareholder (owning over 90 percent of the shares) in most of them, except in the largest one, Mumias, where it owns around 28 percent. Capacity utilization in most factories is below 55 percent, except Mumias which manages over 70 percent. Low capacity utilization and outdated milling technologies have been cited as major factors responsible for high sugar processing costs. Further, due to protection, Kenya has been allowed to become a high cost sugar producer, with cane prices almost equal to the CIF price of sugar at the port of Mombasa. Indeed, Kenya's sugar market is arguably the most attractive open market for sugar in the world, after the EU. The cost of producing sugar is estimated at US\$ 550 per mt compared to US\$ 230-350 per mt in several COMESA countries. Since March 1st 2012, Kenya granted duty-free access to COMESA members, under the market-opening provisions for sugar. Once the government removes the current sugar

import tariffs, Kenyan producers may have to compete with more efficient producers such as Egypt, Swaziland and Malawi.

It is clear that the Kenyan sugar industry remains under global and regional threat, despite the protection being offered to local sugar producers. This in a way demonstrates the inadvisability of pursuing a protectionist policy that is not complemented by deliberate efforts to introduce competitive pressure that will improve internal efficiency. The government plans to privatize five highly indebted state-owned mills, but will retain 19 percent ownership. Once the mills become profitable, the government will then sell its share to private mills. But the process has been slow, and needs to be accelerated.

Without protection, most of the sugar producers in western Kenya would find it difficult to dispose of their sugar in the local market, unless measures are taken to improve production and processing efficiency. Western Kenya, which comprises the main sugar belt, is a poverty hotspot with 55 percent (1.8 million people) of its rural population living below the poverty line (CBS, 2007). Without any viable alternatives to sugar production, the region would definitely sink further into poverty. So as the days of protectionism become numbered, it is prudent that all concerned should

Figure 11.1: Sugar production, consumption and imports (MT), 2000-2012



Source: Kenya Sugar Board

seek alternative medium and long-term interventions for the subsector if increases in poverty are to be avoided. Investments geared towards diversification (both on and off farm), improvements in sugar production, and processing efficiency, are immediate alternatives that can be pursued simultaneously.

Institutional and parastatal reform

Kenya cannot revamp its agricultural sector without proper coordination and regulation, whose objective should be to promote policies that reduce costs and stimulate competition. It is with this realization that the sector in the last two years has invested heavily in consolidating the legal legislation governing various aspects of the sector. As previously mentioned, in January 2013 four major Bills were signed into law and their implementation should be a high priority. The new laws propose major changes by establishing a new body to take over the regulatory, marketing and other functions which are currently being performed by 14 parastatals. Most of the 14 parastatals, including NCPB, will be reformed or abolished altogether. A new agricultural research legislation also provides for the establishment of a new organization to coordinate all agricultural research activities in the country. The implementation of these new legislations will significantly reduce the number of sector parastatals, thereby leading to better coordination and significant cost savings. The new government should prioritize the enactment and full implementation of the consolidated legislation, noting that the political-economy issues arising from these reforms will need to be well managed, to avoid derailment by vested interests.

Agricultural finance

The existing agricultural financing system provided by the Agricultural Finance Corporation (AFC) is highly inefficient. The

credit for investments in agriculture also remains low. As of June 2012, the agriculture sector received KES 64.5 billion as credit and advances from banks and other financial institutions. This amount was a paltry 5 percent out of the total credit and advances of KES 1.29 trillion. No meaningful development can occur in agriculture with these levels of private investments. To enhance access to credit in the agricultural sector, and to ensure that the country increases and broadens its agricultural exports, the government should set up a suitable funding mechanism/facility to be used to finance the development of critical subsectors such as coffee, tea, sugar, dairy, livestock, and aquaculture. Such a funding facility can be used as a wholesaler of funds for on-lending to farmers through financial institutions. The government should initially target at least 10 percent of total credit and advances from commercial Banks for on-leading to agriculture. The activities of such a facility can be complemented by support for livestock and crop insurance, to cover some of the risks associated with farming and livestock keeping.

ENHANCING PRODUCTIVITY AND FOOD SECURITY

Productivity in the sector remains low, and food insecurity is a major concern in the country. To enhance productivity, the government should continue with its investments in research, extension and service delivery to farmers. The government should work closely with the county governments to ensure that service delivery to the agricultural sector is improved and modernized through use of ICT, media and other modern communication methods. The private sector will also be encouraged and supported to offer extension, marketing and other services to the sector. High cost of fertilizers and other inputs (seeds, animal feed, etc.) are of major concern to farmers, as they increase the cost of production,

which in turn raises the cost of food to consumers. As general subsidy program may not be affordable, the government should facilitate and support farmers and pastoralist to be organized to procure and distribute the inputs centrally, through national and county level organizations. In particular, the government should promote the use of suitable cereal drying and storage technologies at farm and community level. This will reduce the estimated losses of 30 percent of the total harvested cereal production through contamination and post-harvest losses.

To address the food insecurity in the country, the government should prioritize the implementation of the National Food and Nutrition Policy which was approved in 2011.

Priority should go towards ensuring that the country has adequate food reserves. In this regard, the government should increase and expand the strategic grain reserves (SGR). The SGR should be converted in a strategic food reserve (SFS) that will include grains such as maize, rice, and other traditional crops, and livestock products (milk powder and conned beef). The SFS will thus offer a ready market for farmers and pastoralist, minimize imports and ensure that excess food in one part of the country is stored for distribution in the needy parts of the country. Furthermore, the SFS will ensure that an assortment of foodstuff is available to meet the different social cultural dietary needs of various communities in the country. A drought contingency fund will also be put in place, to respond quickly and flexibly to drought, whenever it occurs.

Climate variability and change are increasingly affecting agricultural productivity and food security in Kenya, as evidenced by numerous droughts in recent years (Box 11.4). There is therefore need to focus support towards “climate-smart agriculture”, that can sustainably increase production and food security, and be resilient to climate change and variability.

In particular, future support may focus on natural resources management in the main water towers, on investment in irrigation, and on drought management and livelihoods coping mechanisms, especially in arid and semi-arid lands. Kenya’s irrigation potential is estimated at 540,000 ha, of which only about 105,000 ha have been exploited. The potential for irrigation can be expanded further by 1 million ha by developing the Tana and Athi basins. Furthermore, Lake Victoria has a 253 km shoreline in Kenya that is basically unused, despite its huge irrigation potential.

COMMERCIALIZATION OF AGRICULTURE

There is need to build on the current success and recent investments in rural electrification through investments in cold storage and processing facilities to handle milk, fish, and fresh fruits and vegetables.

Potential for adding value to products such as tea, coffee, pyrethrum, hides and skins, milk and beef, and fruits and vegetables remains largely untapped. Through Private-Public Partnerships (PPPs) the government should facilitate private sector involvement in the

Box 11.4: Need for disaster risk reduction

The country has experienced significant crop and livestock production losses, particularly in the arid and semi-arid lands, which cover 80 percent of the total land mass. The regular and increasing occurrence of drought, coupled with the high vulnerability of the ASALs, calls for greater attention to be paid to disaster risk reduction-and more specifically for a hazard-specific focus on drought risk reduction. The impact of drought has intensified over the years, and is likely to worsen with climate change. Available records indicate that in the last 100 years the country has experienced over 29 droughts, while in the past four decades droughts have become more frequent, more widespread, and more intense.

development of marketing infrastructure, especially rural market facilities, regional and international quality and safety standards, and investment for value-addition technologies

Effective marketing is critical in increasing the productivity and commercialization of farming, so that it can be—and be perceived to be—a viable business. National and regional markets have great potential to expand given better marketing infrastructure and quality assurance. Export markets mainly deal with raw commodities, and they have introduced stringent measures regarding traceability, safety, sanitary and phytosanitary standards, and maximum residue limits. An effective market infrastructure should therefore address the compliance process for quality and safety standards. It is estimated that 91 percent of agricultural exports are in raw or semi-processed form. Thus, the country loses billions of shillings in earnings by not adding value to its produce. The potential remains largely untapped for adding value to products such as tea, coffee, pyrethrum, hides and skins, milk and beef, and fruits and vegetables.³

Support for such activity should focus on:

- (i) facilitating private sector involvement in developing marketing infrastructure, especially rural market facilities and regional and international quality and safety standards;
- (ii) empowering farmers' organizations to provide market support services; and
- (iii) investing in value-addition technologies, through building the capacity of farmers and other stakeholders, and by providing material and financial support through Private-Public Partnerships.

Trade in agricultural commodities in the East African Community is still characterized

by high tariff and non-tariff barriers. For example, during the recent drought, Tanzania imposed an export ban on maize and other cereals, which disrupted trade in the region. The new government should therefore prioritize the review of present agreements, and devise a common agricultural trade regime within the EAC and with other regional blocks.

DEVOLUTION

In line with the new constitution agricultural, livestock and veterinary services are to be devolved to the country governments. Although the devolution of these services may present another challenge in 2013 and beyond, it should be regarded as an opportunity to enhance service delivery to the farming community. The in-coming government will be required to develop and implement a plan that will ensure that there is a smooth transition.

12. Reaching new heights: broadening financial sector deepening and stability

By Ganesh Rasagam, Paola Granata, Yira Mascaro and John Randa

INTRODUCTION

Significant modernization and rapid expansion of the Financial Sector have heightened its role as a driver of economic growth in Kenya. Kenya's financial sector stability has strengthened significantly since 2005, through a series of major reforms, which enabled it to weather global and internal crises very well. Kenya also has a much deeper financial sector, with broader access to financial services, but much more is needed. Vision 2030 expects the sector to make more significant contributions to economic growth. However, for that to happen, both access and stability will need to deepen further, to reach new heights.

³ Value addition includes processing, branding, quality certification and accreditation, as well as farm-level quality improvements that the market values.

Preserving the sector's stability is crucial for broader access, but also because the costs of failure are larger to poorer segments of the population. Efforts to improve the banking sector from the early 2000s have paid off, and ongoing reforms at supervisory and regulatory agencies in the sector have substantially improved the framework for enhancing stability. The government is starting to address lingering problems in the pensions and insurance sectors, and with cooperatives. It is also dealing with governance issues affecting the capital markets. However, additional measures to further strengthen the banking sector need to be implemented. Despite these advances, the government must keep a watchful eye over the financial sector, as vulnerabilities, compounded by exogenous and endogenous risks, still remain.

Greater access to finance has emerged from technological innovations, and the expansion of financial institutions, particularly those that target traditionally under-served segments of the market. Challenges to broader access remain, particularly in rural areas, but Kenya is on a path towards reaching new heights, building on successes, particularly during the last decade, and working on a set of reforms that will further develop both financial sector deepening and stability.

RECENT DEVELOPMENTS AND MAJOR ACHIEVEMENTS

In the last couple of years, the significant modernization and expansion of the sector has heightened its role as a driver of economic growth. The booming financial sector has become a significant driver of growth within the service sector, the

backbone of Kenya's economy in recent years. In 2010, the sector recorded its highest ever growth (8.8 percent), and was among the strongest performers in the economy.

The finance sector in Kenya, the third largest in Sub-Saharan Africa after South Africa and Nigeria, has deepened and widened considerably. This is due to: (i) a large banking sector that has shown resilience and strong growth in the last few years, complemented by regulated microfinance institutions (MFIs) and revived SACCOs; (ii) a relatively well-developed securities market; and, (iii) a relatively large pensions and growing insurance sector. Banks grew by over 33 percent per year over the period 2006–2011. This growth has encompassed sizable increases of banks' gross deposits, loans and networks.¹ Kenya's capital markets have also experienced robust growth in recent years.² The insurance sector, while still small, has grown with total assets of insurance companies almost doubling from 2006 to 2010.³ Furthermore, total assets of pension funds are significantly larger, albeit growing at a slower pace, representing about 18 percent of GDP in 2010.

The financial sector's growth has been accompanied by remarkable increases in access to finance and improvements in financial services delivery. According to FinAccess surveys, the share of the population with access to formal financial services increased from 26.4 percent in 2006 to 40.6 percent in 2009. This improvement was mostly driven by the introduction of the *M-Pesa* mobile phone-based payment systems in 2007, but also by branch expansion and product development at banks and MFIs. (see Figure 12.1) Additionally,

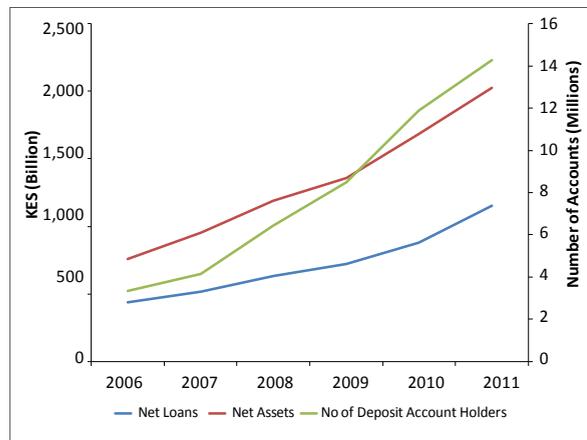
¹ Bank accounts have more than quadrupled since 2006, reaching more than 14 million. Bank branches increased from 534 at the end of 2005 to 1,114 at the end of September 2011, with much larger increases in the rural sector. Private credit to GDP, another indicator of financial development, rose from 28 percent in 2002 to 32 percent in 2010 (compared to a median of 12.3 percent for SSA) and private sector credit accelerated to 36 percent in September 2011.

² Market capitalization of the Nairobi Stock Exchange (NSE) increased from KES 462 billion in 2005 to KES 1,167 billion in 2010. Corporate bond market has expanded noticeably (from 0.7 percent of GDP in 2008 to 2.8 percent of GDP in 2011).

³ Total assets of insurance companies reached KES 223 billion in 2010 (about 8 percent of GDP). Insurance premiums increased by an average of over 10 percent a year for the last ten years.

financial exclusion (i.e. lack of use of financial products—either formal or informal) declined from 38.4 percent to 32.7 percent in the same period.

Figure 12.1: Financial sector has experienced substantial growth



Source: CBK database

Further improvements in access to finance since 2009 are evident, based on proxy indicators, and these will be reported on in the ongoing 2012 FinAccess survey. Financial services delivery has improved with the expansion of branch networks, as well as through the rapid adoption of agency banking and mobile money. Banks and MFIs have nearly doubled the number of their branches, and electronic money transfers (particularly *M-Pesa* transfers) have become widely used. Agency banking, introduced in 2010, has been rapidly implemented by eight banks, with a total of 9,748 agents as of December 2011.⁴ These developments have improved access to finance for underserved sectors (rural areas, lower income individuals and micro-enterprises).

Mobile money has rapidly become a fixture in the lives of Kenyans, as well as a successful example to the world.⁵ Mobile money subscribers in July 2012 stood at 19.5 million, with the number of agents at 49,000.

Total mobile money deposits were KES 192 billion. *M-Pesa* was later joined by three other mobile phone providers, but remains the clear leader in the market, accounting for more than 90 percent of mobile money subscriptions, and over 28,000 agents nationwide (November 2011).

***M-Pesa* now processes more transactions within Kenya than Western Union does globally, providing banking facilities to more than 70 percent of the country's adult population (including half of those in the poorest quintile).** The value of its transactions since 2007 through March 2011 topped KES 828 billion (i.e. half of Kenya's GDP). This expansion has been due to high customer satisfaction, and increased outreach to households and individuals, that were previously excluded from the financial sector.

The sector strengthened substantially from the early 2000s and has remained stable, notwithstanding, the shocks suffered in the last couple of years. The financial sector has been resilient to domestic shocks, namely the post-election violence in 2008 and subsequent lower economic growth, and international shocks (the global financial crisis and the rising prices of food and fuel in particular). The quality of lending has improved significantly, with a noticeable decline in non-performing loans (from 30 percent in 2003 to less than 5 percent in 2011).

Capital adequacy in the banking sector is well above the required minimum, and the banking sector remains profitable with a return on equity above 30 percent over the period 2006-2010. Financial institutions, particularly those targeting the lower income segments of the population (such as SACCOs

⁴ Most of these agents belong to Equity Bank, which is delivering about 20 percent of its transactions through agents, but Kenya Commercial Bank (KCB) and Co-operative Bank are also growing through agent banking.

⁵ For more information on mobile money see World Bank (December 2010, Edition No. 3), "Kenya Economic Update: Kenya at the Tipping Point? with a Special Focus on the ICT Revolution and Mobile Money".

and deposit-taking MFIs), are increasingly formalized. The decline in performance and other stability issues at SACCOs are being addressed through several reforms, in particular:

- **Improved regulation and supervision in the last few years have strengthened the sector.** All financial regulators have adopted risk-based supervision as a goal, but are at different stages of implementation, with younger institutions such as the SACCO Societies Regulatory Authority (SASRA) and Insurance Regulatory Authority (IRA) starting to move towards that goal.
- **The infrastructure and legal framework for large value and retail payments has strongly improved in terms of efficiency and robustness, resulting in high transaction growth rates in recent years.** The Kenya Electronic Payments and Settlement System (KEPSS) which is owned and operated by the Central Bank of Kenya, has grown considerably, since it was launched in 2005.
- **The securities markets infrastructure has been strengthened through improvements in different areas to support the capital markets agenda.** Legislation and regulatory changes to allow the Over the Counter (OTC) market for trading bonds, essential for the development of an efficient wholesale government and non-government fixed income market, was enacted by parliament.

FINANCIAL SECTOR AT THE CENTRE OF STRATEGIES TO PROPEL KENYA'S ECONOMIC GROWTH

Vision 2030 puts financial services at the center of planned economic growth. The economic pillar of this strategy aspires to achieve high economic growth based on high national savings rates, which already

highlights the central role to be played by the financial sector. Vision 2030 also expects the sector (along with the other five economic sectors), to make relevant contributions to economic growth. The strategy identifies as its main objectives for financial sector development: improving stability; enhancing efficiency in the delivery of credit and other financial services; and, improving access to financial services products for a much larger number of Kenyans.

However, structural constraints are limiting Kenya's financial sector potential as an engine for economic growth. The following two sections will detail the main challenges currently faced by the sector and offer policy recommendations to tackle them and help to unleash its potential. Policy recommendations will highlight priorities to enhance the sector's catalytic role in stimulating growth, improving the efficient use of resources, and reducing poverty. These two sections are based on the authors' own assessment/analysis, as well as on relevant research and government plans.⁶

MAIN STRUCTURAL CONSTRAINTS IN THE KENYAN FINANCIAL SECTOR

While the sector has coped successfully with a turbulent global macroeconomic environment and domestic shocks to the economy, it also suffers from vulnerabilities, compounded by the existence of endogenous and exogenous risks. Political uncertainty; the risk of inflation; volatile exchange rates (with resulting higher interest rates); and, droughts; and an unfavorable international environment with low growth and a looming debt crisis—these are some of the risks and vulnerabilities faced by the sector.

The rapid growth in credit over the last few years, together with higher interest rates, may increase the risk of asset quality

⁶ This includes the 2013-2017 MTP, Kenya FSAP Update, ICR ROSC, 2009 Kenya ICA and ICA survey, FinAccess surveys, latest Global Competitiveness and Doing Business Reports, IMF papers/reports and FSD reports.

deterioration. Increased levels of non-performing loans could affect the financial soundness of banks with weaker balance sheets. Credit and liquidity risks have risen with higher credit growth, as half of bank loans are concentrated in sectors more sensitive to a possible deterioration of the quality of the loan portfolio, and smaller banks have more limited access to interbank markets and wholesale funds.⁷

Interest rate spreads remain high. The main challenges in the banking sector are related to the persistently high interest rate spreads as well as to connectivity, infrastructure and supervision issues. High spreads emerge from banks' cost of doing business; the risk premium of borrowers; and profit margins. Even while bank costs have declined noticeably in the last ten years, and efficiency has improved, their costs remain high, relative to best international standards (approximately double), and there is a relatively low level of bank competition.

Spreads had stabilized until 2010, declining to 8 percent, but they have since increased (with higher overheads and profit margins), and further widened to 13 percent in 2011, as deposit rates did not respond rapidly to higher lending rates. Key drivers of higher spreads are:

- the high opportunity cost for private sector credit (government infrastructure bonds constitute a high benchmark);
- international and domestic shocks (global financial crisis, macroeconomic volatility, inflation and election risks);
- higher capitalization and provisions, greater outreach and deposit mobilization; and
- increased lending to higher risk sectors (such as consumers and SMEs).

