IPF
INSTITUTE OF PUBLIC FINANCE

Mid-Year Review of Kenya's Macro-Fiscal LANDSCAPE

2024

MID-YEAR REVIEW OF KENYA'S MACRO-FISCAL LANDSCAPE 2024

Every year, the Institute of Public Finance publishes a Macro-Fiscal Analytic Snapshot (MFAS) for Kenya. This document reviews Kenya's Macro-Fiscal landscape post-publication of the 2024 MFAS and provides an update of recent developments in relation to the macroeconomy, fiscal performance and public finance management issues.

Acknowledgement

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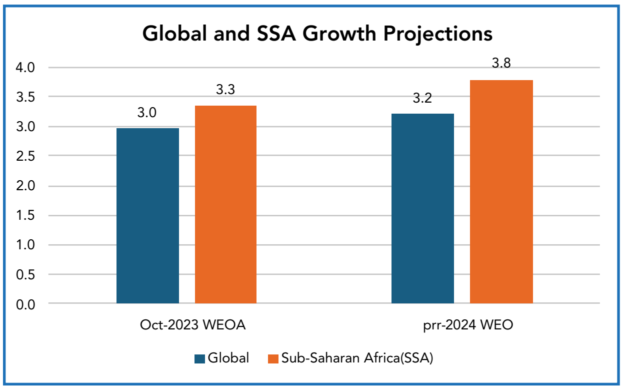
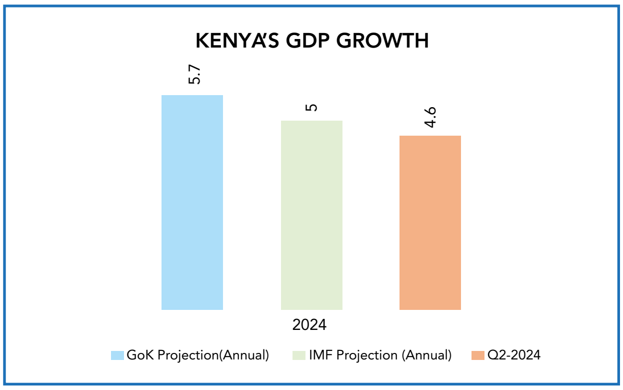
INFLATIONARY PRESSURE HAS EASED, BUT THE KENYAN ECONOMY IS FACED WITH SLOW GROWTH OF INVESTMENT, AND GLOBAL AND DOMESTIC FACTORS THAT WILL SIGNIFICANTLY SUPPRESS ECONOMIC GROWTH.

Global growth has remained steady, an experience similar to that of the Kenyan economy when compared to other Sub-Saharan Africa (SSA) economies. However, disinflation challenges in advanced economies pose an adverse spillover risk to emerging and developing economies. This translates into upward pressure on the dollar, thus rising borrowing costs over the medium-term.

Fig 1: Compared to the Global and SSA economic growth, Kenyan economy is quite resilient, but the growth recorded in the second quarter of 2024 signals an economic slow down and growth below 5%

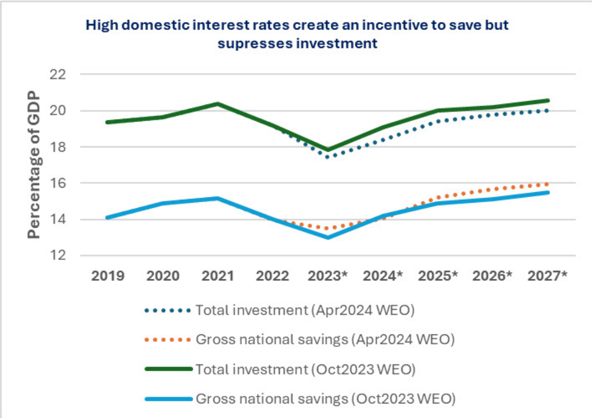


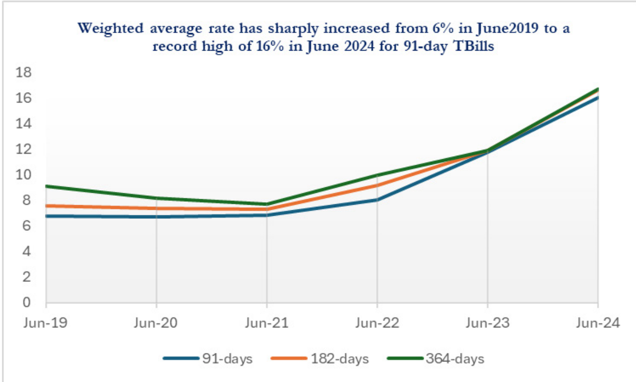


Data source: IMF, Kenya National Bureau of Statistics (Q2 data) and National Treasury (annual projection for 2024)