Further reforms in regulation, supervision, governance, and the bank resolution framework are needed to strengthen the financial sector. The growth and development of the sector have brought new challenges, including an underdeveloped mobile payments regulatory framework; underdeveloped general financial regulations; and, the need to consolidate cross-border supervision (in light of regional deepening).

Conglomerate supervision and consolidated supervision techniques are at their very early stages, and at the cross-border level which consolidated supervision is even less developed, although there are ongoing incipient efforts. Kenya's crisis-readiness framework also has shortcomings, such as lack of a comprehensive crisis management system; constraints to bank resolution; and, an incomplete financial sector resolution framework.⁸ Finally, some of the weaknesses found by the 2009 FSAP update on banking supervision are still valid, including: the need to strengthen licensing; to keep implementing the AML/CFT regime; to continue capacity enhancement for risk management; and, to broaden the coverage of credit bureau regulations—with voluntary sharing of positive information with other financial institutions—included in the 2012 Finance Bill.

Limited connectivity between financial institutions and mobile network operators, as well as high dependence on cash and limited automation of government and other payment systems, are relevant weaknesses of the infrastructure of the sector. MTP 2013-2017 finds that the most relevant weaknesses of the sector's infrastructure relate to: (i) the missing elements in the National Payment System; (ii) the need to

⁷ Annual credit growth has been rapid in the last three years, especially in personal loans, posing challenges for sectors with above-average NPLs and higher sensitivity to economic slowdown. As liquidity tightens and becomes more costly, some banks are starting to hold more excess reserves but small and mid-sized banks depend more on short-term interbank and CBK funding. For more details on credit and liquidity risks please see IMF Country Report No 12/14, "Kenya 2011 Article IV Consultation" (January 2012).

⁸ While banking sector arrangements can be improved, and expanded to include resolution methods such as "good bank-bad bank", mechanisms for the other sectors have not been developed, and crisis management planning and, in general, cross-industry or cross-border issues have only just begun to be addressed.

improve the inter-operability between the three main Electronic Funds Transfer Point of Sale (EFTPOS)/ATM networks; and, (iii) the need to level the playing field for mobile payments.

Kenya's pension system remains a major risk to the stability of the financial system, due to significant contingent liabilities and inadequate corporate governance. The scale of these contingent liabilities remains unknown,⁹ and the management and oversight of NSSF remain weak. As a result of weak governance and management, as well as high administrative expenses, NSSF has underperformed against all market benchmarks. Occupational Pension Schemes are exposed to risks from the asset and liability sides of their balance sheets. The Retirement Benefits Authority, which regulates and supervises all pension schemes in Kenya, still has to operationalize a risk-based supervisory framework. It is unable to enforce NSSF's compliance with key prudential provisions, and should strengthen its off-site monitoring capacity.

The non-government bond market is underdeveloped (but growing at a fast pace), and capital market development had been hindered by ethical problems in the licensed community and by weak supervision, now being addressed. Equities and government bonds dominate the Kenyan capital markets, with the corporate bond market being in a nascent stage. Additionally, the government bond market is still fragmented, even though it is fairly developed in the Sub-Saharan African context. It is also accepted that it has improved in recent years, based on efforts to better develop a yield curve that can serve as a reliable pricing mechanism.

Lack of competition and low standards of professionalism in the licensed community,

as well as loss of investor confidence emerging from fraudulent practices in the brokerage industry, have had a negative impact on the development of Kenya's capital markets. Additionally, the clearing and settlement framework does not support efficient and cost effective secondary market trading in government and non-government fixed income instruments, and operates under risk levels that will deter the further growth of trading.

The Kenyan insurance sector is underdeveloped, and has a relatively large number of companies (given the small size of the sector) with efficiency issues and potential under-reserves. Despite recent growth, the Kenyan insurance sector is small, with a rate of insurance penetration of 2.63 percent in 2008, although growing at a fast pace in 2010. The small size of the market emerges from issues like: low per capita income; income distribution (smaller middle class); lack of public confidence in the sector; and, fraud and weaknesses in regulation and supervision. The Insurance Regulatory Authority suffers from capacity constraints (such as specific knowledge and experience of its staff), and there is need to implement risk based supervision, and early intervention mechanisms, to underpin prudential supervision. In motor insurance (the primary business line for insurance companies) the rates are low and do not cover future liabilities, resulting from high levels of competition and inadequate prudential supervision premiums.

One of the most important weaknesses in Kenya's lending infrastructure remains the process of taking and realizing collateral, a process evaluated as lengthy, costly and unpredictable.¹⁰ A very large proportion of loans are collateralized in Kenya (approximately 90 percent) and the value

⁹ According to MTP 2013-2017, unfunded liabilities were estimated to be 18 percent of GDP in 2008 and have increased rapidly since then, given the salary increases of civil servants and the growth in the number of employees.

¹⁰ For more details on the collateral process please see *Financial Sector Deepening (FSD) Kenya (September, 2009). "Costs of Collateral in Kenya: Opportunities for Reform"*.

of collateral is high (118 percent of the loan value, on average), with extensive use of the “all asset debenture”.¹¹ Securing immovable property comprises six stages, with various steps in each stage, and the cost of creating and perfecting this collateral amounting to 6.7 percent of the loan amount (most of the costs come from legal fees, stamp duty and bank commissions). Enforcing this collateral is expensive, and could take more than five years. Pledged assets stay in the hands of the borrower during these lengthy judicial processes, and assets often depreciate or are destroyed/lost, meaning that even if the court rules in favor of the lender (and, reportedly, the perception by lenders is that this is often not the case), it might only be able to recover a small fraction of the value of the collateral. In this context, lenders tend to request an “all asset debenture” (i.e. the borrower pledges all the assets that the company may hold, in the present or in the future) to grant credit. In fact, 64 percent of firms surveyed in an FSD study had to provide an “all asset debenture” to obtain credit.

High collateral requirements emerge from the judiciary’s and (land and companies) registries’ inefficiency; lack of credit history; problems with bankruptcy proceedings; and multiple laws regulating the collateral process, among others.¹² The courts in Kenya with jurisdiction over enforcement and insolvency procedures have attracted considerable criticism for insufficient capacity, skills, resources and integrity. Contract enforcement is one of the main weaknesses of the business environment in Kenya (the country ranks 127 in the “Enforcing Contracts Index” according to Doing Business 2012 data), with costs representing more than 47 percent of the claim (above the average in Sub-Saharan Africa).

Notwithstanding recent improvements, registry systems tend to be weak and dispersed, using manual procedures and experiencing problems such as incomplete and unreliable search methods, missing records and files and incomplete/incorrect information (FSD Kenya, September 2009). The registration of collateral is expensive and burdensome, as well as involving numerous steps and a relatively expensive stamp duty. The resolution of bankruptcies is also costly and time consuming, taking 4.5 years (compared with an average of 3.4 in Sub-Saharan Africa) and 22 percent of the estate (compared with 23 percent of the estate in Sub-Saharan Africa) according to Doing Business 2012 data. A weak and dispersed legal framework, with twenty laws regulating the collateral process, is a key constraint to the smooth functioning of the collateral process in Kenya, creating inconsistencies, complexities and extra expenses in the collateral process (FSD, Kenya, September 2009).

Kenya’s insolvency and creditor/debtor regimes are incomplete and outdated.¹³

The enterprise credit market is fragmented, and appears not to have served small and medium enterprises well. But innovations (in microfinance, mobile and agency banking) hold considerable promise. Many of the credit laws are outdated, and are often inadequate to meet the needs of a modern economy, although legislative efforts are underway to improve the situation.

The poor legal framework is coupled with weak implementation. Commercial courts have been relatively unskilled, understaffed, and beset with an *ad hoc* attitude. Commercial courts are known for using excessive judicial discretion and lacking

¹¹ Data source: Enterprise Survey of 2009 Kenya ICA.

¹² Initiatives to tackle these issues include: efforts to automate land registries; a Land Policy which prioritizes the reform of the land laws; initiatives to improve judiciary efficiency (such as the establishment of a Bench Research Hotline for judges to obtain updated legal information, improvements to civil and administrative procedures, recruitment of more judges, and computerizing the judiciary system); Insolvency and Companies Bills; improvements at the land and company registries (such as digitization).

¹³ For more details see (World Bank, 2012) Draft Kenya Report on the Observance of Standards & Codes – Insolvency and Creditor/Debtor Regimes (ICR ROSC).

material support, and are frequently tainted by the perception of undue influence and improper practices. Similar weaknesses have been found at the Official Receiver's Office. The Company Charges and Land Registries have been regarded as inadequate, inefficient and beset with dishonest practices, but recent reforms are expected to generate improvements.

While the regulatory framework governing credit reference bureaus is improving the credit environment, it still shows weaknesses.¹⁴ Issues in the legal framework for the creation and enforcement of credit are key contributors to the high interest rate spreads observed in Kenya.¹⁵ Additionally, the insolvency framework is internally inconsistent, incomplete and outdated, and the processes for liquidating companies and for rendering natural persons bankrupt, are moribund in practice, given the deficiencies in their implementation.

FINANCIAL SECTOR REFORM AGENDA

The top priority in the short term should be to complete the legislative program at the Attorney General's office, and accelerate the strengthening of the legal, regulatory and supervisory framework across the different regional and domestic financial regulators. Legislative preparation is slow in Kenya, and strengthening institutional capacity at the Attorney General's office should be a top priority. The strengthening of the regulatory/supervisory process should include crisis preparedness; regulations for mobile banking; regional integration; the implementation of prudential regulation and supervision (e.g. SACCOs, MFIs, IRA); and, expanding the credit bureau mandate.

In terms of operational infrastructure, key issues are the need to:

- accelerate reforms in the registry of collateral and land registry (through automating the processing in Nairobi, Mombasa and Nakuru);
- enable the interoperability of the payments systems; and
- enhance payments and capital markets infrastructure.

The health of the financial sector should also be strengthened by addressing issues at NSSF; passing key draft laws (such as the Insurance Act); and implementing the AML Act.

Crisis response, preparedness and management would benefit from prompt corrective action in the banking industry and the introduction of a crisis-management system. Intervention systems should be strengthened in all sectors. A prompt corrective action framework in banking should be introduced, and a crisis-management system should be developed, assisted by incorporating learning from a study of best practice international arrangements. The financial structure would benefit from a stronger system of intervention by IRA and CMA in their respective industries, insurance and capital markets. These regulators should develop formalized methods of supervisory intervention, and closure or resolution.

The regional financial integration agenda presents a major opportunity for Kenya, being the most developed financial market in the East African Community (EAC) region, and among the leaders in Africa. The transformation of the EAC into a single

¹⁴ These include the absence of a data protection law; the lack of effective dispute resolution mechanisms regarding disputed information stored by credit reference bureaus; the absence of time limits for the retention of information; the exclusion from the system of institutions not regulated by the CBK nor other commercial debt (??); and the absence of any obligation by credit reference bureaus to report positive information. (The last two will be solved by the Finance Bill 2012.)

¹⁵ Enforcement of secured claims through individual or collective processes in Kenya takes an estimated average time of 4.5 years, costs 22 percent of the value of the debtor's estate, and yields the secured claimant only 30 percent of what is owed. By comparison, the averages for jurisdictions in Sub-Saharan Africa are 2.7 years, 19 percent, and 19.1 cents in the dollar, and in OECD countries they are 1.7 years for the duration of proceedings, with costs of 9 percent, and recovery rates of 68.2 percent.

market, with free movement of goods, services, capital and labor, accelerated with the ratification of the Protocol of the EAC Common Market in July 2010. Kenya is already a major financial market in Sub-Saharan Africa, and its banks have been expanding regionally. The deepening of EAC integration enhances the opportunity to transform Nairobi into a regional financial hub. Ongoing efforts in this area include: an integrated Real Time Gross Settlement (RTGS) system, providing the potential for Kenya to become a clearing settlements hub for smaller economies; regional cross-listing of shares across stock exchanges largely centered at the Nairobi Securities Exchange; and, the overall opening up of regional financial markets, with marked participation of Kenyan banks in the region.

Regulation and supervision of the banking sector need further strengthening, with emphasis on consolidated supervision.

Increased credit risk calls for the redoubling of supervision efforts, to ensure that banks comply with provisioning practices. Growing cross border linkages highlight the need to strengthen supervision, focusing on inter-group transactions, and the possibility of regulatory arbitrage (IMF 2012). As was highlighted in the 2009 Kenya FSAP Update and in MTP 2013-2017, reform efforts in the banking sector should focus on: implementing consolidated supervision and on country and transfer risk programs; fully operationalizing the AML Act; boosting supervision capacity with more staff and specialists at the Banking Supervision Department; fully investigating the ownership of banks; and, implementing the Basel I capital requirements for market risk.

High interest rate spreads should be tackled by promoting competition in the banking sector and addressing information asymmetries and risks (perceived and actual). Competition should be motivated by

eliminating the relevant structural barriers (Saya and Gaertner 2012). It is crucial to strengthen property rights (including property registration and enforcement) by:

- modernizing the legal infrastructure (laws governing collateral, bankruptcy and foreclosure);
- providing accessible infrastructure (keep improving credit bureaus and payment systems);
- leveling the playing field across banks; and
- continuing EAC integration, so that banks can reach economies of scale.

Information asymmetries and risks should be ameliorated by:

- expanding information available at credit bureaus (to include positive information, as well as information from non-bank financial institutions and commercial entities, such as shops and utilities);
- passing legislation to enhance the legal and judicial framework of the lending environment (including movable collateral, land reform and dispute resolution—some of which are covered in the Insolvency and Companies Bills); and
- improving the land and companies registries and titling.

These are major contributors to banks' operating costs. Another key factor that needs to be addressed is the inefficiency in the system (such as ATM platforms and back office).

To improve interoperability, a number of legal and institutional reforms are needed. These are: (i) the harmonization of laws of payment systems and enactment of the NPS Act as well as other regulations, with special emphasis on foreign currency liquidity regulation to facilitate real time gross settlement of foreign exchange payments and the adoption of EMV standards, and, (ii) improving several NPS infrastructure elements, such as upgrading

or replacing the current Central Bank CSD to a system supporting the existing script-less registration of Government Securities, and promoting mobile payments, by enabling the delivery of G-Pay payments over the mobile channel.

The priority in the insurance sector is to strengthen its regulation and supervision, and ensure that MTPL can cover liabilities.

This should encompass the sanctioning and implementation of the Insurance Act; upgrading the technical capacity of IRA (particularly regarding prudential supervision, risk-based supervision and financial analysis); and restructuring MTPL to ensure its sustainability and the appropriate coverage of liabilities. The MTP also recommends promoting industry consolidation, improving consumer education, and creating incentives for channel development and product innovation.

Reform in the pensions sector should tackle the issue of contingent liabilities; keep strengthening governance and management at NSSF; and improve funding for DB schemes.

The short-term goal for the pensions sector should be to tackle the weaknesses in the existing schemes, so that these can grow and serve current customers better. First, the level of (funded and unfunded) liabilities should be systemically estimated and disclosed in the budget. Second, NSSF should comply with regulations for the outsourcing of management and custodianship, and its governance and role should be reformed through the implementation of a pension reform strategy. Third, the funding ratios of DB OPS should be increased. Finally, RBA should strengthen its offsite monitoring capacity.

Further, capital markets development requires strengthening of the regulatory framework and enforcement efforts, as

well as improving infrastructure. The improvement of the capital markets framework should focus on: completing the demutualization of the NSE; reforming the Capital Markets Act through the Securities and Investment Bill and the Capital Markets Authority Bill; developing legislation for a commodities futures exchange; completing provisions for a second market to serve SMEs; and, establishing Real Estate Investment Trusts.

To facilitate long-term financing for infrastructure and housing, the development of the non-government bond market and Public-Private Partnerships (PPPs) needs to be accelerated.

Lack of adequate infrastructure has repeatedly been identified by Kenyan enterprises as a major constraint for doing business, and was singled out by relevant research as a key obstacle for growth. Given the large infrastructure financing gap, and the amount of public resources already committed to this effort, private financing is necessary to tackle this constraint. Nevertheless, long term finance (for infrastructure and housing) is limited in Kenya, constituting a major constraint for economic growth. The development of non-government bond structures can serve as suitable vehicles for mobilizing savings for infrastructure investments.

Reforms to promote access should focus on promoting further access to formal financial services (beyond payments), tackling the main obstacles to access credit (including high collateral requirements and weak creditor rights), and strengthening SACCOs and other non-bank financial services providers:

- So far, SASRA has licensed 83 *deposit taking SACCOs*, which still need to make changes to comply with regulatory requirements, the most relevant ones being related to governance issues.

- The *credit information* sharing initiative should be expanded to incorporate (mandatory) positive information and integrate regulated financial institutions (MFIs and SACCOs) and retailers, as reflected in the Finance Bill 2012. Improvement of the regulation should also include incorporating a time limit for the retention of negative information of borrowers, and consideration should be given to requiring banks to notify borrowers before notifying the CRB, when adverse credit information has resulted in a denial of credit and creating a 'credit information Ombudsman' to settle disputes about information accuracy and confidentiality.
- As mobile money operators provide financial products such as savings and insurance, the following changes to the *mobile money regulation* could enhance financial inclusion: (i) consumer protection regulations and financial literacy tailored to mobile money use; (ii) tiered Know-Your-Customer regulations to allow the opening of an account with minimum requirements for poor people, with progressive tightening of regulations; and, (iii) creating regulatory space for a class of non-bank e-money issuers, authorized to raise deposits and process payments, but not to intermediate funds.
- The *legal framework for creditor rights* should be strengthened by: reviewing the Land Act 2012; unifying and strengthening the real property register (including electronic recording of title and interests, and access to the register available through district registry offices and or online); speeding up modernization and strengthening of the registration of interests in movable property; strengthen the chattels registry (such as being moved on line and having mechanisms for the correction of errors); improving the Companies Register; and streamlining the process for debt collection and enforcement of security interests (e.g. by discouraging the use of stay orders).
- The *legal framework for insolvency* needs to be strengthened by: providing creditors with adequate notice of key steps in the insolvency process; ensuring that appeals generally do not suspend proceedings; abolishing the 'acts of bankruptcy' doctrine, strengthening the insolvency moratorium; and, empowering creditors in relation to critical decisions in the insolvency process, among others.
- The *implementation of the creditor rights and insolvency legal frameworks* should be strengthened by: appointing lawyers with suitable commercial legal expertise to the bench at the Commercial Divisions of the High Court; significantly increasing the number of judges/magistrates (in general and commercial); limiting the rotation of commercial judges; modernizing case management processes; and, creating a regulatory framework for insolvency professionals, among others.¹⁶
- SME *financing* should be promoted through: the elimination of obstacles for the development of leasing, factoring and bank SME financing; encouraging the development of leasing, factoring firms/products to eliminate current legal, regulatory, taxation and informational issues; and, having policies which facilitate bank SME financing, since banks are the main providers of SME credit and have the potential to develop profitable business models to serve SMEs.

¹⁶ For more details on reforms to improve insolvency and creditor rights please see ICR ROSC 2012.



Governance

13. Spending people's money well: reforming public financial management

By Winston Cole, George Larbi and Caroline Wangusi

SUMMARY

A review of Public Financial Management (PFM) in Kenya shows that reforms have led to substantial improvements in a number of areas including: (i) revenue mobilization; (ii) transparency and citizen participation; (iii) external audit and oversight; and (iv) an Integrated Financial Management and Information System (IFMIS). This progress has been accompanied by a strengthening in the oversight role of the legislature, which in turn has strengthened the accountability of the executive arm of the government.

Nevertheless, the quality of PFM systems, especially for accounting and reporting, and of the comprehensiveness and transparency of the budget, are often cited as the major reasons for non-use of country systems by donors and for off-budget spending. According to the Public Expenditure Financial Assessments (PEFA), these are the two areas where Kenya performs poorly compared to its East African neighboring countries, scoring an average of 1.5 and 2.2 respectively.

The 2010 Constitution provides a platform to further address the weaknesses in PFM. Under the Constitution, the Treasury has been reorganized, and new agencies have been mandated to focus on various aspects of PFM. These include the Commission on Revenue Allocation (CRA), the Controller of Budget, and the Transitional Authority. The role and function of institutions such as the Auditor General's office and the Kenya National Audit Office (KENAO) have also been redefined and strengthened.

However, key risks associated with the current PFM system arise under the Constitution. It greatly increases the power of the legislature in the budget process, and while creating three separate estimates whose input forms the budget, the Treasury has no control over two of them (the parliament and judiciary). Whereas this is good for financial autonomy, it increases the risk of the total annual budget exceeding revenue, and over time, creates deficits, since the Treasury will not have much say over a significant proportion of the budget.

A significant milestone has been reached with the enactment of the 2012 PFM Act and other relevant legislation, creating additional opportunities for entrenching key reforms.

The Act also has reporting provisions, which will improve the information made available to the public, thus improving transparency. It also requires the Ministry of Finance to report on progress made in implementing audit recommendations, as part of the draft budget submissions to parliament, and improves accountability in the use of public resources. It must be pointed out that there is also need to accelerate and sustain the pace of PFM reforms in the context of devolution.

The following areas are recommended for action by the incoming government:

- complete the inter-governmental financing architecture and finalize the ratios to be used in transferring debts and assets (financial and non-financial) from the local government authorities to the new counties, and clarify the procedure for fiscal transfers;
- conduct a PFM capacity assessment in the counties, and assist with their capacity development; and
- manage and sustain the implementation of the re-engineered IFMIS to full completion and usage across national and county governments. Reliance must not be placed on IFMIS alone, but also on other key areas such as accounting and financial reporting, and comprehensiveness and transparency of the budget. Sustained reforms efforts are also required.

REVIEW OF PROGRESS – FACTS AND TRENDS

An efficient and effective PFM system is critical to the proper allocation and management of financial resources to achieve development results. A sound PFM system is one of the key components of good governance, ensuring adequate infrastructure and improved access to services for citizens. It encompasses information technology; budgeting; accounting and financial reporting and control structures; auditing

and oversight; public procurement; and tax administration, all of which are embedded in a solid legal and regulatory framework. Countries which have made good progress in governance and development effectiveness enjoy PFM systems that are robust enough to prevent or minimize abuse and leakages in public finance.

PFM reforms have been underway in Kenya since the 1990s, but progress has been slow, and the results mixed. Since the 2002 elections, the government has taken significant steps towards strengthening the country's PFM systems. The importance of having such effective systems has been emphasized in key national policy documents, such as the Economic Recovery Strategy for Wealth and Employment Creation (2003-2007), and Vision 2030. The latter in particular defines public expenditure and financial management as a priority in structural reforms, whose goal is to improve efficiency, transparency and accountability, under a coordinated strategy that revitalizes PFM.

In 2006, the government adopted the Public Financial Management Reform Strategy 2006-2011 to guide the continuous development and improvement of PFM reforms. The ultimate goal was to ensure efficient, effective and accountable use of public resources, as a basis for economic development and poverty eradication, through improved service delivery. The strategy also covered the transition period to June 2012. A new strategy for the period 2012-2017 has been prepared in the context of the newly enacted 2012 PFM Act.

The Medium Term Expenditure Framework (MTEF) is fully developed and integrated into the budget process, but a meaningful medium term perspective is lacking. In pursuit of a more disciplined fiscal policy, the MTEF and a new chart of accounts were

introduced in 2005. In addition, the annual budget process is now more inclusive, better defined, more medium-term oriented and has more internal and external safeguards put in place to ensure that the implementation of the budget process continues to improve over time.

However, the following challenges remain:

- (i) the second year of the MTEF is often ignored, with preparation of the subsequent year’s budget effectively starting from zero;
- (ii) the linkage to and alignment with the Vision 2030 Medium-Term Plans of MTEF, for sector working groups and by specific development partner projects is unclear;
- and (iii) performance targets of the budget, policy and performance contract processes are complex and not aligned. Supplementary budgets also still form a significant percentage of the overall budget: for instance in the 2011/12 budget, they were 25 percent of the total.

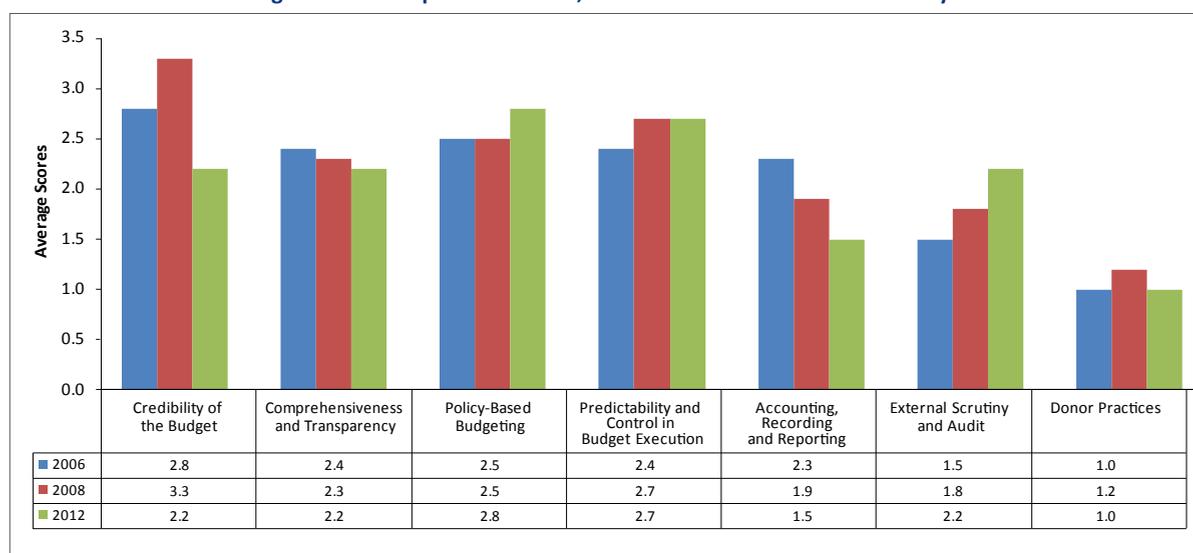
According to the PEFA assessment reports for 2006, 2008 and 2012, the performance of Kenya’s PFM system is slightly above

average, as shown in Figure 13.1. The credibility of the budget has been the best performing aspect of the PFM system since 2006. The most profound progress over the years has been in the area of external scrutiny and audit, but the accounting and reporting aspects perform below average and are deteriorating. Overall, the performance indicators suggest moderate to significant fiduciary risks¹ in the PFM system, with the PEFA ratings declining from C+ in 2008 to C in 2012.

Off-budget expenditure and in-year budget reallocations still hamper effective and efficient use of resources.

Although the detailed budget estimates are comprehensive, they lack transparency and are not easily comprehensible to citizens, due to the huge amounts of tabular details provided, without accompanying narrative. In addition, the budgets of the Semi-Autonomous Government Agencies (SAGAs) do not disclose the government’s potential contingent liabilities, except for debt it guarantees.² Although these institutions submit their reports to the Auditor General,

Figure 13.1: Comparison of 2006, 2008 and 2012 PEFA results for Kenya



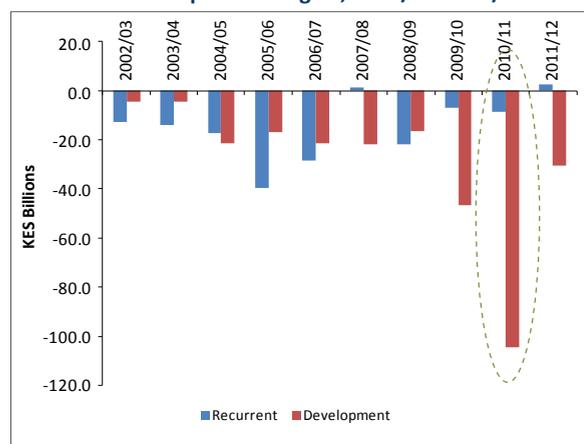
Source: Kenya 2006, 2008 and 2012 PEFA Assessment Reports

¹ A general principle in relating the PEFA ratings with the various aspects of the PFM system is that a high PEFA score (e.g. ‘A=4’) indicates low fiduciary risk, and conversely a low PEFA score (e.g. ‘D=1’) indicates high fiduciary risk.

² In the 2011 financial year, State Corporations represented 13 percent of total budgeted central government expenditure, including net lending(2012-17 PFMR Strategy).

in terms of reflecting actual revenues and spending, they have not been satisfactory. Fiscal risk assessment and oversight of public enterprises have not formed part of the PFM reforms to date, and current practices are not clear. Kenya's performance is below that of its East African neighbors, in terms of PEFA scores on comprehensiveness and transparency of the budget, as shown in Figure 13.2.

Figure 13.2: Trend of deviations within the recurrent and development budgets, 2002/03-2011/12



Source: 2003-2009 (KENAO); 2010-2012 (BPS 2013)

Predictability of budget resources, particularly for the development budget, has been weak and requires attention.

Figure 13.2 indicates that the budget has deviated between the appropriated and the executed development budget, with the worst deviations occurring during the financial year 2010/11. This may be due to the slow process of transferring funds, and/or the lengthy procurement processes that hinder the ability of ministries to use funds for development within set timelines.

Predictability of available cash for expenditure commitment is critical for efficient budget execution. Cash transfers from the exchequer to ministries have improved due to electronic funds transfer. However, there are still significant delays

in the payment processes within the ministries, which impacts the budget execution and service delivery. Payment arrears can arise from financial resource inflow unpredictability, combined with problems which result from weak budgeting and budget execution systems. The Public Expenditure Review 2010 states that delays in cash transfers can take between one week to several months. A critical factor in this regard is the seasonality of revenue collection, which invariably affects cash releases. An effective cash management framework, with tools (and the skills to use them) for proper revenue forecasting and cash planning, supported by procurement plans and disbursement and/or payment schedules, will help to address this problem.

There is improvement in capacity and the regulatory framework for debt management, and this progress needs to be sustained.

Since the introduction of a Medium Term Debt Management Strategy (MTDS) in 2008, public debt transactions have declined from 21.4 percent in 2007/08 to 15.7 percent in 2010/11. The 2009 MTDS recommended a shift in the composition of debt—long-term domestic debt from medium-term, in order to minimize both cost and risk in the debt portfolio. The Internal Loans Act was introduced in 2009 to provide for borrowing by the government, and the Guarantees Act has been replaced by the National Loans and Guarantee Act 2011. The annual Debt Sustainability Assessments show that Kenya's debt levels are indeed sustainable.³ Lastly, new CS-DRMS 2000+ software was recently installed, which has significantly improved the reliability of external debt data.

Some progress has been achieved in procurement reforms through new procurement legislation, but more needs to be put into place for a more robust and

³ The Assessments are carried by the International Monetary Fund with full collaboration of MoF.

less cumbersome system. The need to create an oversight body, whose roles were embedded into law, led to the passage of the Public Procurement and Disposal Act (PPDA) in 2005, followed by the publication of the Public Procurement and Disposal Regulations in 2006. The PPDA created the Public Procurement Oversight Authority (PPOA), which administers the provisions of PPDA. PPOA also has additional roles such as monitoring, regulatory, advisory, sensitization and training.

Other bodies formed by the PPDA include the Public Procurement Advisory Board and the continuation of the Public Procurement Complaints, Review and Appeals Board, known as the Public Procurement Administrative Review Board. These reforms have brought some improvements, such as the introduction of a procurement manual and guidelines for framework contracts. However, little change has occurred. The roles of the three bodies that came into existence prior to the bill have not been clearly defined, and need to be streamlined. Other aspects that remain weak and need strengthening include the institutional framework; procurement capacity; the functioning of the procurement market in terms of private sector participation; enforcement and follow-up on external audit recommendations; and public access to procurement information.

Major improvements have been witnessed in external scrutiny and audit, but following up on recommendations and sanctions remains weak. The Fiscal Management Act of 2004, which lays down the scope of the legislature's enhanced oversight functions, was revised in 2009 to introduce fiscal responsibility principles. The Parliamentary Budget Committee is now fully and legally entrenched in the budget process, and the Public Accounts Committee of parliament has also been active in the review of the

Auditor General's report. However, there are long delays by parliament in reviewing audit reports, posing queries, and getting responses from government ministries, department and agencies (MDAs). Some significant components of the Financial Management Act (FMA) of 2009 have been altered by the 2010 Constitution: public finance under the FMA was centered on the Treasury—under the direction of the executive—as the key player in controlling public funds. In addition, the Controller's function has been removed from the Office of the Auditor General, and given to a new office of Controller of Budget.

Since 2009, the Internal Audit Department has undergone further strengthening and empowering, and its mandate has been expanded. The department has adopted the Risk Based Audit Approach; spearheaded the development of the Institutional Risk Management Policy Framework in the public sector; adopted internal audit standards and best practices as promulgated by the Institute of Internal Auditors; enhanced governance through the establishment of ministerial audit and risk management committees; introduced IT-supported audits and the roll out of Audit Management Systems (Teammate); and, adopted Value for Money Audits/Performance Audits. All ministries and state corporations have adopted the Institutional Risk Management Policy Framework, whose adoption is envisioned to enhance risk identification and management by government MDAs, and provide a policy framework for risk-based auditing for internal audit. However, these systems have not been uniformly introduced or supported by various public entities, and only exist on paper, rather than in practice.

Progress towards International Public Sector Accounting Standards (IPSAS) adoption in Kenya has been slow. In 2009, the Office of the Accountant General issued a circular

directing donor funded projects to have their financial reports prepared in compliance with IPSAS (cash basis). However, there have been delays in the adoption of IPSAS, throughout the public sector. A full set of consolidated annual financial statements is not prepared, and only Appropriation Accounts are submitted for audit. The adoption and implementation of IPSAS requires additional efforts by the various stakeholders who support the improvement of financial management and reporting in the public sector. The Accounting Standards Board, when set up as envisaged in the PFM Law, is expected to drive this process.

The implementation of the re-engineered IFMIS is vital to the success of ongoing reforms. The implementation of IFMIS has rolled-out a full suite of modules comprising accounts payable, purchase orders, general ledger, accounts receivable, cash management and fixed assets.

In addition, the new Hyperion Budgeting Module has been rolled-out to all MDAs and tested with the production of the 2011/12 supplementary budget. Furthermore, an electronic funds transfer system, linked to IFMIS, was recently implemented by the Central Bank. However, reporting standards are still fragmented, and institutionalization of reporting through IFMIS has not been implemented.

Overall, the role of IFMIS is yet to show any significant improvement of actual PFM performance. According to the 2012 PEFA, budget performance reports are prepared on a monthly, quarterly and annual basis, and the information comes from multiple sources. A fully comprehensive IFMIS would help to provide accuracy, uniformity and timeliness. Improvements in the production and reconciliation of accounts by line ministries and the Ministry of Finance would

enable better analysis and oversight by the Auditor General, and provide more reliable information for overseeing the budget by the Controller of Budget. The most significant ongoing reform to date is the roll-out of the re-engineered IFMIS to strengthen the control environment. Through its in-built budget control functionality, it has contributed to addressing the perennial challenge of payment arrears and accounting vis-à-vis financial commitments. The government will need to provide sustained support to introduce and operate IFMIS throughout the public sector, as an important component of ongoing PFM reforms.

The Kenya Revenue Authority (KRA) has been implementing its Revenue Administration Reform and Modernization Programme since 2004, resulting in a significant increase in revenue collection. Revenue collection has tremendously improved over the last five years, with the revenue to GDP ratio having improved from 21.3 percent in 2004/05 to 22.8 percent in 2009/10. Transformation in KRA has brought about improvements in the transparency of taxpayers' liabilities which, inter alia, have resulted from making the legislative framework clearer, including the removal of tax exemptions and other discretionary powers. KRA is currently executing its Fourth Corporate Plan, 2009/10—2011/12. However, results from the 2012 PEFA indicate that domestic revenue has been persistently over-estimated, unlike during the period covered by the last PEFA assessment (FYs 2005-07) when revenue out-turns exceeded budget estimates in two of the three years.

The operational efficiency of the pension system has improved since the introduction of the new Pension Management Information System (PMIS) in 2009. The automation of the Integrated Personnel and Payroll Database (IPPD) and the PMIS have

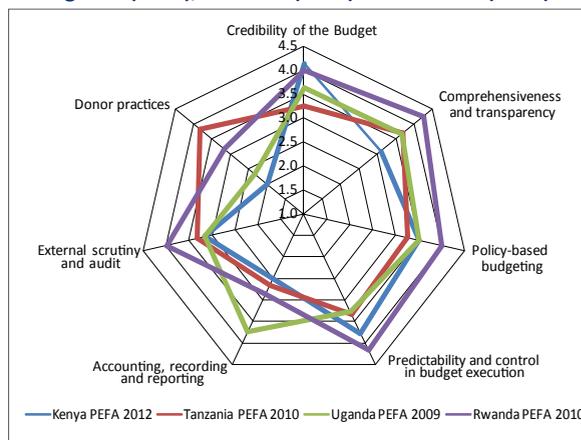
helped to address the challenges of manual payroll administration by making personnel information more accurate, timely and reliable.

The 2012 PEFA indicates that the Ministry of Public Service and the Pensions Department have no arrears in wage, salary and pension payments. However, the IPPD is a distributed system with each ministry or agency having its own database, and it is not integrated with IFMIS, which has a centralized database structure. Furthermore, the systems are built on different technical platforms, hence, the payroll data is entered manually into IFMIS, generated from IPPD printouts, posing the risk of errors, with loopholes for fraudulent payments. The fiscal sustainability of the pension scheme is also an issue, and the government is considering to change the civil service pension scheme to a contributory system, from the current non-contributory one.

The use of country systems by donors has declined, with most aid programs and grants remaining off budget. Kenya's budget regulations do not require donor funding to be included within the budget framework, though this is under review as part of the draft Kenya External Resources Policy. Generally, Kenya performs worse than all Eastern Africa countries in donor aid management, as shown in Figure 13.3. An initiative on Open Aid Partnership, together with the proposed External Aid Policy, is likely to reduce off-budget aid and improve transparency.

Although the country has made considerable progress in PFM reforms, Kenya performs below average, and lags behind in almost all PEFA indicators, when compared to other countries in Eastern Africa. Figure 13.3 shows that the country's 2012 PEFA scores for accounting, recording and reporting and donor practices are significantly lower than those of its peers. But the country's

Figure 13.3: A comparison of PEFA results for Kenya (2012), Uganda (2009), Tanzania (2010) and Rwanda (2010)



Source: 2003-2009 (KENAO); 2010-2012 (BPS 2013)

performance is at par with Rwanda in predictability and control in budget execution, where both countries are performing above the others. Kenya has made much progress in the credibility of the budget, an area where it is ahead of its peers.

THE 2010 CONSTITUTION AND IMPLICATIONS FOR PUBLIC FINANCE MANAGEMENT REFORMS

The 2010 Constitution has introduced a set of principles and dimensions to PFM reforms. In particular, Article 201 of the Constitution emphasizes the principles of transparency, accountability and equity as the key foundations for PFM and prudent and fair use of resources for the benefit of society. The enactment of the Constitution puts fiscal decentralization and PFM, at the center of policy reforms in Kenya, and it addresses the composition of the legislature, the appointment of the executive and judiciary, independent positions, and the public service. It introduces major reforms in PFM that will require parliament to enact legislation over the next several years, to have them fully institutionalized. The Constitution, inter alia, strengthens the oversight role of parliament in budget and other PFM areas such as auditing and accounting, as well as budget monitoring.

The operational independence of the Auditor General has been enhanced with the splitting of the role of the Controller and Auditor General, into those of Controller of Budget and Auditor General. The capacity of the Office of the Auditor General needs to be strengthened to be able to manage its increased scope and audit demands arising from devolved government, decentralized operations and development partner projects. The audit committees also needs to be effectively deployed. It is anticipated that the revised financial management regulations will define and entrench the role of these committees, more solidly in the PFM systems. From a resource dependence perspective, the Audit Bill that is being developed should seek to protect the financial and operational independence of the Office of the Auditor General.⁴

The Controller of Budget is now mandated to oversee the implementation of budgets, of the national and county governments, by authorizing withdrawals from public funds under Articles 204, 206 and 207 of the Constitution. With requirement to submit a report on the implementation of the budgets of the national and county governments every four months, to each house of parliament, this new office will need a strategy, an organizational structure and appropriate multi-disciplined staff with experience in Monitoring and Evaluation. The introduction of Program Based Budgeting, when fully embedded across the government, will provide a framework to perform the role of overseeing the implementation of the budget.