What the slowdown in Kenya's GDP growth to 5% in 2024 means is that unless revenue performance exceeds earlier projection or expenditure is cut more than planned, government will not achieve the target fiscal deficit to GDP ratio. This slowdown in GDP growth is driven by climate-related, external and political shocks. Floods had a significant impact on the vulnerable that required reallocation of resources for emergency responses while the youth-led demonstrations adversely affected investment. However, the political calm experienced post-reconstitution of the Cabinet may have a slight positive impact on the economy for the remainder of the year.+**Although the economy will slow down, the good news is that investment is expected to recover but at a slower pace than earlier projected.** The slower than earlier projected recovery in investment is due to the anticipated decline in government spending and high domestic interest rates that disincentivize private investment. Negative investor perceptions adversely impacted demand for government bonds while at the same time international borrowing conditions have not been conducive. This continues to push interest rates up as investors demand high returns to compensate the risk.

Fig 2: Investment and average rate for Treasury Bills (TBills)



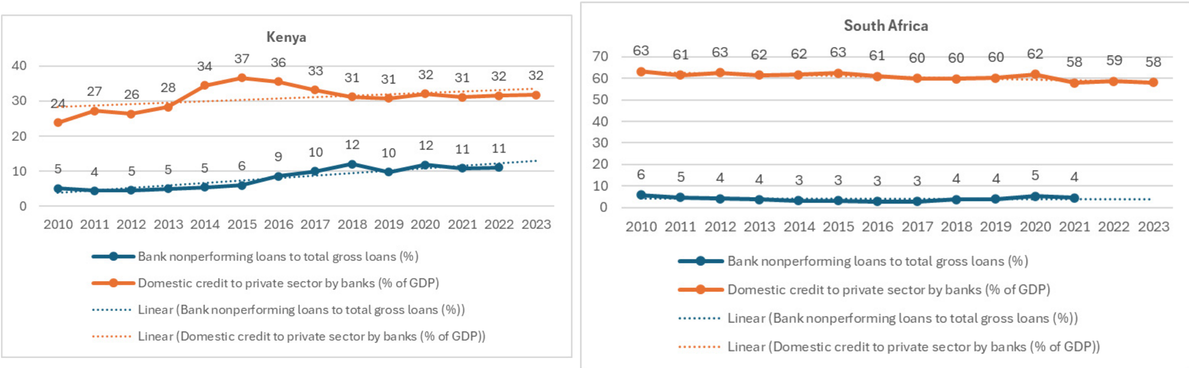


Data source: IMF, WEO and the Central Bank of Kenya

The slow recovery in investment and contraction in GDP growth calls for the current government to critically interrogate what past administrations did during challenging economic times to turn around investment and economic growth (see Fig. 3). Understanding how the **Economic Recovery Strategy for Wealth and Employment Creation agenda** worked between 2003-2012 to raise investment to GDP from 15% to 22%, and why investment fell from 25% in 2015 to 19% in 2022 during the **Big Four Agenda** (with manufacturing, affordable housing, universal healthcare, and food security as key focus areas) can help guide the current model, the **Bottom-Up Economic Model** (with emphasis on empowering small and medium-sized enterprises (SMEs), informal sectors, and marginalized communities, digital economy and job creation more so through the housing programme).

Moreover, **sluggish investment indicates the high borrowing cost has reduced the willingness or ability to take on new credit and expand while growth in non-performing loans indicates those investors that borrow are unable to service debt.** A comparative analysis is shown in Fig. 4, where Kenya has a worrying trend in the level of NPLs relative to credit to the private sector. According to the Credit Survey Report by the Central Bank of Kenya, contraction in demand for credit has been high in manufacturing, building and construction, tourism, restaurant and hotels, while highest non-performing loans stem from personal and household, trade and building and construction.

Fig 4: Comparative analysis reflects broader economic problems in Kenya that require economic reforms necessary to address underlying issues affecting borrowers' repayment capabilities

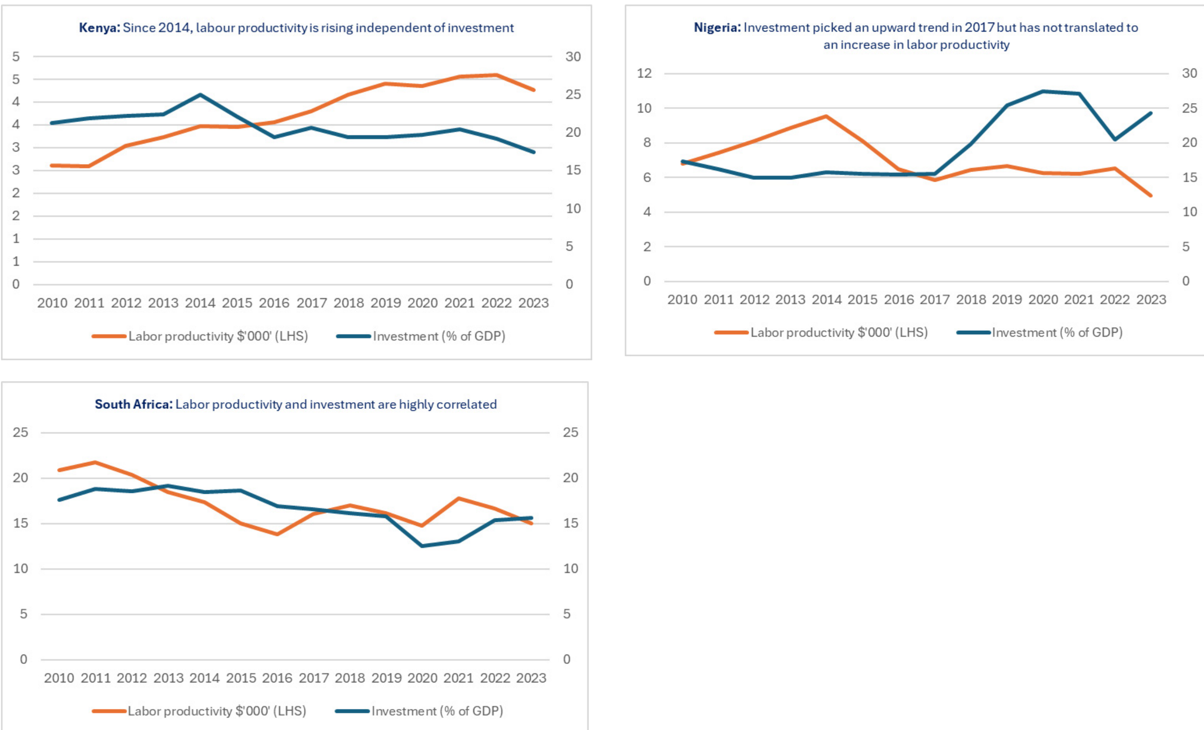


Data source: World Bank

From the analysis, South Africa emerges as an example of best practice with high level of credit to the private sector alongside low non-performing loans. The trends observed in South Africa shows robust regulatory framework for the banking and financial sectors which ensure that banks conduct thorough risk management hence reduces the likelihood of loans turning non-performing.

Compared to her peers (shown in Fig. 5), investment in Kenya is on a downward trend but labor productivity is rising. Possibly, it is either workers have become more skilled, businesses have improved ways to streamline operations, technological advancement has led to higher productivity without necessarily requiring proportional increase in investment or there is a shift from capital-intensive industries to those that rely more on human capital.

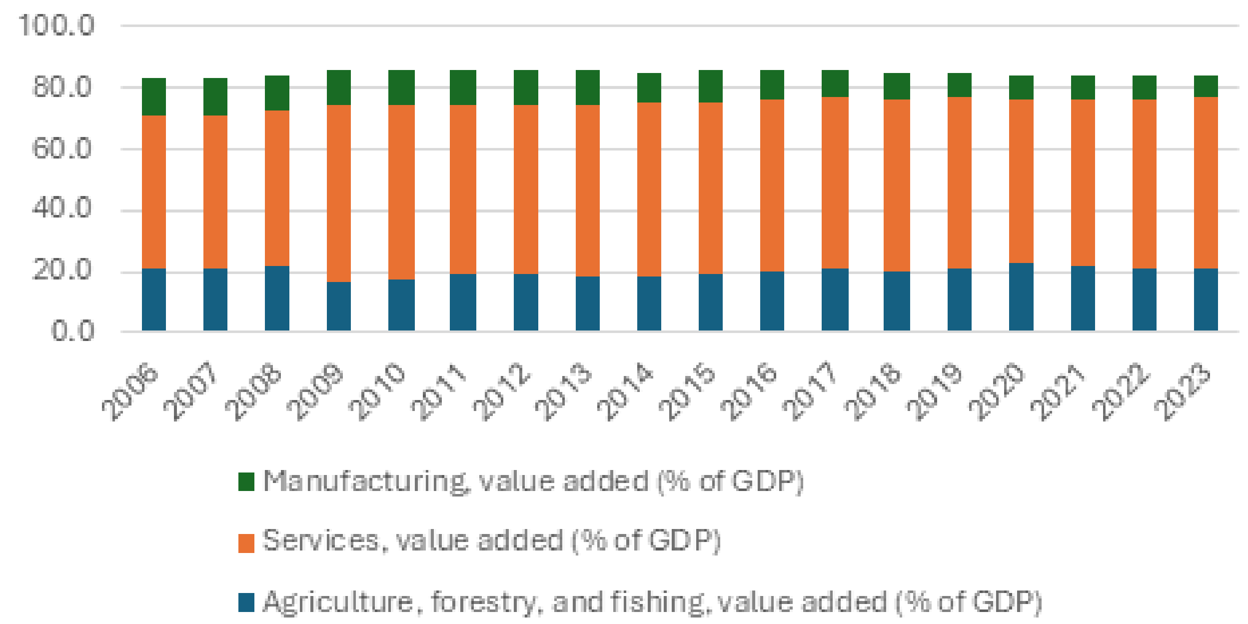
Fig 5: South Africa has high investment-labor productivity co-movement, Kenya since 2014 and Nigeria since 2017 have inverse movements