The PFM Act introduces a Treasury Single Account (TSA) at central and county governments and sees the adoption of a single unified PFM system for national and

sub-national government. The adoption of the TSA will result in the phasing out of the Guaranteed Payment Solution, and its replacement by the G-Pay/Electronic Fund Transfer system, which would increase the reliability and completeness of payment information in IFMIS.⁵ According to the 2012 PEFA, some donor agencies have indicated that they may start to open accounts at the Central Bank of Kenya, thereby reducing the amount of donor aid that is off budget.

The Constitution also established the Commission for Revenue Allocation (CRA). This is mandated to oversee the allocation of revenues between national and county governments, and to advise the legislature on issues related to revenue sharing.

The Constitution provides the basis for a more coherent PFM legal framework, but oversight remains contentious. For the first time in Kenya, there will be a single PFM legal framework for all levels of government. Even so, the Constitution leaves room for interpretation regarding the extent to which the national government has a role in “overseeing” county government’s finances.

The Constitution empowers parliament to subject the budget to discussion and scrutiny. The 2012 PFM Act makes provisions for reporting that will improve the amount of information that is made public. The Act also outlines a new budget calendar, with clear deadlines, and clarifies the roles and responsibilities of the actors, including parliamentary oversight functions and the establishment of a new accounting standards body. Moreover, the new requirement for the Ministry of Finance to report progress on the implementation of audit recommendations, as part of the draft budget submissions to parliament is a step towards ensuring greater

⁴ Following the Lima Declaration of Guidelines on Auditing Precepts (October 1977), Section 7, specifying the financial independence of supreme audit institutions.

⁵ G-PAY is an authorized Payment Service Provider registered as a System Operator with the Payment Association of South Africa.

accountability by the executive branch of government.

The Constitution guarantees the citizens' rights to access information held by government, but this needs to be made operational through an act of parliament.

Nevertheless, a number of reports are still not required to be shared, such as the Mid-Year Review of budget performance, and a simplified Citizens Budget. The law's provisions for some budget documents already contain a timeframe for publication, but a number of critical documents are not required to be released within a specific time. For example, the law mandates the production of Budget Estimates, new reports on state corporations, and a supplementary budget, but does not specify when these should be made public.

The Constitution reinforces aggregate fiscal discipline. The Constitution has established the Public Debt Management Office, with a view to instilling efficiency and reliability in debt management, including the establishment of reliable databases that enable the development of medium and long term perspectives on current transactions. These obligations stretch to the county governments, as they will also incur—and need to manage—their debts. Nevertheless, the design of the inter-governmental financing architecture is incomplete, and the share of debts to be transferred from local government authorities to the new counties, as well as the procedure for fiscal transfers, remains unclear.

The implementation of devolution under the Constitution means putting into place new institutions. Kenya's devolution brings with it several governance risks and challenges with regard to service delivery, in part due to the ambitious scale and

timetable mandated by the Constitution. Implementing Kenya's devolution is very challenging, because it entails transferring a significant amount of resources to counties. However, no comprehensive assessment of the PFM capacity of the new counties has been carried out.

POLICY RECOMMENDATIONS

There is need to conduct a PFM capacity assessment in the new counties as well as to provide assistance for their capacity development. The devolution of responsibilities to county assemblies results in a four-fold increase in the share of resources to be managed outside of the central administration. So given past experiences, where there has been poor management of devolved funds and poor resulting outcomes (as noted in several audit reports), there is need for an in-depth assessment of the PFM capacity of new counties to handle such funds. The government urgently needs to develop and roll out a long-term programmatic approach to systematically support capacity development in the counties. This may require phasing in the transfer of PFM and other functions to counties over time, following predefined capacity benchmarks.

Improving budget performance will require further reforms. While there is need to align performance targets between the budget, policy and performance contract processes, monitoring and evaluation of outcomes and outputs of the budget will need to be strengthened, especially at the sectoral level. This means focusing on a few key indicators, and better alignment of national and sectoral plans. In addition, further work will be required to embed program-based budgeting in the budget culture, which implies the need to sensitize and train budget officers and staff in MDAs.

Managing and sustaining the implementation of the re-engineered IFMIS to full completion and usage across national and county governments is a priority PFM requirement. The full implementation of IFMIS will enable the integration of planning, budgeting, accounting, financial reporting and the procurement functions of the government. IFMIS is being launched in ministries and counties, thus, it is important that its institutionalization takes center stage in the PFM reform strategy under preparation.

The establishment of the IFMIS Academy is an excellent step, considering the enormous need for training across the government. The implementation of IFMIS should receive the necessary political, technical and financial support, but it is also important to manage the costs of implementation and of dealing with multiple vendors and consultants. To get the maximum benefit from IFMIS, it is important that complementary PFM reforms, such as the adoption of IPSAS, are carried out by both central and county governments.

Given the introduction of sub-national administration who have the potential to borrowing, and the history of arrears in existing sub-national units, the monitoring and management of fiscal risks is a key new area of responsibility for the national treasury. Given the large number of extra budgetary entities that already exist, and the development of public private partnerships for new capital investment projects, the fiscal risk framework should be comprehensive, and include all risks. The extent of extra-budgetary entities needs to be rationalized, and financial reports and/or information made available to the public.

14. Improving transparency and accountability for service delivery

By Christopher Finch, Philip Jespersen and George Larbi

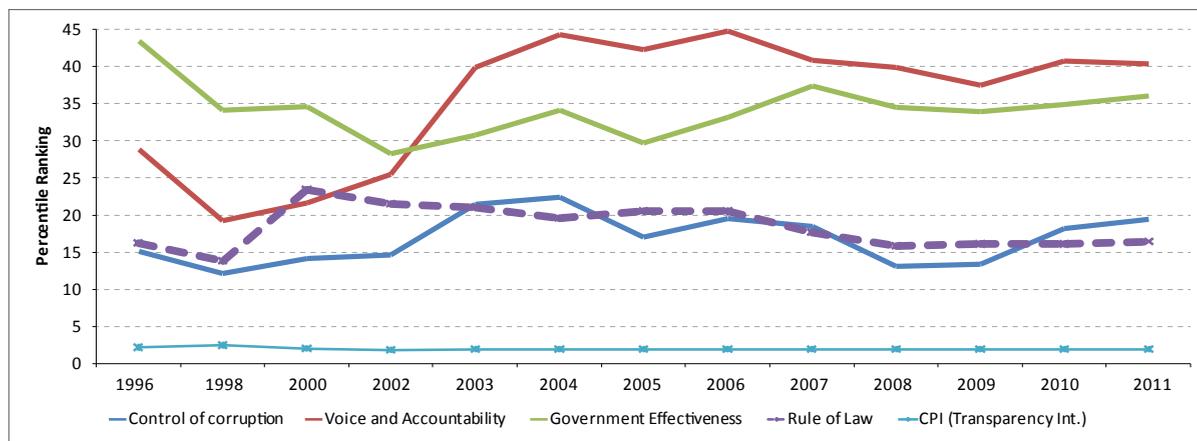
EXECUTIVE SUMMARY

Kenya's record on governance¹ is mixed and it has been identified as a key constraint to the private sector's investment and development. Compared to other countries in the region and beyond, Kenya does relatively well on voice, regulatory quality, revenue mobilization, quality of public administration, and macroeconomic and budgetary management. However, it does poorly on rule of law, accountability, and control of corruption. Figures 14.1 and 14.2 summarize Kenya's mixed performance on key governance indicators, since 1996. There are a number of positive and encouraging factors in the country's governance arena and fledgling democracy. These include, a strong and open media, a vibrant civil society, resourceful use of ICT to improve access to information and transparency (e.g. the Open Data Initiative), and revamped institutions of governance, such as parliament and the judiciary.

Improving governance would address one of the greatest constraints preventing Kenya from reaching its economic and social potential. Whereas the country matches or exceeds its peers in many development indicators, it recurrently underperforms when it comes to the quality of governance, and registers high levels of corruption when compared to other Sub-Saharan African countries and global averages. The country's performance has remained stagnant (see CPI in Figure 14.1). This not only constrains Kenya from reaching its economic and social potential, but it significantly increases the cost of doing business, and limits opportunities for job creation and improved service delivery to citizens.

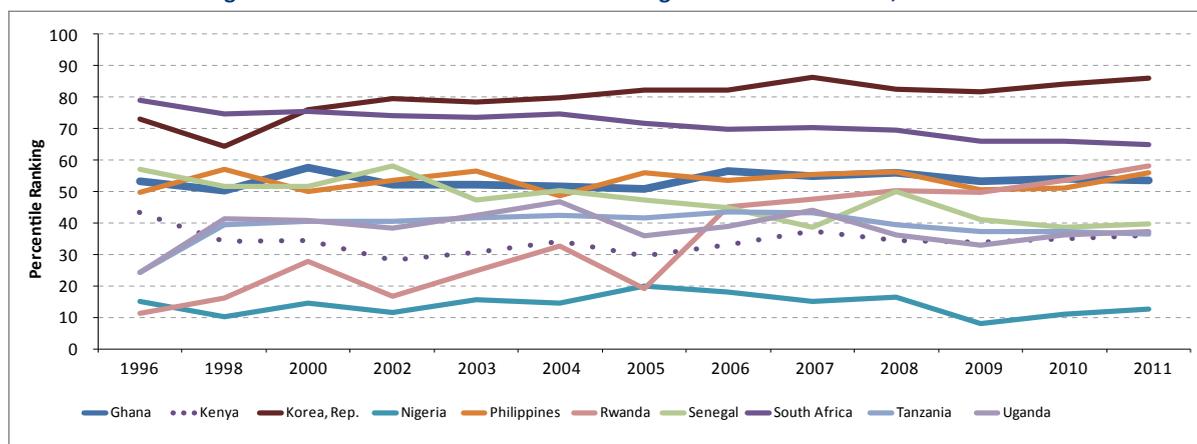
¹ World Bank, 2010. *Doing Business in Kenya 2010*. The World Bank Group.

Figure 14.1: Selected governance indicators for Kenya, 1996-2011



Note: Indicators range from 0 (lowest) to 100 (highest) Rank
 Source: World Bank, World Governance Indicators 2012

Figure 14.2: Government effectiveness ranking for selected countries, 1996-2011



Source: World Bank, World Governance Indicators 2012
 Note: Indicators range from 0 (lowest) to 100 (highest) Rank

The 2010 Constitution and its implementation provides a platform to address long-standing governance problems.

It offers hope for the consolidation of democracy, but also poses some challenges, especially in devolution and the sustainability of other institutional reforms. The success of Kenya’s devolution will largely depend on the quality of governance arrangements in the new counties. The EACC lacks the mandate to prosecute corruption cases, and this weakens its ability to confront corruption. But the enforcement of the Ethics and Integrity provision in Chapter Six of the Constitution should go a long way to complement the efforts to fight corruption and unethical behavior in the public service.

The incoming government can build on the foundation of the 2010 Constitution, and on the opportunities it provides to Kenyans in keeping up the momentum for reforms that advance governance. Three key areas of focus are:

- carefully plan and coordinate the implementation of devolution, by devoting adequate human and financial resources to manage the transition process to a devolved government, with priority being given to establishing sub-national systems and capacity building. This should safeguard accountability of both national and county governments to citizens, and lead to improved service delivery;

- reforms that enhance the capacity to address corruption, through *inter alia*— (i) amending the EACC law to enable the body to prosecute cases of corruption, and designating selected courts to indict corruption cases; and (ii) making emphasis on corruption-prevention methods, through engaging in public education on corruption, in the medium to long term; and,
- strengthen the use of ICT to provide public access to services and information, intra-government use of M&E information in policy-making, and planning and budgeting, in order to enhance transparency and accountability.

REVIEW OF PROGRESS AND TRENDS

Compared to other countries, Kenya scores lowest in the World Governance Indicator on government effectiveness, followed by Nigeria. (see Figure 14.2) Governance is often identified as a constraint to development and rapid growth in a country, which in turn translates into improvement in service delivery and livelihoods. Corruption is a symptom of weak governance systems, and is among the top constraints to investment by the private sector. Continuing fiduciary problems of ineligibility, fraud and corruption

in service delivery and community-driven development projects, (including donor and World-Bank financed projects), have been highlighted over the past two years, and have led to the suspension of three World Bank projects.

The latest Kenya Investment Climate Assessment from 2009 states that despite some improvements, Kenyan firms still face an adverse business environment in governance: 79 percent of the firms surveyed reported having paid bribes to get things done, and 38 percent identified corruption as a major constraint. Similarly, the latest Global Competitiveness Report for 2009/10 identifies corruption, infrastructure, tax rates, crime and theft, and inefficient government bureaucracy, as the most problematic factors for doing business in Kenya, hence, the cost increases.

Several factors explain Kenya's mixed track record in governance and corruption. First, poor performance tackling corruption is attributed to the fact that the institutions which have been charged to investigate and prosecute corruption-related crimes in Kenya have historically been weak, and open to political interference. There is weak law

Table 14.1: Selected governance indicators for Kenya and other countries

	GDP per capita (current US\$)	Voice and Accountability	Control of Corruption	Rule of Law
Ghana	1,570	62	63	54
Kenya	808	40	19	16
Korea, Rep.	22,424	69	70	81
Nigeria	1,502	27	9	10
Philippines	2,370	49	23	35
Rwanda	583	12	70	47
Senegal	1,119	39	31	40
South Africa	8,070	66	59	59
Tanzania	532	46	36	34
Uganda	487	30	20	44

Note: Indicators range from 0 (lowest) to 100 (highest) rank

enforcement and compliance, largely due to laxity from the enforcement agencies, particularly the police, the Department of Public Prosecutions and other regulatory and oversight agencies. For example, little progress has been made in prosecuting offenders and recovering assets acquired through corruption: in 2010/11 the EACC submitted 113 files to the Attorney General (AG), recommending prosecution. Although the AG accepted the EACC's recommendation, out of 95 cases, only 23 appear before the courts.

Second, although Kenya scores well in some national-level benchmarks of transparency, access to information at the local level is generally poor. Citizen's access to financial and other information, related to devolved funds and services is limited. The Public Expenditure Review, the Public Expenditure and Financial Assessment, government audits, and multiple civil society monitoring reports document how difficult it is for citizens to access reliable, timely and accessible information on funds and performance of local service delivery units. Kenya's Public Expenditure and Financial Accountability (PEFA) score on the availability of information on resources received by service delivery units is low (D). This is despite the strong and open media, and a vibrant civil society.

Third, a core challenge is lack of visible, comparable performance indicators across administrative units, service delivery facilities or sectors. For most facilities such as local authorities, although the government monitors performance on a number of metrics, the information is generally not made public, therefore compromising accountability and transparency. Even where rules for disclosure exist, they are not strictly enforced or applied. Several research and monitoring efforts, conducted by the government, civil society, and donors, indicate that information at the

local level funds and service delivery is not made available to citizens on a timely basis or in suitable formats, or through channels that the public can easily access. Where information is made available, it is rarely provided in formats that enable citizens to compare a selected facility's financing and performance with other comparators. Another contributing factor is that the public financial management system lacks the ability to disaggregate expenditures down to local facility levels. This coupled with lack of formal recourse mechanisms for citizens to voice their dissatisfaction with service delivery, creates major accountability gaps.

Kenya is becoming a global innovator in applying ICT to improve transparency. However, access to information by citizens through the Kenya Open Data Initiative and other initiatives, is yet to impact on the accountability of the government and its officials. Since 2000, the ICT sector has outperformed all other segments of the economy, growing at an average 20 percent annually. Kenya's ICT sector continues to expand phenomenally, attracting global attention, especially after the introduction of mobile money. Since then, Kenya has developed the largest mobile money platform in the world. It has positioned itself as a global ICT hub, attracting investors who wish to extend the domestic ICT revolution, as well as look into ways of replicating the knowledge in other developing countries. The rapid diffusion of mobile phones (9 out of 10 Kenyan owns a mobile phone), together with other socio-technical and grass-root innovations such as geo-mapping, provide the opportunity to further enhance transparency, accountability and public participation in governance.

The 2010 Constitution lays out a framework which enables Kenya to address long-standing governance challenges. These include strengthening transparency and

accountability, and tackling corruption. The Constitution provides a clear delineation of roles, and strong checks and balances between the three arms of the government. It strengthens the independence of the judiciary, improves public access to information, introduces new Bills of right, as well as an ambitious devolution program. It also outlines an open vetting process for key positions, and establishes the Office of the Ombudsman, and the Commission on the Administration of Justice. The Kenya Anti-Corruption Commission has been replaced with the EACC; and the Auditor General's capacity is improving, having recently achieved full coverage of audits for all central government ministries and departments.

The Constitution also specifies that ministers charged with fraud and corruption need to step aside—and several have done so in the past. However, high profile corrupt officials have rarely been jailed. A major constraint is that the Anti-Corruption Act 2011 does not empower the new commission to prosecute offenders. Just like its predecessor, the EACC does not have prosecutorial powers, and has to depend on the public prosecutor for the prosecution of corruption cases. The inherent risk of this arrangement is that it creates room for delays in prosecuting corruption cases, which often lead to loss of evidence, resulting in impunity of offenders. It is also worth noting that most high profile cases of corruption in Kenya have not been successfully prosecuted. In Hong Kong, some of the most successful anti-corruption bodies have the power to prosecute offenders (see Boxes 14.1 and 14.2).

Chapter Six of the 2010 Constitution on Leadership and Integrity clearly lays out the high ethical standards and guiding principles by which public office-holders must abide to. These include, *inter alia*, avoidance of conflict of interest, selection on the basis of

personal integrity, honesty in the execution of public duties, accountability to the public for decisions and actions taken, and financial probity of state officers (including restrictions on the maintenance of bank accounts outside the country). The key challenge for going forward will be to see the enforcement of these constitutional and related legal provisions, in order to ensure that public office-holders are held accountable.

Despite the opportunities presented by the 2010 Constitution to strengthen governance, many institutional challenges and vested interests remain. These challenges include Kenya's very ambitious devolution (see separate chapter); the need to strengthen bodies and systems for reporting and detecting corruption; ensuring successful prosecution of corruption offenders; and further strengthening systems to enable information disclosure and citizen recourse.

The success of Kenya's devolution will depend on the quality of governance arrangements in the counties. Implementing Kenya's devolution is challenging, because it entails transferring a substantial amount of power and resources to an entirely new—and hence untested—level of government. Drawing on Kenya's own extensive experience in managing decentralized funds (such as CDF and LATF) over the past fifteen years, the performance of devolved funds has often failed to meet expectations—with audits and citizens' monitoring revealing considerable waste and leakages.

Contributing factors include:

- lack of an overarching legal and regulatory framework for decentralized funds;
- weak institutional capacity;
- poor monitoring and evaluation systems; and,
- wide gap between transparency and citizen engagement.

Kenya is using ICT to boost government transparency and openness. The Open Data Initiative was launched in July 2011, and Kenya became one of the first developing countries to make government data freely available to the public, through a single online portal. In 2012, the government formally announced its intention to join the Open Government Partnership (OGP), and tabled an Action Plan at the OGP conference in Brazil. However,

Box 14.1: Hong Kong: lessons on anti-corruption reforms

The use of a three-pronged strategy

Corruption is a multifaceted phenomenon and it is systemic. To address this problem the Independent Commission Against Corruption (ICAC) developed a three-pronged strategy, reflected in its internal structure. The Operations Department carries out enforcement to discover and investigate corruption and prosecute the corrupt. The Community Relations Department implements education to inform the public of the role of the ICAC, spreads knowledge of anti-corruption laws, mobilizes the public to report corruption, and raises the moral costs of corrupt actions. The Corruption Prevention Department works on institutional design to reduce opportunities for corruption.

Enforcement

ICAC investigators had the power to make arrests without warrant for all offences described in available laws. They also had full powers of arrest without warrant for any other offence that may be detected during investigations. Therefore, the ICAC used its powers to consolidate its reputation with early well-publicized enforcement successes-catching and prosecuting “big tigers” and targeting syndicated corruption in the police force. Corrupt officials quickly revised expectations about corrupt pay-offs and changed their behaviors accordingly. In turn, ordinary citizens revised expectations about the volume and severity of corruption. In time, they no longer viewed corruption as routine.

Public Education

Enforcement was followed by a broad anti-corruption public education effort that reached out to the community in innovative ways: teaching the mass public the legal connotation of corruption, publicizing enforcement successes and thereby strengthening ICAC credibility, and advertising the ease with which corrupt acts can be reported. Education also included an effort, targeted at youth, to transform public morality.

Institutional Design

The ICAC studied the organization of work procedures in government and recommended specific measures to reduce incentives for corruption inherent in institutional design. It also vetted arrangements proposed in new legislation to consider their implications for corruption. Corruption prevention work was unique in concept at the time the ICAC was established:

- (a) A standard practice was developed for “conventional studies” of design flaws in the organization of work in government departments.
- (b) Corruption prevention analysts returned to the client department after a short time to monitor implementation and assess effectiveness. At the same time, they checked that the changes had not produced new opportunities for corruption.
- (c) Corruption prevention analysts offered external training in corruption prevention, organizing sessions in government departments.
- (d) Consultation at the stage of policy formulation or legislative drafting. Under this arrangement, the government department that originates legislation seeks the advice of the Corruption Prevention Department so that analysts there can advise, especially on whether there has been an adequate assessment of enforcement capability in terms of resources in the agencies responsible for implementing the proposed legislation. This work aims to pre-empt the creation of corruption opportunities.

Source: The Chilla Review, Vol. 4, No.2 (Fall 2004), 81-97

Box 14.2: A participatory approach to anti-corruption reforms, lessons from South Africa

Broad Based Partnerships

It was realized early that the public service could not succeed in the battle against corruption on its own, and a broad based partnerships needed to be developed in order to provide the necessary assistance and capacity to fight corruption. Strong components of such partnership were the business sector and civil society.

Popularizing the Act

This was done by simplifying it through a guide both in terms of language and through the use of illustrations. The National Anti-Corruption Forum (NACF) believed that by publishing a reader-friendly guide, it has contributed in a small way towards bringing legislation closer to the people.

Feasibility of establishing a common database of corrupt persons and businesses for use by all sectors

The challenges in establishing such a database were deliberated on during a roundtable on the Prohibition of Corrupt Persons and Businesses. It was agreed that a committee of specialists should, emanating from the roundtable, meet to discuss and recommend an appropriate course of action for the NACF. The meeting was attended by all sectors, as well as academics and other interested players.

The much smaller Implementation Committee has facilitated quicker communication

The existence of the much smaller Implementation Committee, which consists of only one representative per sector, has facilitated quicker communication and provides necessary oversight over the projects. Furthermore, individuals have been nominated to serve on cross-sectoral task teams to implement specific projects.

The lack of accountability structures had a definite impact on the inactivity of the forum

Internal accountability in the non-governmental sectors has improved significantly during the evolution of the forum, but it seems that this accountability stems more from a committed group of peers, rather than from constituencies.

The National Anti-Corruption Programme (NAP): A programme of action

The partnership of civil society, the public and business sector was further consolidated through the development of NAP. The NAP was adopted as a two-year programme and it serves as an important barometer against which the public can hold stakeholders accountable. Government showed its commitment towards the implementation of the projects of NAP by making funds available. Since the development of NAP the pace of the NACF's activities has noticeably accelerated.

Source: Case study on the South African National Anti-Corruption Forum

both initiatives are potentially fragile, and will require further support to sustain them. Similarly, access to survey data is limited due to lack of up to date information that is available for downloading, and a convoluted and cumbersome data dissemination policy at the Kenya National Bureau of Statistics (KNBS). These factors have increasingly reduced user access to the required data. Strengthening and solidifying these governance gains will require policy and institutional reforms to be put into place, such as Access to Information

Law, and an institutional context for Open Data.

An increasing focus on results, in monitoring and evaluation systems, and performance information, provides opportunities for better-informed decision-making and accountability. Since 2003, a culture of Managing for Development Results (MfDR) emerged in Kenya following the introduction of the National Integrated Monitoring and Evaluation System (NIMES). Among notable

achievements are the development of a national indicator handbook that covers key sectors in the economy, the production of the Annual Progress Report (APR), and the comprehensive 2009 Census report.

A draft M&E Policy submitted in 2012 for Cabinet’s approval will provide a much improved basis for strengthening M&E across the government if implemented; and a national project database, e-ProMIS is designed to offer citizens, managers and decision-makers with an integrated platform to monitor government project implementation—nationally, across sectors, and at decentralized levels. However, entering project data into e-ProMIS has been remarkably slow. These M&E tools and the data generated from them, can enhance transparency and enable citizens to hold their governments and service providers accountable for results. However, the will and the capacity to use such information, to hold officials accountable, is still weak and yet to evolve to its full potential.

ONGOING REFORMS: THE 2010 CONSTITUTION AND ITS IMPLICATIONS FOR GOVERNANCE AND ANTI-CORRUPTION

The 2010 Constitution strengthens the independence of the judiciary, which in the past was ranked as one of the most corrupt institutions in Kenya. Initial judicial reforms include:

- (i) the appointment of the Chief Justice and new judges, through an open and transparent process, and the establishment of a Judicial Service Commission for the appointment, promotion and disciplining of judges;
- (ii) vetting of existing judges and magistrates, who were in office before the new Constitution came into effect. Already judges found wanting by the vetting

processes have been asked to leave the service;

- (iii) charging the budget of the judiciary on the consolidated fund, to provide some level of financial independence from the executive; and
- (iv) the establishment of a Supreme Court as the highest court.

The new leadership of the judiciary has been demonstrating its commitment to reforms. Notably, by the actions already taken, including the launch of the Judiciary Transformation Framework and increased public confidence in the judiciary.

The oversight role of the executive by parliament is enhanced and expanded under the 2010 Constitution, potentially reducing opportunities for abuse by the executive, as had been characterized by previous administrations. Parliament no longer merely rubber-stamps budgets submitted by the executive, instead, it subjects them to discussion and scrutiny. The Parliamentary Budget Committee and the Public Accounts Committee are fully and legally entrenched in the budget process, and are supported by a professionally staffed Parliamentary Budget Office.

The 2010 Constitution guarantees the citizens’ right to accessing information, but this needs to be translated into legislation. The government is in the process of drafting a Freedom of Information Law. Although there is no constitutional deadline for such legislation, stakeholders agree that it should be enacted before the 2013 national and county elections. The draft bill meets most of the criteria for an effective law of this kind, scoring 114 out of a maximum 150 on the Right to Information legislation rating methodology, which—if passed in its current form—will see Kenya taking the 10th position

as the country with most progressive law in the world. The draft bill makes provision for continuous proactive disclosure of information held by all government ministries, departments and agencies, and greatly reduces the scope of secrecy laws. At the same time, the government is drafting a Data Protection Law to ensure that privacy laws do not contradict or infringe on Access to Information Laws.

Significant progress is being made in PFM reforms, which will enhance transparency, accountability and participation. First, the PFM Act 2012 makes provisions to enhance transparency, accountability and participation in the management of public finances. Second, and as noted above, under the 2010 Constitution and in the PFM Act, the oversight role of parliament over the national finances is enhanced through the Budget Committee, which has the powers to review budget policy statements, budget estimates, and compliance with the fiscal responsibility provisions in the Act. The PFM Act and the Constitution require that public finances are managed transparently and accountably, at both national and county levels; and public officers are accountable to the public for the management of public finances through parliament and County Assemblies. Therefore, the PFM Act in particular and the Constitution in general, provide an overall legal framework for accountability and transparency, in the management of public resources (see separate chapter on PFM).

The PFM Act also provides for the establishment of an Intergovernmental Budget and Economic Council, which provides a forum for consultation and cooperation between national government, counties and other stakeholders, on issues such as the budget policy statement and the recommendations of the Commission for Revenue Allocation. The implementation of

these legal provisions in the PFM Act will need to be carefully monitored and supported. This is both from the perspective of whether it is achieving its objectives (i.e. increased control of resources at the local level; more efficient service delivery; and increased equity), and to monitor the quality and consequence of spending by counties. The Treasury will need to set up a unit to manage disbursements, and oversee conditional grants (if they are used), and monitor counties' PFM compliance and performance in terms of results.

The implementation of devolution under the 2010 Constitution requires several new legal reforms and regulations, in order to create an enabling environment for anti-corruption efforts. As previously noted, the EACC has been established with the mandate to investigate corruption cases. The Commission has been involved in investigation and asset tracing, and as a result, approximately KES 3.8 billion of losses have been averted during the 2010/11 fiscal year. The recovery of illegally acquired public and otherwise unexplained assets has been witnessed, thus leading to corruption prevention.

Despite many advantages of devolution, with it are inherent risks of increased corruption, especially at the sub-national level. County Governors will have significant authority, which could be abused. However, devolution presents opportunities for reducing corruption in service delivery, provided that there is sustained focus on introducing and managing accountability mechanisms. A strong legal framework is important, but building effective participation and accountability mechanisms, require substantial capacity at both national and sub-national levels.

Capacity building will be required at the national level to develop systems (e.g. for soliciting citizens' feedback and registering

complaints), and at the local level to implement them (e.g. transforming complex financial information into formats that are accessible by citizens). This is an important component of long-term capacity building to support effective devolved government. It is important that these long-term goals are not overlooked in the preoccupation, with the immediate and urgent concerns that will inevitably accompany the early transition period.

Building a strong culture of Managing for Development Results at county level is important, both for the continuity of service delivery during the transition as well as for ensuring value for money. Monitoring and Evaluation (M&E) capacity at decentralized levels has improved in recent years, including the quality of the District M&E reports, which are received by the Ministry of Planning on a yearly basis. But there must be further progress in moving from output to outcome measures.

Clear guidelines need to be laid out for both statistics and M&E at county level, including linking county results to planning and budgeting. This needs to be complemented by the development of capacity for evidence-based decision-making, based on a comprehensive assessment of present capability, county-by-county. Improving access to information at the decentralized level, involving civil organizations in providing feedback on the quality of service provision, will be essential to ensuring value-for-money—both in the planning and implementation stages.

POLICY RECOMMENDATIONS

Devote additional human and financial resources to manage Kenya’s transition to a devolved government, with priority being given to the establishment of sub-national

systems that will ensure accountability between national and county governments, service providers and citizens. Priority actions on devolution include:

- effective co-ordination structures for devolution by key players (e.g. the Transitional Authority, the Commission for Revenue Allocation, ministries of Local Government and Finance). This is critical to avoid overlaps, turf wars and building of synergies;
- develop national standards and processes to support the framework for sub-national accountability (e.g. transition arrangements, intra-governmental co-ordination, civil service restructuring, and rules for transparency and accountability), including a system to benchmark and monitor county development outcomes and performance;
- enhance voice and inclusion in Kenya’s counties, through mechanisms that build transparency and accountability between citizens, service providers and the government at the national, county, and sub-county levels, for example, inclusion of measures and indicators of citizens’ satisfaction with devolved service delivery in the county performance measuring system;
- build service delivery capacity of stakeholders (government, providers and CSOs), to manage decentralized funds, transparently and accountably;
- encourage leaders at both local and national levels to be committed and to set examples through the promotion of high-standard service delivery and ethical behavior that are conducive to the development of the economy and the eradication of poverty; and,
- develop short, medium and long term county capacity building programs with the Kenya School of Government.

Enhance the capacity to address corruption through:

- amending EACC laws to enable the body to prosecute cases of corruption, and designating selected courts to try cases of corruption. The inability of EACC to prosecute corruption cases is a major constraint, which partly explains the delays in prosecuting corruption cases;
- in the medium to long term, the government is advised to put emphasis on strengthening corruption-prevention systems and public education on the subject. In reviewing the strategy, emphasis should be placed on strengthening systems to prevent, or perhaps more realistically, to minimize opportunities for corruption in the public sector; and
- EACC's ongoing corruption perception surveys for public institutions and sectors, and publishing the information for citizens on a regular basis.

Strengthen public access to information and intra-government use of M&E information in policy-making, planning and budgeting, and enhance transparency and accountability. This includes:

- accelerating reforms to institutionalize access to information, e.g. through Open Data;
- passing the Access to Information Bill;
- putting into place the rules and intra-government linkages required to sustain and expand available data;
- engaging the ICT community, academia, media and think-tanks to unpack and disseminate analysis behind the data; and
- encouraging the uptake of these skills and tools in public service delivery.

15. Judicial reforms: A journey of turmoil and opportunities

By Nightingale Rukuba-Ngaiza and Stephen Mukaindo

“We found an institution so frail in its structures; so thin on resources; so low on its confidence; so deficient in integrity; so weak in its public support that to have expected it to deliver justice was to be wildly optimistic. We found a judiciary that was designed to fail ...” (Chief Justice Mutunga, “The First Hundred and Twenty Days” speech, October 19, 2011).

A TURMOUS HISTORY AND A WINDOW OF GREAT OPPORTUNITY

Kenya’s long term political, social and economic development cannot be attained or sustained unless the rule of law is pursued as a central theme, and is grounded on an independent and robust judiciary.

The rule of law supports transparent and accountable government, and protects the freedom, liberty and security of citizens. It ensures fair and timely resolution of disputes, and the effective enforcement of contractual and property rights; vital for social stability and for attracting foreign and domestic investment. An efficient and independent judiciary is essential to the rule of law¹; it helps to ensure respect and adherence to the law. It also plays an invaluable role in promoting a country’s governance and development efforts. The 2010 Constitution, for example, reaffirmed the judiciary’s significant role for Kenya, i.e. to interpret and to enforce governance, public finance (including equitable sharing of national resources), devolution, and the bill of rights.

However, a favourable private sector and development environment requires much more than the presence of an effective judiciary. Other legal and justice institutions—

¹ The political pillar of the country’s Vision 2030 strategy aims at realizing a democratic political system based on the respect of the rule of law.

such as, the Attorney General’s office, the National Police Service, the Director of Public Prosecutions, the Kenya Prison Service, and associated public bodies—must also possess the will and the institutional capacity to play their own roles effectively. Inescapably, the efficacy of these institutions affects the judiciary’s own performance and the overall state of rule of law in the country.

The justice sector was neglected and underfunded for many years, undermining the capabilities of legal and justice institutions, the rule of law and the country’s development, including its peace prospects. Consequently, Kenya’s ranking in adherence to the rule of law, good governance, ease of doing business, and as an investment destination is low compared to neighboring countries (Figure 15.1). Moreover, the 2008 post-election violence which set back the country’s GDP growth rate—from 7 percent in 2007 to 1.6 percent in 2008—was largely attributed to the fragility of the legal and justice institutions in the country.

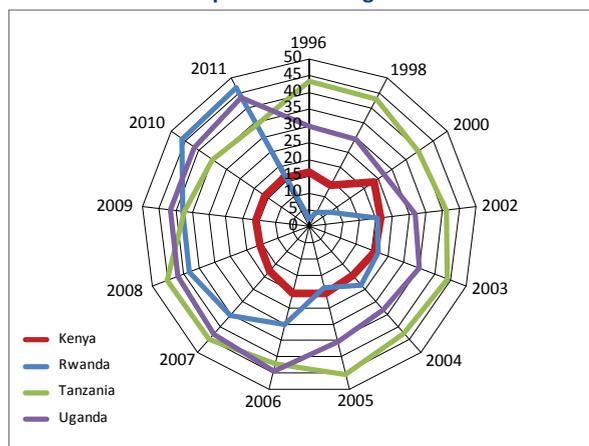
“... the Constitution has created opportunities for transforming judicial services in Kenya. It has given the judiciary the institutional and financial freedom to pursue this goal, and to extend its reach throughout the country”

The challenges facing Kenya’s judiciary are traceable to the country’s post-independence political history. The years following independence saw the dismantling of checks and balances, in favor of an all powerful executive. The executive held the power to appoint judicial officers and to determine the judicial budget. The judiciary, in effect, became an instrument of the executive. Ironically, the judiciary’s own management style—under highly centralized and powerful control—looked extremely similar to the executive’s. Executive actions, therefore, went largely unchecked and the end result was a disempowered judiciary, lacking the independence, integrity and institutional capacity to deliver on its mandate. Public trust and confidence in the judiciary waned, and impunity took hold in the country.

At least twenty judiciary reviews were conducted over the last two decades to assess the problems and offer solutions. Some of their recommendations were implemented in varying degrees, but the fundamental ones related to the judiciary’s independence and its institutional structure were finally taken up by the 2010 Constitution. This marked the start of significant institutional and managerial changes in the judiciary—listed in Box 15.1—that support the possibilities of even more reforms.

Basically, the Constitution has created opportunities for transforming judicial services in Kenya. It has given the judiciary the institutional and financial freedom to pursue this goal, and to extend its reach throughout the country. In addition, it has made it possible for the institution to help

Figure 15.1: Kenya ranks lowest in rule of law compared to its neighbors



Source: Worldwide Governance Indicators (WGI), 2011
 Note: Ranges from 0 (lowest) to 100 (highest)

Box 15.1: Major changes heralded by the Constitution for the Judiciary

- (a) appointments of the Chief Justice, Deputy Chief Justice and Chief Registrar;
- (b) establishment of a Supreme Court to address fundamental legal and policy issues (e.g. constitution interpretation, elections, etc.) and develop indigenous jurisprudence;
- (c) establishment of an expanded Judicial Service Commission with more representation from the public;
- (d) establishment of specialized courts—the Land and Environment Court and the Industrial Court—to expedite administration of justice;
- (e) establishment of the Judiciary Fund to give the judiciary financial autonomy from the executive government;
- (f) establishment of a National Council on the Administration of Justice to coordinate reforms across all institutions in the Justice sector; and
- (g) enactment of the vetting of judges and magistrates.

improve the country's development and governance efforts—including its vision for a Middle-Income status—through an expanded and enhanced judicial service.

REFORM OBSTACLES: THE PURSUIT TO OVERCOME THEM

Kenya is at the beginning of a momentous judicial reform program, articulated in the Judiciary Transformation Framework (JTF), 2012-2016. The process is beginning to show some promise following several early accomplishments, such as the open and transparent recruitments for judicial officers; a vetting process to remove judicial officers found unsuitable; large scale recruitment to meet the needs of a greatly expanded judiciary; and a program that is actively strengthening public participation. These unfolding events are improving public support for an institution that suffered from low public trust and confidence, and perceived as corrupt and weak.

Public opinion polls show that satisfaction with the judiciary has risen; from a low 31 percent in 2008 to double, 67 percent, in April 2012². The more recent September 2012 Infotrak Harris opinion poll indicates that 84 percent of Kenyans trust Kenyan

courts, 77 percent prefer using courts to resolve their disputes, and 70 percent have confidence in the Chief Justice and other newly appointed judges for many reasons (see Figure 15.2). Nonetheless, if this turn-around is to be maintained and deepened, it still has to tackle many of the difficult and deep-rooted obstacles that continue to bedevil meaningful reform. Some of these are discussed below.

(i) Management system issues

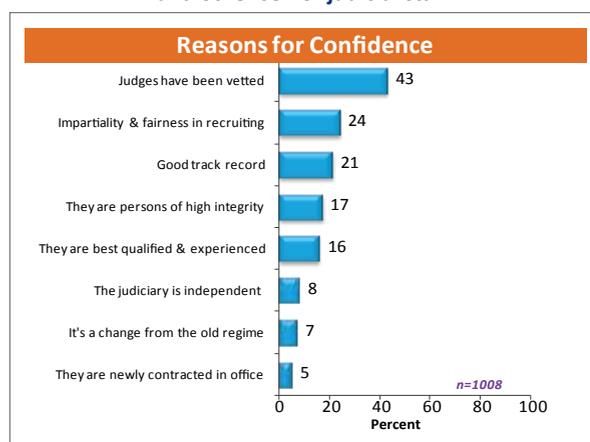
Despite separation from the civil service in 1995, the judiciary never established effective management systems. The Judicial Service Commission remained dysfunctional, court stations outside Nairobi lacked autonomy, and administration was centralized featuring 16 cumbersome committees made up largely of judicial officers (and taking them away from their core judicial duties). In addition, a 2007 forensic audit revealed serious leakages in financial management leading to a loss of hundreds of millions of shillings.