Data source: IMF, WEO April 2024

Overall, growth in labor productivity has translated into relatively constant value added as a share of GDP from the agriculture sector but no higher gains in value added for manufacturing. Although it is arguable that unfavorable domestic financial conditions due to high interest rates has adversely impacted investment, a fiscal intervention such as tax incentive would be needed to stimulate investment by way of countering the discouragement from borrowing to investment.

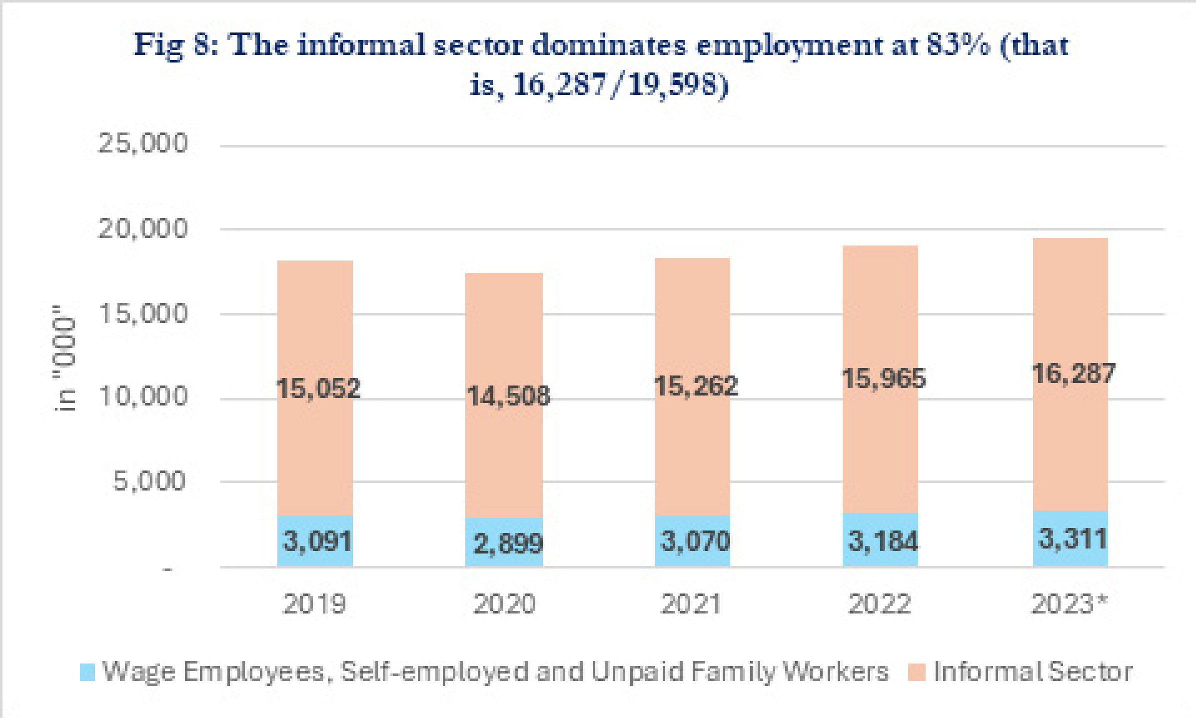
Fig 7: Growing value addition in the service sector, as manufacturing shrinks, while agriculture has stagnated



Data source: World Bank

STRUCTURE OF THE ECONOMY

While strategizing on the required investment and sectors to target for increased value addition, employment generation and economic growth, there is a need for a gradual formalization of the economy. Such a move will aid in accurate and realistic revenue projections, and revenue collection. To encourage the informal sector to formalize, government need to increase enforcement of tax and labor regulations while simultaneously offering support or amnesty programs, sensitize businesses how formalization can grant access to legal protections such as enforceable contracts and secured property rights, structure Public-Private Partnerships (PPPs) in a way that offers informal businesses the opportunity to formalize through mentorship and funding, and provide tax breaks.



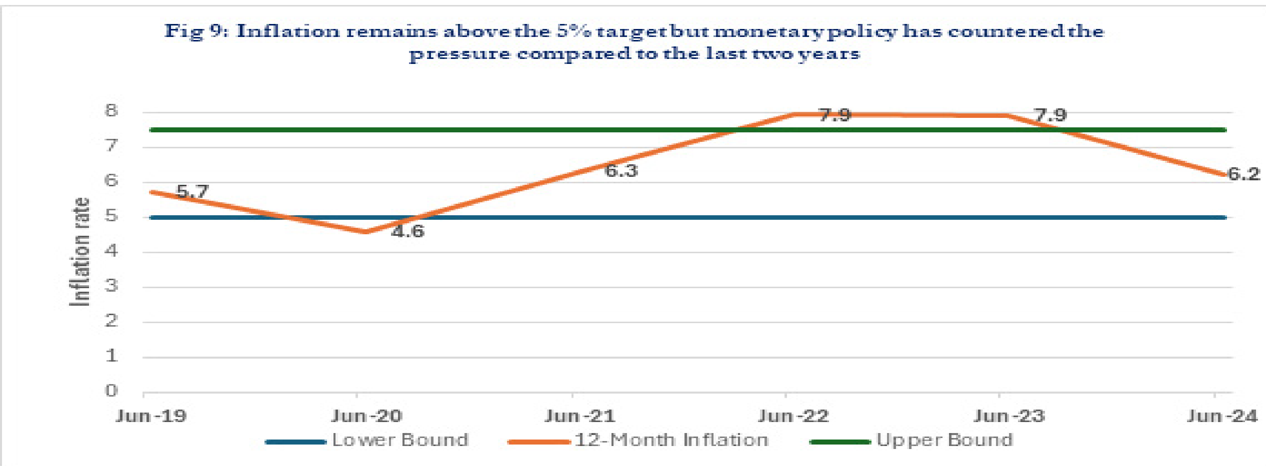
Data source: KNBS, 2024 Economic Survey.

Note: * indicates estimates

Inflation

High domestic interest rates are also a result of tight monetary policy that has been sustained to counter a high inflation period experienced since 2022. This together with the easing of food and fuel prices has achieved an inflation level within target. Hence, consumer purchasing power and real government spending is expected to improve.

Data source: CBK



FISCAL PERFORMANCE

Despite KRA missing revenue target by 5%, revenue outturn in FY2023/24 shows setting of more realistic revenue targets than five years ago. A significant growth in revenue is recorded in FY 2023/24 at 11% compared to 6.4 % in FY 2022/23. This growth is to some extent associated with introduction of new taxes like the 8 percent increase in VAT for petroleum products, 2 percent increase in turnover tax rate and an increase in duty for certain goods among others.

In FY2024/25, a real test is presented by the high revenue target that the government has maintained even after the rejection of the 2024 Finance Bill. To mitigate revenue losses, the government is planning to amend some tax laws and also introduce tolls on some of the highways in order to raise additional revenue.

Nevertheless, the possibility of the government failing to raise adequate revenue has forced a reduction of the national budget from Ksh. 3.99 trillion to Ksh. 3.87 trillion. As a result of the inevitable austerity measures, critical sectors like health and education have experienced budget cuts.