Improvements have since been made in management systems and controls, but more still remains to be done. Notably, in 2012 the judiciary established five registrars and

“...if this turn-around is to be maintained and deepened, it still has to tackle many of the difficult and deep-rooted obstacles that continue to bedevil meaningful reform”

²The Kenya National Dialogue and Reconciliation Monitoring Project: Reforms and Preparedness for Elections, Review Report (May 2012), page 30.

Figure 15.2: Why Kenyans have confidence in the new CJ and other senior judicial staff



Source: Infotrak Research and Consulting, *Judiciary Perception Survey, September 2013*

seven directorates³ to lead and to strengthen the institution's management structures, including monitoring and evaluating judicial services and the JTF's results indicators. In addition, an independent, private sector fiduciary agency is expected to shortly join the judiciary for a limited period to help implement the World Bank-financed Judiciary Performance Improvement Project (JPIP). The firm will help to manage and to strengthen financial and procurement systems, including building the capacities of judiciary staff.

(ii) Staff issues

Severe under staffing made it impossible for the judiciary to deliver on its mandate.

By 2011, the organization was running on only 47 percent of its staff requirement. The justice to population ratio was one judge for every 500,000 people and one magistrate for every 90,000 people.⁴ This translates to only one judicial officer for every 245,000 Kenyans, in comparison to 2.39 for every 100,000 Tanzanians, 3.83 in South Africa and 3.5 in United Kingdom. Poor terms and conditions of service worsened the situation, characterized by a demoralized staff, frequent staff departures, and scarce pay rises and

promotions. Since 2011, the judiciary has embarked on a vigorous recruitment program that has seen the entry of 251 new senior staff comprising judges, magistrates, kadhis, registrars, legal researchers, and directors, including a better gender balance. Moreover, terms and conditions of service are being improved.

A 2003 internal report implicated several judges, magistrates and paralegals in corruption, and the majority were dismissed or opted to retire.

Since then the judiciary has established a Code of Conduct and an Office of the Ombudsperson to receive and to respond to complaints from staff and the public. It has also set up a Judicial Service Commission Standing Committee to handle disciplinary cases. A Governance and Anti-Corruption Strategy is also under development. Perhaps the most significant mechanism to address judicial corruption and integrity has been the vetting of judges and magistrates. However, stakeholders' involvement in promoting oversight, transparency and accountability, as envisaged in the JTF, will also be very powerful. Some progress has been made (see the Participation Issues section below), but more needs to be done to help build and sustain such public engagement.

Weak staff capacities, along with a poor performance and accountability culture, has frustrated reform efforts for decades.

In a bid to reverse this, the judiciary has established human resources and performance management directorates led by high level, experienced professional. The Judicial Training Institute is also being revamped to help it respond better to the severe capacity building requirements, including the expanding workforce. Change management efforts—to help transition personnel to the judiciary's new vision, performance culture,

³ Directorates of human resources; performance management; information and communications technology; financial management; public affairs and communication; and supply chain management and others.

⁴ Chief of Justice speech, *State of Judiciary, October 19, 2012*.

structure, and processes—are also underway. Furthermore, there are plans to conduct an organizational review, to implement an Integrated Performance Management and Accountability System⁵, to conduct regular court users’ satisfaction surveys, and to institutionalize Court Users Committees, among other measures that are intended to improve performance and accountability. In the meantime, court stations have seen the introduction of Customer Care desks to help improve service, and Leadership and Management Committees to help oversee the transformation process and the day-to-day running of courts.

“Change management efforts— to help transition personnel to the judiciary’s new vision, performance culture, structure and processes—are also underway”

(iii) Funding issues

The judiciary has for many years been grossly underfunded. In 2007/08 the institution received 0.3 percent of the national budget percent (at the same time parliament received 1.3 percent) compared to an international benchmark of 2.5 percent for judiciaries. The allocation, however, rose sharply following the establishment of the Judiciary Fund from KES 3.9 billion in 2011/12 to KES 15.9 billion in 2012/13. This is equivalent now to 1.3 percent of the budget, but is still below the international benchmark. To help finance the JTF’s performance improvement goals, the judiciary received US\$ 120 million for the JPIP from the World Bank (October 2012) and, more recently, from the Netherlands (June 2013, US\$22,965,000) as part of a United Nations Development Programme managed basket fund.

(iv) Access to justice issues

One of biggest problems for the judiciary is case delays and backlog, brought about by a multitude of circumstances. These include

the use of manual operations; deliberate case delays by litigants; inflexible rules of procedure; under staffing; over-stretched judges and magistrates⁶; and weak staff accountability and performance management issues such as corruption, poor work ethics and sudden, disruptive and punitive transfers.

The judiciary is fighting this out on all fronts. It has revised the procedural rules to allow judicial officers more control of

the trial process; culled inactive cases; hired more staff; is gradually freeing judicial staff from administrative duties; and is managing transfers better (including a transfer policy under development). In addition, cases of great public interest—such as the Electoral and Administrative Boundaries cases and the election date—were fast tracked which “had the effect of stabilizing the political environment ...”, The State of Judiciary 2011–2012 Report, October 2012. Between July 2011 and June 2012 there were 428,827 new court cases lodged, 421,134 concluded, 802,570 pending, and a rate of disposal of about 1,685 cases concluded each day⁷.

In addition, the judiciary has instigated a number of interesting ICT innovations capable of several outcomes. For example, they could save costs, increase efficiencies, and enhance transparency, as well as reduce case delays, and the opportunities for corruption. The emerging innovations include the telephone short code number, 5834, for lodging complaints with the Office of the Ombudsman, and the mobile phone transfer payment system, *Faini Chap Chap*, for traffic fines which is to be rolled out throughout the country. In addition, the judiciary is assessing the possibility of using credit/debit cards for other money collections, and is piloting

⁵ This system will modernize and operationalize performance management and accountability. It will establish performance factors, criteria and scoring guidance; performance agreements at unit and individual levels; and links between performance and reward mechanisms.

⁶ Since they also have administrative responsibilities, e.g. procurement, supervising construction, etc.

⁷ State of Judiciary 2011–2012 Report, October 2012.

case management systems, an audio-visual recording system and a Court Fees Calculator. The latter “will be available online and is expected to eliminate opportunities for corruption, obviate the need for advocates and litigants to visit the courts, and reduce congestion in the registries”⁸.

Plans are also underway to link all the high courts, the magistrates’ courts in Nairobi and the Judiciary Training Institute to a single network. JPIP will also be automating 68 courts under a case management information system that aids systemization and allows case processing and court procedure information to be more transparent to users, improving accountability. The system will offer audio/visual recording of court proceedings, electronic case tracking and management, an Integrated justice information portal, electronic display of case listings, SMS notifications of court case events, video conferencing facilities for courts, versatile reporting tools/business intelligence, a sentencing information system and other legal knowledge processing databases for the use of magistrates and judges.

Many other issues such as the cost of litigation, lack of legal information, ignorance of the law, complex court procedures, and the absence of Alternative Dispute Resolution mechanisms limit access to justice. Access is particularly unreachable for the vulnerable and marginalized. In this regard, a pauper brief system for indigent capital offence offenders and a national legal aid scheme piloted under the Ministry of Justice and the National Cohesion and Constitutional Affairs are in place to help provide legal aid. However, they remain challenged by inadequate funding (e.g. to attract experienced, high paid lawyers) and are yet to be mainstreamed into the country’s legal practice.

The judiciary is also seeking to establish a small claims court as a means of increasing and diversifying access to justice. This is awaiting parliamentary review and approval. The customer care desks and plans to have court counsels in every court (to assist court users understand court processes) should help to improve lack of information and ignorance of the law. At the same time, various court procedures are being simplified by the judiciary through the Rules Committee and a sentencing and bail handbook for judicial officers, led by the Judicial Training Institute, is under development. In addition, the judiciary is promoting use of Alternative Dispute Resolution mechanisms—such as a court-annexed mediation program and traditional dispute resolution mechanisms—but these are still in early development and consultation stages.

Access to legal information has tremendously improved, led by the National Council for Law Reporting. Laws of Kenya are now available online free-of-charge, and decisions made by superior courts are reported regularly and are available online. Electronic newsletters are published monthly to draw attention to recent laws and judicial decisions of significance. A data base of Gazette Notices since 1896 and up-to-date access to the Parliamentary Hansard have also been established. Although access to information has visibly improved, it is not yet adequate. It still needs to be expanded, and its quality, accuracy and targeting enhanced.

The nonexistence of nearby courts, as well as the dilapidated—sometimes condemned—state of many of those that do exist relentlessly cuts back access to justice. There are no courts in 43 percent of the existing districts, and only 83 out of the 146 districts have at least one court. The travel costs alone prohibit many Kenyans from pursuing justice. In addition, the large

⁸ Chief of Justice speech, *State of Judiciary*, October 19, 2012.

number of the cases handled by urban courts present inefficient, unsafe and unsanitary conditions due to constricted spaces, too few magistrates and numerous litigants and their lawyers.



Snakes, termites and hedgehogs infested the Machakos Law Court's archives and records before a recent rehabilitation

The judiciary aims to have a high court in every county (47) and a magistrate court in each district (285). As at June 2011 there were 16 high court stations and 111 magistrate courts in the country. By October 2012, the judiciary had built an additional four high courts with 13 in the pipeline for construction (leaving a shortfall of 14 courts). Two new magistrate courts have also been opened and two others are scheduled for construction and 30 for rehabilitation⁹ (leaving a shortfall of 142 courts). In the meantime, 11 prefabricated courts (30 more planned) are being built to provide operational capacities and reduce construction and rehabilitation delays. Furthermore, mobile courts have been launched to enhance access in underserved areas in the Rift Valley, Nyanza, North Eastern, Western, Coast, and Eastern regions.

“Meaningful reforms need to occur likewise in the other justice sector bodies to help maximize judicial reform outcomes”

Cost effective and uniform-space planning and design standards have been lacking for Kenyan court buildings. Court building typically aspire to meet some level of functionality, accessibility, safety, health, comfort, efficacy, and environmental friendliness, among other considerations. In February 2012, the judiciary launched a nationwide campaign to collect public ideas on a prototype court design. Entries were evaluated on creativity, functionality, form and strength of design concept, quality of sustainable ideas, durability, internal comfort, green ideas, and the impact the proposal will have on accessibility and transparency of the judiciary. The results of this initiative led to the development of construction guidelines, including meeting public concerns (see Box 15.2) such as on having separate washrooms and cells for men and women.

The quality of past judicial decisions has been concerning. Some judicial officers have issued decisions that were not in line with local realities, public expectations or established precedent. They have been criticized for unreasoned judgments which makes development of jurisprudence difficult and the appeal process more tenuous. In a number of cases, litigants have felt that judicial outcomes did not reflect standards of fairness. Going forward, judicial officers will find it increasingly difficult to issue sub-standard decisions. The increasing legal information, the stronger Judicial Training Institute, a growing vigilant media and the newly defined avenues for lodging complaints is tightening the reins.

⁹ Of the 13 high courts due for construction, ten are JPIP funded and three are GOK. The two constructions and 30 rehabilitations for magistrate courts in the pipeline are JPIP funded.

Box 15.2: Court facility problems identified by court users in interviews, 2009

- (a) Inadequate security, including the absence of separated internal circulation routes for judges, the public, and defendants in remand.
- (b) Lack of basic public amenities, such as wash rooms, waiting rooms or space for reviewing documents and for consultations.
- (c) Inadequate space for remanded defendants, including lack of separate facilities for females, males, and juveniles.
- (d) Great distances and travel times to courts.
- (e) Courtrooms of inadequate numbers and size.
- (f) General building deterioration and structural problems affecting functionality, health, and safety.
- (g) Lack of space for important court functions, e.g. storage of evidence and records, libraries, help desks, court-annexed mediation, small claims courts, etc.
- (h) The absence of non-threatening rooms from which children can “appear” in courtrooms.
- (i) Lack of barrier-free accessibility for the handicapped, including features that support sight, mobility, and hearing impairments.
- (j) Buildings that are unable to support the installation of modern sound recording and automated equipment.

(v) Participation issues – government, stakeholders, the public and partners

Adequate Inter-agency coordination, including public participation remains challenging. The JTF aims to strengthen the capacities, collaboration and participation of stakeholders and the public through the Judicial Service Commission, the National Council on the Administration of Justice, the National Council of Law Reporting of Kenya, and the Court Users Committees¹⁰. This program is still in early stages. In the mean time, other public participation initiatives—such as the public education and information programs, court service surveys, media outreach, citizens’ open days, etc.—are also in progress.

The slower reform pace of other justice institutions is holding back the country’s rule of law and the judiciary’s performance. Meaningful reforms need to occur likewise in the other justice sector bodies to help maximize judicial reform outcomes and the judiciary’s performance. The unequal reform pace blocks the promise of better

sector performance. Because the judiciary, for example, has more magistrates than the office of the Director of Public Prosecution’s prosecutors, two or three magistrates are now forced to constitute courts in turns so as to be served by one prosecutor.

The Governance, Justice, Law and Order Sector (GJLOS) reform program, 2003–2009, helped the sector to address many challenges. For instance, more than 36 policies, laws, regulations and strategies were developed. Sector players, such as the police, prisons, office of the Director of Public Prosecution, the Judiciary, the Anti-Corruption Commission, Public Complaints Office (Ombudsman), the Kenya Anti-Corruption Campaign Steering Committee, and others received valuable office equipment, infrastructure, and capacity building support. GJLOS also helped to promote inter-agency dialogue and collaboration, and raised the sector’s visibility at the national level. Nevertheless, much more still needs to be done at the national coordination level to help accelerate and deepen sector reforms.

¹⁰ These forums are represented by partners and stakeholders of court services such as the police, NGOs, lawyers and the general public.

AREAS THAT NEED CLOSE ATTENTION AND SUPPORT

Incoming policymakers need to continue and deepen ongoing judicial reforms. The change in leadership and culture at the judiciary and the reforms initiated so far, give hope to many Kenyans that significant improvements in judicial performance are achievable. It will be critical for the judiciary to show tangible results in the short-to-medium term, especially in reducing case delays, in professionalizing case management, and in issuing well-reasoned judgments so that reform momentum builds, rather than dissipates.

It will also be important to keep a close watch on those areas that could deteriorate and potentially sabotage or even erode success if not properly managed. Some of these vulnerable areas are discussed below with a list that serves two purposes: (i) as a useful monitoring watch list for the judiciary and its partners on critical, but fragile reform points, and (ii) to help the government, parliament, stakeholders and partners identify areas where they could be of help to the judiciary, especially by giving much more support, e.g. in accelerating alternative access to justice solutions, in providing stronger participation and involvement, etc.

(i) Staff

(a) **A still uncertain organization and performance orientated culture.** The current leadership of the judiciary has the vision and the drive to champion the required reforms, but this vision and passion needs to be translated and embraced much more widely by everyone in the judiciary, down to the lowest level. The change management efforts are already a major priority for the JTF, but are still at an early vulnerable stage.

(b) **The importance of an effective staff capacity building program cannot be underestimated.** The reorganization of the judiciary has seen an unprecedented clear demarcation between the judicial and the administrative functions. Focus must shift now to strengthening the capacities of staff so that they can deliver effectively on their mandates, including on the ambitious program envisaged by JTF. The capacity program must be strong and responsive enough to meet the wide range of training needed by different types (e.g. judicial, managerial, technical or administrative skills) and the various levels of staff, including the demands brought on by new recruits and the decentralization agenda.

(c) **Past reform initiatives have tended to focus on the upper echelons of the judiciary in Nairobi, with little participation of court stations outside Nairobi.** Similarly they have tended to over-emphasize the needs of judges and superior courts to the detriment of magistrates and paralegals. The ongoing initiative to collect the views of magistrates and judiciary staff on the JTF is in the right direction.

(ii) Better access to justice

(d) **High hopes in continuing the turn-around of the judicial sector will only be maintained if measures to improve access to courts—especially the automated case management system for reducing case delays and opportunities for corruption—are fully implemented.** It's important that this process begins to show early results. A faster disposal of commercial cases, for example, will give confidence to investors and encourage further development. It's also vital that the staff of the judiciary take centre stage in the new case management technology.

Experience from other countries shows that staff involvement and commitment are critical to its success.

- (e) **Alternative Dispute Resolutions offer a useful and practical solution.** The JFF supports Alternative Dispute Resolution mechanisms that help to reduce case backlogs and enhance access to justice, such as a court-annexed mediation program. It also promotes innovations like the small claims court that will increase and diversify access to justice. The support and cooperation of parliament, government, other legal and justice bodies and stakeholders is needed to help accelerate and to expand these initiatives.
- (f) **World Bank studies identify several conditions that could improve the efficiency of courts.** These are functional judicial information systems; the transfer of non-contentious matters (such as administrative disputes) from courts to administrative bodies to reduce judicial caseloads; simplified judicial procedures and processes; and establishing small claims courts and specialized commercial courts. Some of these are already under implementation in Kenya while others have still some way to go.
- (g) **Decentralization provides both great opportunity and challenge.** The Constitution’s ambitious devolution program creates new opportunities for transforming judicial services, bringing services closer to Kenyans. However, it also brings enormous challenges. There will be a massive increase in the number of judges, magistrates, legal researchers, administrative and other staff all across the country. All requiring infrastructure

“The JTF supports Alternative Dispute Resolution mechanisms that will help to reduce case backlogs and increase access to justice”

(e.g. court stations, libraries, registries, mobility, equipment, etc.), as well knowledge, operating systems, communication, training, management and other resources. This process will be highly complex, dependent on good planning, insight and oversight, as well as on an implementation program that’s carefully matched to priorities and to available resources.

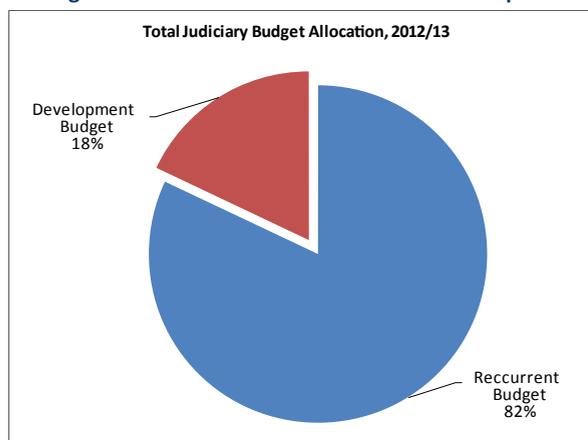
(iii) Budget priorities

- (h) **Despite the frontloading needed to catch up after years of underfunding and to accelerate reforms, much of the judiciary’s spending is strikingly recurrent.** For example, in FY14 the judiciary proposes to spend only KES 7 billion on development and KES 17.1 billion on recurrent expenses. In 2012/13 only 18 percent of the budget was dedicated to development (Figure 15.2), largely for construction and ICT (Figure 15.3). There could a risk that the foundations for a strong, lean and sustainable body are not being properly built due to a possibly skewed spending or investment approach. In this regard, it would be useful if some analysis was done to ascertain what would be the ideal budget ratio for the judiciary’s development and recurrent agendas, and when this ratio should be put in place.

(iv) Participation – government, stakeholders, the public and partners

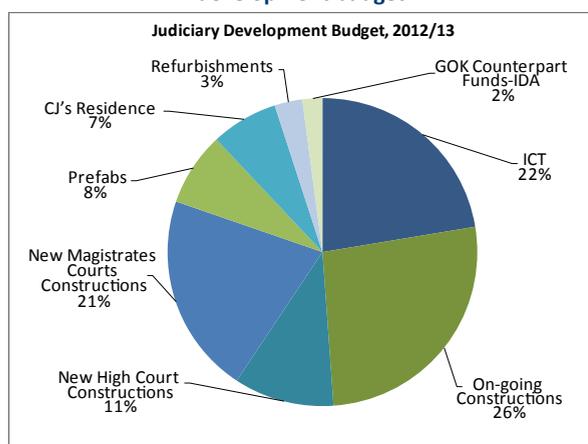
- (i) **Efforts to build and to sustain public participation need be strengthened and scaled up by both the judiciary and by its stakeholders.** Public participation is invaluable; it promotes oversight, accountability, team work and service results. The Judicial Service Commission, the National Council on the

Figure 15.2: Only 18 percent of the current judiciary's budget of KES 15.9 billion is available for development



Source: GoK, Judiciary Budget, 2012/2013

Figure 15.3: A breakdown of the judiciary's 2012/13 development budget



Source: GoK, Judiciary Budget, 2012/2013

Administration of Justice, the National Council of Law Reporting of Kenya, and the Court Users Committees are in particular crucial players.