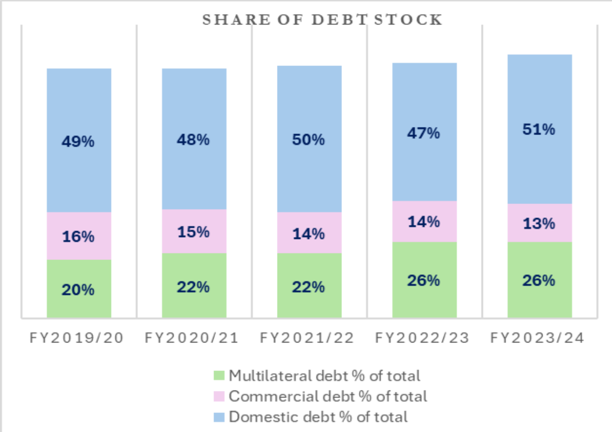
Although government's efforts to raise additional revenue through the 2024 Finance Bill were thwarted, a positive market reaction and appreciation of the Kenya Shilling against the US dollar following the $ 1.5 billion Eurobond and repayment of $ 0.5 million has reduced pressure on external debt and freed some resources that can finance the FY2024/25 budget. Appreciation of the Kenya shilling against the US dollar from 162 per dollar as of 23rd Jan 2024 to 132 as of 27th May 2024 helped the country save Ksh. 1.49 billion through reduction of external debt stock by 1.19 trillion between 23rd of February 2024 and 13th May 2024 and reduction of interest on external debts by Ksh. 316.9 billion from 1.67 trillion to 1.36 trillion.

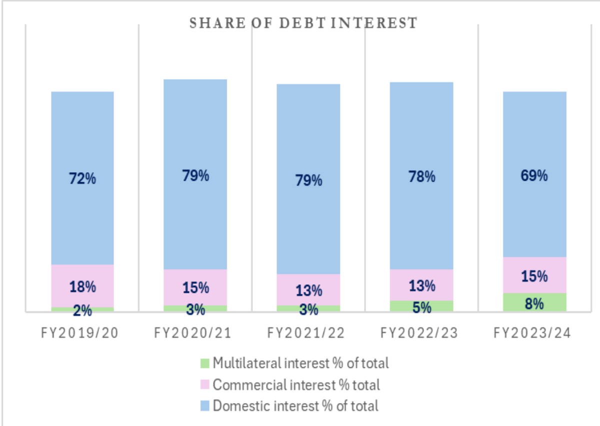
Avoiding default sparked positive market reaction. Unfortunately, it came at a higher refinancing cost (from an interest rate of 6% in 2014 to 9% in 2024) and did not solve the debt problem but rather deferred it. This, in addition to the continued borrowing trend, has seen the country fail to improve its credit rating with the recent rating by Fitch being a downgrade to B-.[1] Within a span of six months, between Jan-June 2024, record high borrowing amounting to Ksh 534 billion was recorded, mainly to cover the budget deficit and repay maturing loans.

In the FY2023/24, Kenya spent Ksh. 840 billion in payment of interests, a 22 percent increase from the previous year, highlighting the challenge of balancing investments with debt obligations.

1 See, August 2024 Fitch Rating for Kenya. Link

Fig 11: Concessional debt is more attractive than domestic debt when considering the share of debt stock against interest





Source: Treasury (QEBR)

Going forward, the country should rely more on concessional loans, because while domestic debt gives the country protection from exchange rate volatility and flexibility in restructuring, it comes at a high cost. In FY 2023/24, the interest payable exceeded the volume of debt for commercial loans at 13% of total debt with the interest taking 15% of total interest and domestic debt at 51% of total debt with the interest taking 69% of total interest. The only exception is multilateral debt at 26% of total debt with the interest taking 8% of total interest. This evidently shows that multilateral debts attract the least interest even when compared across the other years. Hence, it would be prudent for the government to consider terms of the loans and acquire the most economical and viable ones in order to manage future debt sustainability.

Moreover, a decisive policy action including privatization is needed to address fiscal risks stemming from guaranteed debt of financially struggling SOEs, as they drain much-needed fiscal buffers. In the third quarter of FY2023/24, the Government serviced Ksh. 17.4 billion on behalf of Kenya Airways (KQ). To date all the publicly guaranteed liabilities stand at Ksh. 170 billion.

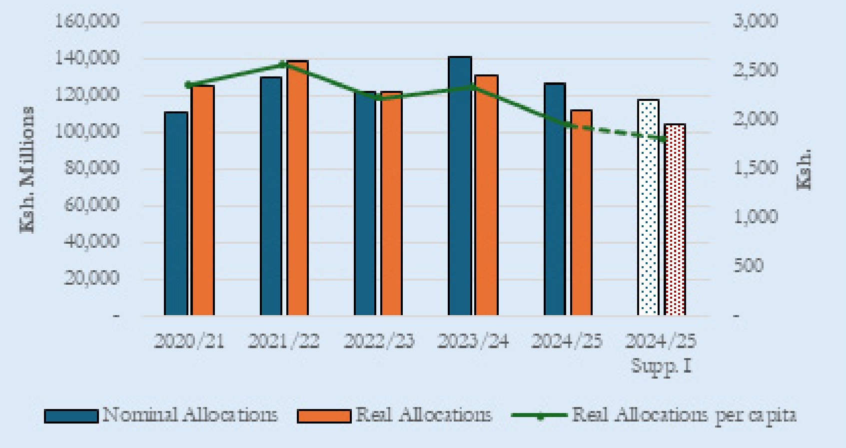
Irreconcilable public debt figures published by government agencies remain a concern thus underscoring the need for a special audit of public and publicly guaranteed debt. According to the 2024 Economic Survey released by KNBS, total debt stock stood at KSh 9.6 trillion as at end of June 2023 while the National Treasury reported KSh 10.3 trillion over the same period. The two reports should give the same figure.