- (j) ***As long as other justice institutions remain unreformed, the country's enormous potential for improved rule of law—along with its corresponding development and governance prospects—remains unrealized.*** For this reason, the ongoing reform initiatives of the National Police Service, the Kenya Prison Service, the Attorney-General's office and the Director of Public Prosecution's office need to be given the urgency they deserve, including equal recognition and financial support.

16. Delivering on the promise of devolution: Seven challenges ahead

By Geoff Handley, Aurelien Kruse, Fred Owegi and Kathy Whimp

The adoption of Kenya's 2010 Constitution marks a critical juncture in the nation's history. Its introduction is widely perceived by Kenyans from all walks of life as a new beginning. Its vision encompasses a dramatic transformation of the Kenyan state through new, accountable and transparent institutions, inclusive approaches to governance, and a firm focus on equitable service delivery through the newly established county governments.

Prior to the landmark 2013 elections, much progress had been made in building the legal and institutional framework for devolved government. The Taskforce on Devolved Government, working with other ministries, departments and agencies, developed key policy and legal provisions in a collaborative manner, leading to the promulgation of six laws dealing with different aspects of county governments. A further two laws were passed in January 2013, to facilitate transitional financing arrangements. The sum of these laws is that county governments will have significantly more autonomy than any sub-national units in Kenya's history to date. While the national parliament can make laws on a variety of areas affecting county governments, the powers of the President and cabinet to hold county governments accountable are relatively limited.

Kenya's devolution is very ambitious and complex, and therefore commensurately risky. Many countries—both rich and poor—have transferred responsibilities and resources to lower levels of government. Few have done so to entirely new sub-national

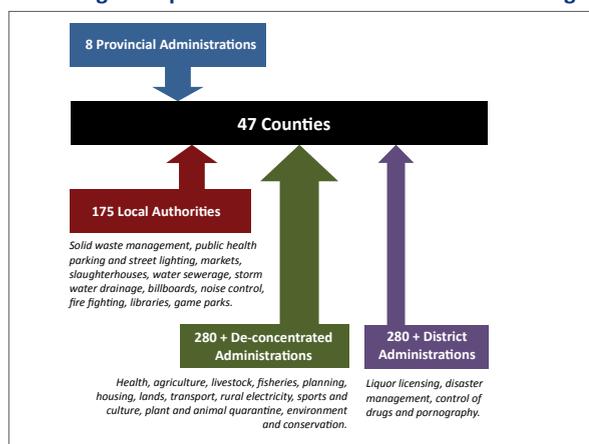
Box 16.1: What is the meaning of devolution?

Devolution is the transfer of powers and functions from national government to sub-national governments. In many countries, the devolution of responsibilities and resources is effected by the national parliament, which can modify or withdraw the powers it has devolved. In Kenya’s case, devolution is a requirement of the Constitution. The national parliament cannot withdraw powers from county governments. The “objects, principles and structure” of devolved government can only be altered through a referendum (Article 255).

Source: Case Study on the South African National Anti-Corruption Forum

units, which they have established from scratch. Kenya will undergo a dual transition: a transfer of responsibilities and resources from the center to the sub-national level, and a simultaneous reorganization of local government, with the consolidation of previously existing local structures into forty-seven newly-created county governments (see Figure 16.1).

Figure 16.1: Kenya’s devolution presents massive challenges for political and administrative restructuring



Source: World Bank KEU, 5th edition

Moreover, there are diverging views on how far and how fast it should go, and extremely high public expectations exist. Clear leadership will be essential if Kenya is to chart a successful path to devolved government. In particular, the goal of achieving greater equity and redistribution will need to be traded off against the risk of service delivery disruption, including urban service provision in particular.

The next three years are critical: this is the period when the foundations of the

devolution architecture will be laid. This section focuses on helping Kenya to manage the balancing act of transition to devolved government. It covers the critical issues facing Kenya’s policy-makers today, and presents suggestions and recommendations on how best to navigate the tough choices ahead, with respect to seven major and immediate challenges:

- (i) Financing county needs and ensuring a fair and equitable vertical and horizontal distribution of resources will require balancing political demands for speed with time to prepare properly, and the right mix of instruments to ensure service delivery is adequately resourced.
- (ii) In pursuit of greater equity, existing imbalances are better tackled over time, with a focus on people rather than try to equalize geographic locations.
- (iii) Budgeting for devolved government without compromising fiscal sustainability will require timely and constructive dialogue between the newly empowered parliament, the executive and the Commission for Revenue Allocation (CRA).
- (iv) Kenya’s cities are crucial for its economic development, and counties should be encouraged to ensure that urban services continue to improve, through empowered management arrangements and financing that creates the right incentives.
- (v) Effective civil service management at county level will require an effective framework of uniform norms and standards, to ensure that mobility

between county services is maintained; and capacity building for human resource management at county level.

- (vi) Meaningful devolution will take place at the sector level as functions are handed over, but sector implementation must be supported by clear policy decisions on functions, staffing, financing and asset ownership that are taken at the center. Outstanding decisions on transition should be taken soon.
- (vii) The constitutional vision of engaged citizens supporting transparency, accountability and inclusiveness in devolved government should be operationalized.

CHALLENGE 1 - FINANCING COUNTY NEEDS

Devolving power requires transferring resources from the center to the local level: but how much, how fast and to whom is not obvious. Resourcing Kenya's future counties involves a two-step process to divide national resources fairly. First, it requires determining the optimal aggregate split between the national and county governments in such a way that each is adequately resourced to carry out its mandated functions (vertical sharing). Second, total county resources must be split across the forty-seven counties, in a way that recognizes their different inherited costs and also addresses historical inequalities between them (horizontal sharing).

Determining the overall vertical split

The vertical split of resources between national and county governments will be critically important in the 2013-14 budget, as the new administrations fully take on their new responsibilities. However, if funding is to follow functions—the golden rule of fiscal decentralization—the first question to answer is “which functions?”, since this will determine how much they will need. While Kenya's Constitution provides high-level

guidance on the respective functions of the national and the county governments, much more granular work is needed to provide a basis for sharing resources.

If functions are to be transferred all at once, the law needs to be changed. The Constitution provides for the phasing in of functions over time during the transition period, but political pressure has been growing for counties to receive the full set of devolved functions quickly, together with the entire amount required to finance the functions. The concern that underpins this move is that phased transfer may once again leave behind the very counties that have been marginalized for many years. But the phased transfer approach is spelled out clearly in the Transition to Devolved Government Act. Governing by the rule of law is at the core of Kenya's new dispensation. If it is now considered that this approach is politically undesirable, the law should be changed before it is abandoned. Parliament decided upon the phased approach and it should now be the body that decides whether to overturn it.

Mobilizing the right mix of transfer instruments

In one “moderate” scenario, the World Bank has costed aggregate county needs at KES 170 billion, just to maintain services at their existing levels. But the devil of matching funding to functions is in the detail. First, not all the devolved services are suitable for financing through the equitable share. The minimum 15 percent equitable share is a subset of the total resources available to fund devolved services. Examples of services that would be better financed through grants that target funds to specific services, in specific locations are cross-county services that impose disproportionate cost burdens on only some counties while serving many; funding which Kenya has contracted to

provide under counterpart agreements with donors; and services that respond to Kenya’s international obligations.

Counties will inherit substantial—and unequally distributed—staff costs as functions are transferred to them. It is not clear how payroll will be managed in the short term, but payroll costs will be a first call on the equitable share. Clarity is urgently needed around how much these costs will be to each county, so that county governments can prepare their budgets with a clear understanding of the discretionary resources available to them. If the payroll is managed centrally for the time being, national government will need to negotiate with each county to hold back a proportion of the equitable share to meet these costs. Counties will want to see clear and verifiable data, to substantiate these agreed deductions.

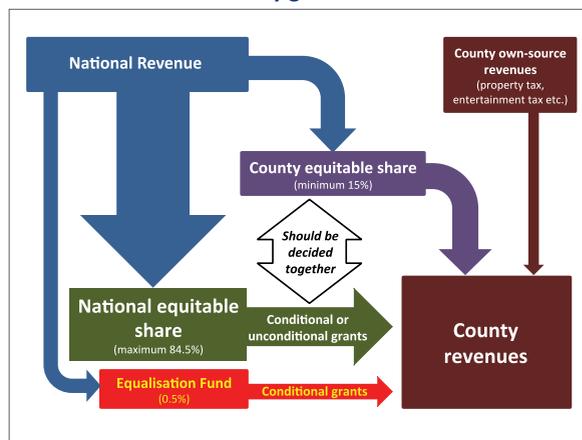
Enhancing revenue capacity

Own-revenues will be critical for resourcing county governments and also for fostering accountability at the local level. Yet the Constitution only grants limited revenue-raising powers to counties (broadly those previously enjoyed by Local Authorities), which will remain highly transfer-dependent, unless new revenue-raising powers are granted to them. To maximize the own-revenue potential of Kenya’s counties, existing sources should be reformed and new ones found.

The collection of property taxes should be strengthened (as Kenya under-collects by a wide margin by international standards) by updating revenue base information, updating rates and minimizing applicable exclusions. There is also scope to revisit the Single Business Permit. However, increasing county fiscal autonomy would almost certainly require creating additional revenue sources such as piggybacking county taxes

on existing national taxes. Figure 16.2 shows various ways in which county governments will be resourced, including the equitable share, county own revenues, the Equalization Fund and additional transfers from the national government (conditional or not).

Figure 16.2: Flows of revenues from different sources for county governments



Source: World Bank KEU, 5th edition

In the short term, the priority is to ensure that county governments do not experience legal challenges in collecting revenues, after they have come into existence. This is because the constitutional provisions for county tax collection have not been converted into the necessary legal instruments, to authorize counties to take over the revenues currently being collected by Local Authorities. Having forty-seven different tax administration systems is not economically efficient, but the window of opportunity to have a single national system may have passed.

Now that counties are in existence, a constitutionally conservative interpretation is that they must pass their own taxing laws. National government could help to ensure some uniformity, by providing a consistent template for tax administration legal instruments, although the determination of the base and rate should remain a decision of individual counties. The PFM Act permits the county governments to appoint a collection

agent as a collector of county government revenues, including the option of using the Kenya Revenue Authority as a collection agent. If this option is to remain viable, it is particularly important that consistent administrative arrangements be applied across the counties.

Policy debate on inter-governmental transfers has so far focused almost exclusively on the equitable share, yet it would be misguided to seek to meet all county needs through this instrument alone. Targeted grant decisions should be made at the time the vertical share is decided. The larger the equitable share, the less will be available for targeted grants. These targeted grants do not need to be highly prescriptive, or undermine the autonomy of counties. They are mainly about compensating disproportionate cost burdens that the formula for the equitable share does not address. Urban service delivery and service delivery to slum areas are one example of a cost burden not addressed by the equitable share formula.

The immediate policy priority for targeted grants involves deciding on the fate of the three major devolved funds and agencies managing the funds. Altogether, these three funds—the Road Maintenance Levy Fund (RMLF),¹ the Constituencies Development Fund (CDF) and the Local Authorities Transfer Fund (LATF)—accounted for KES 52 billion in 2012/13,² or 8 percent of 2010/11 shareable national revenues (2010/11 forms the base year for sharing in 2012/13). Maintaining these funds at their existing levels would greatly reduce the fiscal space available for unconditional funding through the equitable share, and for other targeted grants for cross-county services, international obligations, and donor counterpart funds.

In the County Allocation of Revenue Bill negotiated in May 2013 between the National Assembly and the Treasury, the proposed equitable share for 2013/14 is KES 190 billion, or approximately 28 percent of shareable revenues. To provide this level of funding for the equitable share and maintain the three existing funds at their current levels will be fiscally challenging. It also drastically reduces the scope for other targeted grants that address cost disproportionate burdens. Moreover, further increases to county funding can only be achieved through cuts to nationally funded programs—in June 2013, the Senate proposed that the equitable share be increased by an additional KES 48 billion.

A system of capital grants may be required to protect county-level development spending. World wide, sub-national governments tend to spend a high proportion of their budgets on wages and salaries and relatively little on investment. While the regulations to accompany the PFM Act will seek to limit county wage bills, additional incentives may be required.

In order to ensure minimum standards of service delivery throughout Kenya and promote catching up in capital-poor areas, the national government may consider implementing a (conditional) capital grants scheme based on a transparent formula, which could also provide the backbone of a county performance monitoring system. As part of a sub-national performance monitoring system, grants can help spur healthy competition among counties, providing the incentive for county governments to regularly monitor and report on their performance and identify and address key service delivery bottlenecks.

¹ RMLF is currently administered by the Kenya Roads Board (KRB), which disburses money to five other agencies currently being restructured to align them with the Constitution.

² KES 21.8 billion was allocated to CDF; KES 8.5 billion to the devolved component of RMLF and KES 21.5 billion to LATF.

CHALLENGE 2 – PROMOTING GREATER EQUITY WHILE SAFEGUARDING SERVICE DELIVERY

Promoting greater equity in the allocation of spending and services is at the heart of Kenya’s 2010 Constitution, but seeking to equalize too quickly would be risky. The goal of equalization will need to be pursued in a tight fiscal environment, with limited scope to increase spending without undermining existing levels of service delivery. This has two major implications. First, existing imbalances may only be tackled over time. Second, equalization should target the people who will benefit from services, rather than try to achieve equalization across geographic locations.

Parliament has adopted a formula for allocating the equitable share. While it places heavy emphasis on county populations (weighting them at 45 percent), this is logical since population is the main driver of service needs. Taken together, all of the other components in the formula (amounting to 55 percent) tend to favor counties that have been historically underserved (see Table 16.1).

This formula will result in highly redistributive transfers. This is not obvious at first glance because in absolute terms, the better-off counties (such as Nairobi and Kakamega) will be receiving the lion’s share of the funds.

However, the picture is almost entirely reversed when looking at allocations per person, with Isiolo, Lamu, Marsabit and Tana River coming out the big winners. In other words, once population is taken into account, the poorer, more sparsely populated and smaller counties receive disproportionately big (per capita) allocations (see Figure 16.3).

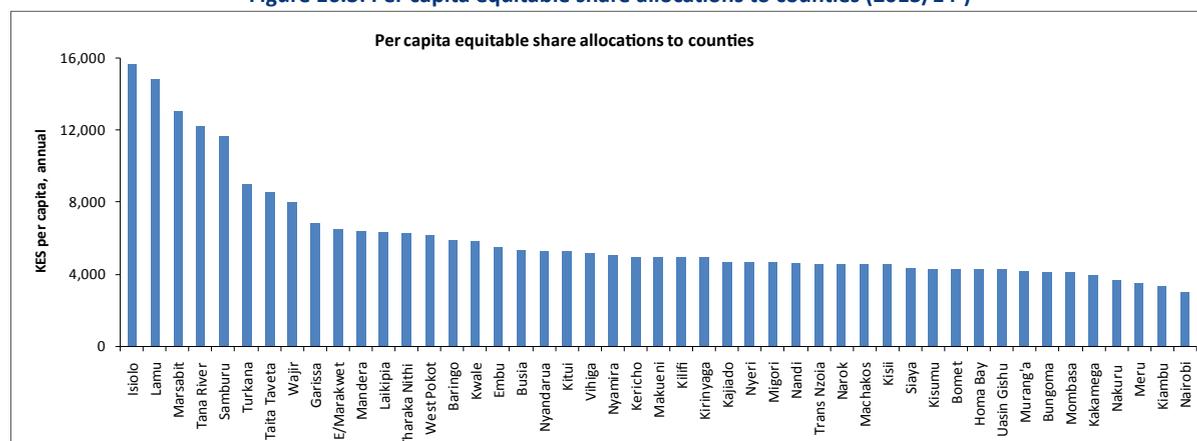
Because it promotes substantial redistribution of resources across counties, the formula creates risks for counties at both ends of the spectrum. Areas that were historically privileged (in most cases with larger populations and more densely populated) will inherit service delivery obligations that will require substantial funding. A significant proportion of their equitable share transfer will be eaten up by these inherited costs, with the result that these counties will be “cash-poor”—meaning that they will have less revenue left over for discretionary spending, including on development projects. In these counties, the challenge will be to rapidly streamline service delivery without interrupting key services or making inefficient reallocations.

At the other end of the spectrum are more sparsely populated counties, that have been underserved in the past. They will receive substantial extra cash through the CRA formula relative to their current service

Table 16.1: Components’ source, weights and objectives in the CRA consultation formula

Components	Population	Poverty	Equal Share	Land Area	Fiscal Responsibility
Weight (percent)	45	20	25	8	2
Objective	Resource counties to deliver services equally on a per capita basis	Promote redistribution in favour of historically lagging areas	Provide each county with resources to cover the fixed costs of running county administrations	Factor in the higher cost of delivering services in remote, sparsely populated areas	Provide incentives for prudent fiscal management

Source: World Bank based on CRA documentation

Figure 16.3: Per capita equitable share allocations to counties (2013/14³)

Source: World Bank calculations based on presentation by CRA to Governors' Forum on 4th April 2013

delivery obligations: they will be “cash-rich”. Here the challenge will be to manage these additional resources well, and to scale-up service delivery with limited capacity. Cash-rich counties will need to focus their spending on infrastructure projects in order to expand their service networks.

These likely imbalances call for three short-term actions to phase in equalization over time. First, it is urgent to understand the fiscal impact of inherited costs of service delivery at the county level. This would require compiling detailed county-disaggregated spending data on devolved services, in particular, costs which cannot readily be reduced, like civil service wages.

Second, on the basis of this information, the government may need to consider complementing the formula-based equitable transfers, with provisions to ensure that no county loses out in nominal terms. Such provisions should be limited in time and specifically targeted to allow cash-strapped counties to maintain existing services, at least at their current level. In essence, this would mean maintaining a constant level of funding for previously better-resourced counties in nominal terms, while at the same time increasing resources

to counties that have been historically under-resourced. Presently, it is not clear to know if the cash-poor counties will receive enough through the equitable share to maintain existing service delivery levels.

Third, a strategy is needed to build capacity rapidly and systematically among the cash-rich counties to develop adequate PFM, HR and service delivery systems, and in particular to improve their capacity to plan, budget, implement and manage infrastructure projects. Gradually phasing the transfer of functions over the 3-year transition period will also help to buy time for capacity building.

CHALLENGE 3 – BUDGETING FOR DEVOLVED GOVERNMENT

Budgeting for the transition will be difficult, especially under an asymmetric transfer of functions. If functions will be gradually transferred to counties during the transition period, this raises challenges for both revenue sharing and for the annual budget process. Functions that will be asymmetrically transferred to counties within the same fiscal year are not suitable to be financed through the equitable share, because the equitable share formula assumes that all counties have the same functions. Some certainty is

³ The allocations shown above are based on an equitable revenue share for county governments of KES 190 bn, as per the Division of Revenue Act (2013).

also needed, well in advance, around what functions a county will be responsible for in the coming year, so that they can budget for these functions.

The national government will continue to perform some devolved functions during the transition period, and these allocations to counties could be clearly shown through transitional budget laws. This is what the Transition County Allocation of Revenue Act (2013) does: it provides for: (i) a KES 9.8 billion allocation to counties for functions transferred immediately after elections, and, (ii) KES 175.8 billion for county functions to be performed by the national government.⁴ However, it does not show how the KES 175.8 billion is allocated between the counties, and Governors will want to know this information. Future revenue sharing laws could be more detailed, by including 47 county schedules and showing county allocations by devolved function. Alternatively, there could be 47 “county votes” that clearly set out in the national budget estimates, showing explicitly the total funding allocated to each county and specifying how much is to be spent on each county’s behalf through national government systems. (Hence this should be included in the national government Appropriation Act). This may require a short amendment to the transitional provisions of the PFM Act.

The 2010 Constitution greatly increases the power of the legislature in the budget process, creating the risk of gridlock. In particular, there is a risk that delays in approval of the Division of Revenue Bill (DoRB) could derail the budget process at both national and county levels. One approach used in other countries to address this risk is to introduce a two-tier budget process in parliament, through which the national legislature binds itself to a fiscal framework (total spending) prior to the consideration of the allocation

of spending (Division of Revenue Act, County Allocations of Revenue Act and national budget estimates). The PFM Act provides for this to some extent, by providing for the simultaneous submission to parliament of the Budget Policy Statement (BPS), DoRB and County Allocation of Revenue Bill (CARB), requiring parliament to pass a resolution on the BPS by 1st March, and to consider the two bills by 15th March.

To avert possible gridlock, dialogue between the national treasury, parliament and the revenue allocation commission should start much earlier in the budget cycle. Currently, there is no explicit requirement for the DoRB to conform to the BPS, which means that there is a real risk that parliament could alter the DoRB after it has voted on the BPS, thereby undermining the budget process at national and county level. An earlier dialogue between the national treasury and parliament would build consensus on the fiscal framework, and maintain that consensus to ensure that the Division of Revenue Act matches the previously approved BPS. Further, inclusion of the Commission for Revenue Allocation in this dialogue could help to achieve an earlier consensus on the shareable revenue denominator, failure to which could also unnecessarily delay approval of the DoRB.⁵

Building-up the capacity to budget at county level will be a tall order. Counties will comprise of staff from districts—who have very limited experience of preparing and managing budgets—and from former local authorities—whose limited experience in budget management needs to be developed further. Therefore, in anticipation of the difficulty of establishing budgeting functions from scratch at county level, integrated planning and budgeting guidelines and associated templates should be developed

⁴ Passed just before the 10th parliament rose, *The Transition County Allocation of Revenue Act (2013)* covers the period March to June 2013. It is expected that the 11th parliament will prioritize a new revenue allocation law for 2013/14.

⁵ Two months before the end of 2012/13 FY (and well into the budget preparation cycle for 2013/14), the Treasury and the CRA still had vastly different recommendations on what the shareable revenue should be.

to guide the county in the planning and budgeting process. This would provide an opportunity to integrate the annual planning and budgeting functions into a single process, and this should be overseen by a single county institution. Lastly, it will be essential to ensure that county budgets are prepared, executed and reported using a single country-wide chart of accounts.

CHALLENGE 4 – PROTECTING THE URBAN GROWTH ENGINE

Unless corrective action is taken, Kenya’s cities may well be the big losers in the devolution process. Kenya’s devolution is unique in that it involves simultaneous decentralization of key services and resources from the national to county governments, but also recentralization of urban management. Existing arrangements will be profoundly transformed in the new dispensation, as the current system of local authorities, with elected management and significant discretion over resources and functions, will be replaced by a new system that gives much more power to county executives. Kenya’s biggest cities will be managed by appointed boards, with far less power and autonomy than the local authorities they replace: most of their functions will be delegated at the discretion of county governments, and they will have no guaranteed funding.

Moreover, only three urban centers will have municipal or city boards. The Urban Areas and Cities Act (UACA) sets the threshold for city status at 500,000 and for a municipality at 250,000, and only cities and municipalities are entitled to boards. Yet currently, there are only five urban areas in Kenya with a population of over 250,000 (Nairobi, Mombasa, Kisumu, Nakuru and Eldoret), two of which will effectively be county-cities and will be governed as county governments (without city boards). In all

other urban centers, a rather uncertain arrangement for “town committees” will apply. A number of substantial urban centers with viable existing local governments, including twenty-one urban centers each with more than 80,000 residents, will thus be effectively recentralized into their county administration.

There are three ways in which the management autonomy of urban areas could be expanded. One is by lowering the threshold for the definition of municipalities. Alternatively, the act could deem all county capitals to be municipalities (which would still leave out important towns like Ruiru, Naivasha and Ngong). A third option would involve enhancing the managerial autonomy of town committees, to make them function in the same way as municipal boards.

With all urban functions and resources vested by the Constitution in county governments, specific functions and resources will need to be delegated to city and municipal boards. Yet there is no clear process or framework for such delegation, and no transparency requirement concerning the delegation by county governments to city and municipal boards. A useful measure would be to require county governments to publish the functions and revenue streams assigned to urban boards, so that urban residents understand what services they are entitled to receive, and from which level of authority.

Kenya’s Constitution makes county governments responsible for financing urban service delivery, and there is a risk that urban services may be under-funded as a result. Because rural residents will dominate most counties, county governments may choose to prefer offering rural services, and so to redistribute revenues raised from urban residents to their rural constituencies. This

may jeopardize the economic development potential of Kenya's urban areas, and violate the fiscal federalism axiom that revenue and expenditure responsibilities should be aligned to the greatest extent possible at the local level.

Urban services will therefore depend on the priority which county assemblies give them, unless the national government develops urban grants to provide stronger incentives. The UACAct envisages that county governments will provide transfers to city and municipal boards but not to town committees, and it offers no guidance as to how these amounts ought to be calculated. The national government could help to ensure that urban services are adequately provided through earmarked urban services grants (such as a modified LATF), which could be paid either to county governments or to the urban boards directly. To ensure that counties maintain their own levels of funding for urban services, the transfer could include an additionality clause binding the county to maintain a certain level of funding from its own resources.

However, even additional transfers may be insufficient to finance the type of infrastructure that Kenya's cities and towns need. While counties may be able to borrow, this will be subject to national government review and guarantee. This is helpful to prevent the risk of uncontrolled borrowing at the sub-national level. However, the flipside may well be insufficient access to capital for infrastructure, particularly in Kenya's larger cities, as the national government may discourage sub-national borrowing that would end up on its balance sheet.

CHALLENGE 5 – DECENTRALIZING THE PUBLIC SERVICE IN A SUSTAINABLE WAY

The risks of the secondment approach in the coming months, managing the transfer

of staff to counties will be the number one transition challenge. Most of the public servants needed to run county functions are already in place, but the conditions under which they will remain are unclear, and fiscal implications have not been properly assessed. Initially, national public servants will be seconded to county governments but the “zero-basing” approach, whereby counties are not required to employ them permanently, is unusual and risky. Most commonly, countries that establish a new level of government simply transfer existing staff performing devolved functions to the new governments. In Kenya, in order to maximize county flexibility, a secondment approach has been chosen.

The secondment of national staff will come to an end when the seconded officer is either appointed to the county public service or handed back to the national government. Moreover, if public servants feel they have the right of return to the national government, they may also choose not to apply for a position in the county public service. If a large number of secondees are returned to the national government, it may not have the jobs or the funding to absorb them. A rapid fiscal assessment should be undertaken to assess the costs of different scenarios and identify strategies to manage them.

Plugging the gaps in the legal and policy framework for county public services

Kenya's existing public service structure is currently highly centralized, so devolution will bring about major changes. Forty-seven new county civil services will be created, with two immediate and extremely important sets of challenges: defining the overall governance framework for county civil service; and managing the HR transition implied by their creation.

The County Governments Act (CGAct) provides the regulatory framework for counties to engage their own public servants, but it leaves a number of important gaps in the policy framework. In particular, while the Constitution provides clear authority for the national government to set out a framework of national standards, this could still leave room for counties to regulate some aspects of civil service management. There should be a clear decision as to which issues national laws and policies should cover and which should be left to counties.

Also, some interim provisions will be needed before counties develop their own laws. The new framework should set national standards and guide counties in their day-to-day management of public servants, by setting the general framework for management. This should specify who is responsible for regulating the detail of how county public servants should be managed; and provide statutory instruments to specify the detail of the management arrangements.

Devolving public service management involves balancing the risks of too much central control against excessive local autonomy. With too much control, county autonomy and accountability may be undermined. With too little oversight, local controls could be ineffective, undermining service delivery. Failing local controls could result, for instance, in elite capture and politicization of appointments. Establishing independent county public service boards has the potential to mitigate these risks, but they have been given too much power. In particular, the concentration of HR management in these boards creates the potential for fiscally unsustainable recruitment, excluding direct supervisors from playing a role in recruitment.

Politicization is also a potential risk at county public service boards, because their

members are political appointees. The integrity of Kenya's county public service boards will depend on the quality of the process used to recruit their members. They are required to have university degrees; not to have breached a professional code of conduct; and to have satisfied the leadership and integrity provisions of the Constitution. However they are appointed by the governor, with the approval of the County Assembly. There is no requirement for members to have any expertise in public sector human resource management.

The independence and competence of county public service board members will depend on how committed individual governors are in selecting people: (i) with appropriate skills and experience; and (ii) who are committed to checking the political interests of the governor in the way they exercise their powers. Capacity building for county public service board members should be a first order priority.

Current staff performing district-and provincial-level functions are inequitably distributed across Kenya. County governments cannot be expected to regularize this redistribution on their own. A strategy is needed to help identify the excess staff who are present in some counties, and match them with unfilled positions in others. There is no ideal level of staffing for any function, and resource availability will be a key driver. Analysis of the inherited staffing cost of each county is a first requirement to allow this assessment to be made.

Uncontrolled spending on personnel is a common feature of decentralization and a big risk for Kenya. Spending on personnel alone does not contribute to better services, especially if the recruitment is driven by patronage or leaves insufficient access to funding for operating costs and facilities, or

pays insufficient attention to performance management. The public service provisions of the CGA emphasize control over recruitment of public servants, but leave employment of non-public-service staff relatively unregulated—potentially a very expensive loophole. The PFM Act specifies a minimum of 30 percent of the budget over the medium term should be spent on development. Some counties may find this very difficult to achieve, if they inherit a high wage bill for staff currently located in the county.

Paradoxically, devolution could widen capacity gaps across Kenya. There is already gross inequity in the distribution of skilled public servants across the country. Yet the counties that currently have the lowest levels of public service skills are also likely to be those which will have the hardest time attracting skilled personnel, given their overall remoteness, the lack of mobility prospects they offer and weak incentive systems. In turn, this could put undue upward pressure on remuneration, crowding out other important types of expenditure. These risks call for incentives—especially non-financial—within the framework of a single nationwide public service, where staff can be offered greater access to training and promotion, if they serve in remote counties and where inter-county mobility can be guaranteed.

CHALLENGE 6 – MANAGING THE TRANSITION TO HIT THE GROUND RUNNING

For the transition to be as smooth as possible, Kenya needs institutional arrangements for managing the transition itself. There is a broad legal framework, but much work remains to be done. As a result, the Transition Authority (TA) has a great deal to accomplish in a very short time. The TA needs to command respect across the government. Although the Transition to Devolved Government Act (TTDG Act) gives the TA power to make

regulations, there are no clear sanctions if they are not followed. The best way the TA can ensure that the rest of government follows its lead is by: (a) ensuring that it gets cabinet’s sign-off on its strategic direction; (b) seeking meaningful involvement of the implementing ministries; and, (c) using transparent reporting of expectations and progress in meeting them (for example through a “performance dashboard” to track progress), to create an environment in which line ministries feel public pressure to meet their planned obligations.

A detailed planning process for the transition is ongoing, but is lagging behind implementation timeline expectations.

The details of devolution will be designed in part by the new Ministry of Devolution and Planning, jointly with line ministries. Particularly if a number of functions are transferred across the board on 1st July 2013, line ministries need to speed up the detailed planning for transfer of staff, assets, functional responsibilities and assets. There is so far little sign of line ministries moving to formalise their new role in devolved sectors, or of developing meaningful and achievable standards that can be used to measure county governments’ performance in carrying out their new roles. Some uncertainty remains on how key services like provincial hospitals and regional water boards will be handled in the devolution process.

County governments are now a reality and work is only just beginning on the institutional architecture to include them in decision-making and for improved coordination. The Constitution and devolution laws provide only limited scope for the national executive (as distinct from parliament) to hold county governments accountable. The Constitution prescribes that county and national levels of government should be distinct and interdependent, and

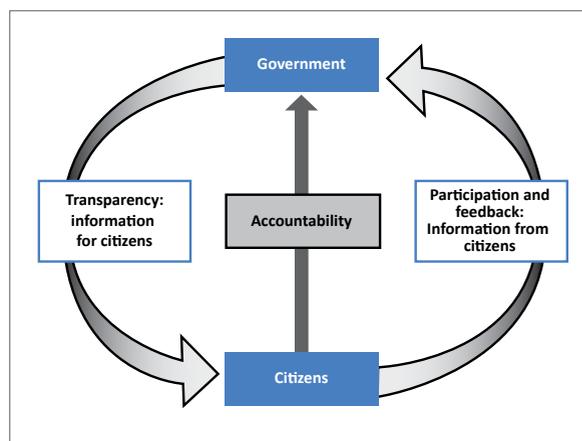
conduct their mutual relations on the basis of consultation and cooperation, with early tensions showing the struggles for control between the centre and the devolved units. To implement the vision of interdependence, an intergovernmental architecture is needed, that can give the 47 county governments a meaningful but workable role in sector policy, and in the decisions that remain to be made about function assignment.

There will be big differences in capacity between weaker and stronger counties. One of the main risks of devolution is that it actually exacerbates these gaps. The TA should develop a strategy for ensuring that weaker counties receive special assistance. This might involve targeting donors to give priority to supporting specific counties, or developing special assistance programs for them.

CHALLENGE 7 – BUILDING SOCIAL ACCOUNTABILITY INTO DEVOLVED GOVERNMENT

Transparency, participation and accountability are clear requirements in the Constitution, but laws alone are insufficient. The experience of devolution in other countries indicate the importance of building mechanisms that ensure sub-national governments are not only accountable upward, but also downward to citizens. Establishing formal government systems is a necessary but not sufficient condition for good governance at the devolved level. Similarly, demand-side social accountability initiatives face major challenges of sustainability and scale, and are typically heavily reliant on donor financing. Integrating demand—and supply-side systems is therefore needed. An effective social accountability system, embedded in county governments, requires three core elements: (i) fiscal transparency; (ii) participation mechanisms; and, (iii) accountability mechanisms (see Figure 16.4).

Figure 16.4: Elements of social accountability systems



Source: World Bank

Kenya can draw on its extensive experience with devolved funds to reinforce both upward and downward accountability. Learning from CDF and LATF highlights several key challenges. Local government had weak systems and incentives to support social accountability in devolved funds. Systems to distinguish between well and poorly performing service delivery units, to reward good performers and sanction poor performers were not uniformly applied or enforced. Local authorities also had limited capacity to involve citizens in the planning, monitoring, and evaluation processes as per project guidelines.

Although Kenya scores well on some national-level access to information benchmarks, access to information at the local level is generally poor: it is often difficult for citizens to access basic information on local service delivery rules, budgets, expenditures, and results. More attention is required in the design of accountability systems to address gender, education levels, ethnicity, poverty levels and disability which also affect citizens' awareness and ability to participate in decentralized funds. Finally, while there are many civil society initiatives to encourage citizen participation and monitoring in decentralized funds, civil society initiatives are typically small, fragmented, and CSO

monitoring experiences show that even where participatory processes are applied, there is significant variation in the implementation of such engagement.

Work is underway to translate Constitutional provisions for citizen participation into practice. Recently passed legislation is being converted into regulations, guidelines, system-building and training that will allow counties to be more responsive and accountable to citizens. Several steps are needed for transparent and responsive county government to take hold. Firstly citizens, as well as government officials, need to understand county government roles and functions, as compared with those of national government. Secondly, simple mechanisms for transparency and participation need to be integrated into county planning, budgeting, and performance management systems.

Regulations, guidelines and capacity building will be needed that convert Constitutional principles into practice. For example, it is important to specify where, when and how budget and performance information are made available; how citizens can participate in planning and budgeting processes; and how citizens can seek recourse if rules are not followed. Also, county planning units will need to be supported with regulations and guidelines that specify procedures for citizen engagement in county planning. PFM regulations and guidelines need to incorporate principles and mechanisms for citizen participation in budgeting and financial reporting.

County governments will also need the tools to support responsiveness to citizens. Recourse mechanisms such as ones for complaints should be made available to citizens, and county officials should provide feedback to petitions and challenges from citizens. Comparative county performance

monitoring can enable citizens to track how their county is performing versus baselines and also other counties, besides focussing leaders' attention on results and fostering competition and learning between counties. Regular, repeatable surveys of citizen satisfaction, as part of overall performance monitoring, can also reinforce downward accountability and government responsiveness. Effective incentives and sanctions will need to be put in place to ensure genuine participation of citizens and the accountability of county governments.

Greater transparency would be supported by county officials understanding their obligations to proactively publish budget documents within certain timescales. Budget and performance data and information need to be shared in formats citizens will understand, using a range of tools and fora. The passing of the Freedom of Information Bill would support transparency in county governments and citizens' ability to demand information.

Finally, citizens and county governments need the capacity, resources and tools to understand their roles and the tools and options that are available to them. County governments need to make sure that citizen engagement is budgeted for in the planning and reporting processes. And capacity building programs for county governors and officials and civic education programmes for citizens need to include awareness and understanding of social accountability.

KEY RECOMMENDATIONS

A fiscally realistic threshold for unconditional resourcing of counties needs to be determined—over and above the constitutional requirement of 15 percent—leaving sufficient scope for conditional funding. Ideally, this should be carried out by the Treasury in consultation with sectoral

departments (formerly ministries) and with leadership from the Transition Authority. Two preliminary steps must be taken to achieve a sustainable basis for unconditional transfers. The first involves undertaking a granular assessment of functions to be transferred vis-à-vis competencies. This step should lead into a clear and simple function transfer roadmap—noting that a phased approach is recommended. The second step involves a comprehensive costing of all devolved functions, beginning with historical costs, but eventually, also taking into account equalization objectives. This would require additional budget.

Central support will be required to build strong county PFM systems, which will contribute to efficient and effective county spending. Such support should be directed at three critical areas: (i) capacity building, particularly in the areas of planning and budgeting, as well as for financial reporting; (ii) systematic tracking of county performance using data and clear benchmarks; and (iii) nationally-developed standardized guidelines and templates for planning and budgeting. Central support for county PFM systems should also include initiatives to expand citizens' access to financial information, allowing them to assess the efficiency and effectiveness of county (as well as national) government spending.

A national policy on county public services should be developed, providing uniform procedures and a comprehensive regulatory framework. This policy should be developed by a legally mandated national agency in liaison with stakeholders, county governments included. The policy should provide for:

- (i) regulation of critical aspects of county public service management e.g. recruitment, promotion and mobility within the public service;

- (ii) a standard pay policy that does not cause fiscal stress on counties; and
- (iii) national government support for county public service boards, specifically to build capacity, develop systems and establish staff management practices and procedures.

Meanwhile, final decisions should be made relating to seconded staff, i.e. who will pay their salaries, whether the salaries will be deducted from counties' equitable share transfers, and if at all redundant staff will be re-absorbed at the national level.

Building effective citizen engagement will require civic education; building county systems and capacity to interface with citizens; building incentives for counties to respond; and encouraging collaborative ventures with civil society. Key elements include accurate and timely financial and performance information—which in turn would require both capacity building and enforcement mechanisms (such as penalties for failure to produce accurate information).

The first priority is to strengthen the relationship between the planning and the budget processes, since public participation in planning will only be meaningful if the choices made are translated into spending. A second priority is to incorporate transparency and participation mechanisms into county government systems—systems to share information (“disclose, simplify and disseminate”) on budget and spending, and to enable effective citizen participation in setting social service delivery priorities and monitoring performance.

In addition to creating an enabling environment for citizen participation and oversight, county governors and administrators can make use of civil society capacity to help them build participatory

planning, budgeting and performance systems that citizens and civil society will actually use. Finally, civil society can place greater emphasis on building coalitions around service delivery monitoring;

collaborative work with counties to ensure that county systems have useful interfaces with citizens; and building shared platforms for monitoring information.

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ACHIEVING SHARED PROSPERITY IN KENYA

Kenya has almost everything going for it. Its people are well-educated and energetic, its location is superb, and its neighbors are growing strongly and using Kenya as a gateway. So why is Kenya underperforming compared to its peers? Why does the average Kenyan earn only half of what the average African south of the Sahara does?

*The country has just experienced one of the most successful and peaceful national elections in its history. A dynamic new administration has assumed the levers of power and begun to fundamentally shape the country's future. Guiding the new leadership is the 2010 Constitution, which ushered in a sweeping new system of devolved government that will have a profound impact on Kenya's future. Against this momentous backdrop, Kenya's leaders will need to grapple with an extensive range of issues, as they strive to launch Kenya's economy on the path of high economic growth. The purpose of this book, *Achieving Shared Prosperity in Kenya*, is to offer a comprehensive yet digestible assessment of the challenges and possible responses for Kenya's leadership to consider, as it plans its strategy for sustained economic growth.*

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