Health Financing and pursuit of UHC under BETA

The Kenya Kwanza government came in with health service provision and achievement of UHC being at the top of the agenda. This promise appears to be on course especially with the passing and enactment of four new health laws. These are: i) Social Health Insurance Act, 2023; ii) Primary Health Care Act, 2023; iii) Facility Improvement Financing Act, 2023; and iv) Digital Health Act, 2023.

However, health sector allocations in FY 2024/25 experienced a significant decline, raising doubts about the government's commitment to improve health service delivery. The sector faced budget cuts on two fronts. The initial sector's allocation for FY 2024/25 was a decrease of 10 percent from FY 2023/24 allocations. Subsequently, following the rejection of the Finance Bill 2024, the Supplementary Budget I imposed an additional 7 percent cut, resulting in a cumulative reduction of 16 percent from the preceding year. The decline in the budget allocations has been accompanied by a decline in the real allocations per capita (2022 prices), which has now dropped below the average of Ksh. 2,376 recorded over the past four financial years, to Ksh. 1, 819.

Fig 12: The health allocations in the Supplementary Budget I are a 16 percent decrease from FY 2023/24 allocations. This is accompanied by a 22 percent decrease in the real per capita allocations (2022 prices).



The Supplementary Budget I has curtailed the implementation of critical health programs and projects. The State Department of Medical Services has experienced substantial cuts to infrastructure development, with projects like the upgrading of Kibugua Level [3] Hospital's children's ward and the construction of Ugenya Hospital facing complete defunding.[2] Additionally, the reduction of funding for family planning commodities, which was halved in the Supplementary Budget, threatens to reverse progress in reproductive health, due to impending FP commodities shortages. The State Department for Public Health and Professional Standards has also suffered budget cuts, resulting in reduced targets for TB control, nurse staffing, and Primary Care Network (PCN) development in FY 2024/25. In recent years, programs like TB control and family planning have experienced declines in donor funding, a challenge that is likely to persist. The simultaneous reduction in both government and donor funding for the programs present a significant threat to the progress made in these critical health areas.

When analyzing the implementation of the new UHC laws it is worth noting that they encountered a series of challenges at the outset. Insufficient public participation and buy-in has led to legal challenges that are hindering their implementation and thus delaying the long-term improvements in the health system that these laws were designed to achieve. A July 12, 2024, ruling suspended the Social Health Insurance Act (SHIA), Primary Health Care (PHC) Act, and Digital Health

2 2024/25 Supplementary Estimates I Programme Based Budget. Link

Act due to inadequate public participation in their development.3 The SHIA intends to replace the National Health Insurance Fund (NHIF) with the Social Health Insurance Fund (SHIF) and increase social health insurance contributions through a mandatory 2.75 percent levy on all citizens. However, the key provisions, clauses 26 (5) and 27(4), which mandated fully paid-up insurance contributions as a prerequisite for accessing public services and health care services respectively, were deemed unconstitutional. This makes the government's task of enrolling the elusive informal sector into SHIF difficult. If the government opts for a voluntary enrollment approach for the informal sector, it is likely that only a small fraction will participate. Historically, under NHIF, only about a quarter of the sector have been active members.

The court mandated the government to conduct meaningful public participation and amend the unconstitutional clauses within 120 days, which lapsed on 11th October 2024. Should the government fail to comply with the court's directives, it will be forced to reconsider its strategy for increasing health care financing. The 2.75 percent levy is the cornerstone of the revenue generation plan for SHIF, aiming to finance the increase in health insurance coverage for citizens. If implemented, this will yield significant revenue for SHIF. For example, revenue collections from the formal sector under NHIF averaged at Ksh. 48 billion in the period between FY 2018/19 and FY 2022/23, while under SHIF, the revenues would be higher at Ksh. 72 billion.4 While the levy will increase revenues to SHIF, it is important to recognize that claims payout will also increase, reflecting the increased costs of providing care to a larger membership base.

Billions	2018/19	2019/20	2020/21	2021/22	2022/23	Average
Formal sector in the national scheme	31.14	32.33	31.49	34.34	35.90	33.04
Enhanced schemes	12.66	10.77	12.73	24.10	16.37	15.33
Total	43.80	43.10	44.22	58.44	52.27	48.37

Source: National Assembly (2024)[5]

The Social Health Authority's (SHA) ability to effectively manage the increased revenues is a key concern, given past experiences with poor fiscal management under NHIF. The recent NHIF audit for FY 2022/23 revealed significant financial irregularities, warranting an 'adverse opinion'[6]

3 In the High Court, Nairobi - Constitutional and Human Rights Division - Petition No E473 of 2023 - SHIF Judgment. Link

4 The revenues for the formal sector under SHIF are calculated using Kenya's average wage for the formal sector, Ksh. 72,130 and the number of workers, 3,015,481, in 2022 as provided by the Kenya National Bureau of Statistics (KNBS) in the Economic Survey 2023.

5 http://www.parliament.go.ke/sites/default/files/2024-06/Report%20of%20the%20Departmental%20Committee%20on%20Health%20on%20its%20Consideration%20the%20inquiry%20into%20alleged%20Fraudulent%20Payments%20of%20Medical%20Claims%20and%20Capitation%20to%20Health%20Facilities%20by%20the%20National%20Health%20Insurance%20Fund.pdf

6 The Auditor General in her audit reports expresses satisfaction or lack thereof, of the financial statements through one of four audit opinions. This could either be: i) an unqualified opinion which means that the entity's transactions were recorded properly or accurately ii) a qualified opinion meaning that the Auditor General is unsatisfied with some insignificant amounts; iii) an adverse opinion where the Auditor General is unsatisfied with significant amounts of expenditures and; iv) a disclaimer of opinion, which implies that the Auditor

from the Auditor General.[7] These irregularities included nearly Ksh. 1.7 billion in overpayments due to poor claims verification. Some of these errors, which would have been flagged if there were adequate verification, were attributed to typographical errors in claims entry by facility clerks, and duplicate payments to facilities. The Auditor General found that while NHIF was aware of the data entry errors, it made no attempts to recover these funds, indicating a lack of accountability by the institution. The Auditor General's report highlights this failure: *'Although Management attributed the variance to typing errors made by hospital clerks while inputting bill amounts in the E-claim system, there was no evidence of reconciling the billed amount to claims paid or requests for refunds for overpayments.'* NHIF, was also shrouded in opacity, as it rarely made its financial information public.[8] As such, SHA should implement strong internal controls from the very beginning, including undertaking frequent audits on claims made and making financial statements publicly available to develop a culture of financial accountability and build public trust.

Emerging issues

Rejection of the 2024 Finance Bill is a big hurdle to the implementation of BETA programme in FY2024/25. Following a financing deficit of Ksh. 346 billion that was targeted by the measures introduced in the Bill, government 's response revised expenditure downwards, with the development budget taking the largest cut of 22%.

The government further suffered another blow following the declaration of the 2023 Finance Act as unconstitutional. Unless the Supreme Court overturns this decision, the option left is to revert to the Finance Act 2022. Some of the key changes would include: a return of VAT on fuel back to 8% from 16%, a return of excise duty on various industries such as betting, gaming and prizing competition will back to a rate of 7.5% from 20%, and the elimination of withholding tax on digital content monetisation and the Digital Asset Tax. However, these court decisions do promise to improve the budget making process if, going forward, revenue projections are tabled before Parliament alongside proposed expenditure.

Legal hurdles against revenue raising measures have come at a time when there is a heightened perception of Kenya's risk of defaulting on its debt obligations as has been witnessed in credit rating downgrade by Moody's. This will potentially justify investors demand for higher yield to compensate for the increased risk, making it more expensive for Kenya to borrow money from international markets. This will make it more challenging for the country to refinance her existing debt. The downgrade could also lead to a depreciation of the Kenyan shilling.

This will require the government to undertake additional austerity measures, including the dissolution of 47 state corporations with overlapping mandates as was announced by the President. However, the fiscal practicability of this move remains to be seen because such a move is not costless: it will be necessary to compensate employees whose contracts will be terminated, or to offer early retirement to those on permanent and pensionable terms. The short-term costs of this may prove too high to achieve the longer-term gains of reforming state corporations.

General cannot undertake an audit due to unreliability of the accounting records, lack of verifiable supporting documentation and explanations for the transaction.

7 Report of the Auditor General on National Health Insurance Fund for the year ended 30th June, 2023.Link

8 Transparency and Accountability: The Opportunities and Gaps for Kenya's National Health Insurance Fund. Link

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