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Report No: PGD82

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 540.3 MILLION (EQUIVALENT TO US$750 MILLION)

TO

THE REPUBLIC OF KENYA

FOR THE

KENYA INCLUSIVE GROWTH AND FISCAL MANAGEMENT
DEVELOPMENT POLICY FINANCING

April 29, 2019

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Macroeconomics, Trade And Investment Global Practice
Africa Region

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The Republic of Kenya

GOVERNMENT FISCAL YEAR

July 1 – June 30

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of March 31, 2019)

Currency Unit = Kenyan Shilling (KES)

US$1.00 = KS 100.8

US$1.00 = SDR 0.72033135

ABBREVIATIONS AND ACRONYMS

ASAL	Arid and Semi-Arid Lands
ASTGS	Agricultural Sector Transformation and Growth Strategy
CAK	Competition Authority of Kenya
CBK	Central Bank of Kenya
CIT	Corporate Income Tax
CPF	Country Partnership Framework
CPS	Country Partnership Strategy
DPF	Development Policy Financing
DSA	Debt Sustainability Analysis
EAGC	Eastern Africa Grain Council
EIA	Environment Impact Assessment
EMCA	Environmental Management and Coordination Act
EU	European Union
FY	Fiscal Year
GDP	Gross Domestic Product
GESDeK	Governance for Enabling Service Delivery and Public Investment in Kenya
GNP	Gross National Product
GoK	Government of Kenya
HCI	Human Capital Index
HDI	Human Development Index
IBRD	International Bank for Reconstruction and Development
ICT	Information and Communication Technology
IDA	International Development Association
IEIA	Integrated Environment Impact Assessment
IFC	International Finance Corporation
IFMIS	Integrated Financial Management Information System
IMF	International Monetary Fund
IRWA	Irrigation Water Users Association
KES	Kenyan Shilling
KeFS	Kenya Fisheries Service

KIP	Kenya Investment Policy
KMRC	Kenya Mortgage Refinance Company
Mbps	Megabytes per Second
MDAs	Ministries, Departments and Agencies
MoALFI	Ministry of Agriculture, Livestock, Fisheries and Irrigation
MoEF	Ministry of Environment and Forestry
MoU	Memorandum of Understanding
MTP	Medium-term Plan
NBS	National Broadband Strategy
NCPB	National Cereals and Produce Board
NEMA	National Environment Management Authority
NIA	National Irrigation Authority
NIB	National Irrigation Board
NIC	National Investment Council
NPL	Non-performing Loans
OAG	Office of the Auditor General
OSHA	Occupational Safety and Health Act
PDMO	Public Debt Management Office
PER	Public Expenditure Review
PFM	Public Finance Management
PIM	Public Investment Management
PPP	Public-private Partnership
PPRA	Public Procurement Regulatory Authority
PV	Present Value
SBA	Stand-by Arrangement
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
SEA	Strategic Environmental Assessment
SGR	Standard Gauge Railway
SME	Small and Medium Enterprises
SOE	State-owned Enterprises
UNDP	United Nations Development Program
US$	United States Dollar
VAT	Value Added Tax
WB	World Bank
WBG	World Bank Group
WRS	Warehouse Receipt System

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THE REPUBLIC OF KENYA

INCLUSIVE GROWTH AND FISCAL MANAGEMENT DEVELOPMENT POLICY FINANCING

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P168204	Yes	1st in a series of 2

Proposed Development Objective(s)

The program development objectives are to: (i) crowd in private investment and financing for affordable housing; (ii) enhance farmer incomes and food security; (iii) create fiscal space to allow the government to invest in key development programs; and (iv) crowd in private investment and leverage digitization to support the government's inclusive growth agenda.

Organizations

Borrower: REPUBLIC OF KENYA

Implementing Agency: NATIONAL TREASURY AND PLANNING

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**750.00**

DETAILS

International Development Association (IDA)	750.00
IDA Credit	750.00

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Moderate

Results

Indicator Name	Baseline	Target
Number of housing units with building permits that meet the affordable housing threshold (as defined in Development Framework guidelines of the GoK)	20,000 (2017)	40,000 (2021)
Number of affordable housing titles issued (including individual or joint ownership agreements), *of which women*	5000 (2017) of which 1,000 for women	25,000 (2021) of which 7,500 for women
Number of private sector shareholders in KMRC	0 (2017)	6 (2021)
Number of licensed warehouses under the Warehouse Receipt System participating in the Commodities Exchange	0 (2017)	30 (2021)
Percent of arable land under irrigation	2 (2017)	2.5 (2021)
Number of farmers benefitting from e-vouchers, *of which women*	0 (2017)	100,000 (2021) of which 35,000 women
Availability of strong fisheries surveillance system with up-to-date licensing information	No (2017)	Yes (2021)
Domestic supply of meat (in thousand metric tons)	619 (2017)	743 (2021)
VAT and income tax revenues as a percent share of GDP	11.4 (2017)	12.1 (2021)
Availability of monthly cash plan	No	Yes (2021)
Number of investigations related to bid rigging undertaken jointly by the CAK and PPRA	0 (2017)	5 (2021)
Share of government securities transacted on electronic platform	0 (2017)	70 percent (2021)
Broadband penetration (number of subscribers, in millions)	12.7 (2017)	14.0 (2021)
Days to register a business	14 (2017)	7 (2021)

IDA PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY CREDIT TO REPUBLIC OF KENYA

1. INTRODUCTION AND COUNTRY CONTEXT

1.1 **The proposed Development Policy Financing (DPF) is the first in a programmatic DPF series of two operations in support of the Government of Kenya's (GoK) reform program to further enhance economic growth and make it more inclusive.** The GoK's medium term reform program prioritizes four areas comprising of food security, affordable housing, universal health coverage, and manufacturing - otherwise referred to as the "Big Four". The proposed DPF lends support to this agenda by seeking to crowd in private investment and enhance the public sector's capacity to deliver on the government's inclusive growth agenda. The proposed amount for the first operation is an International Development Association (IDA) credit of US$750 million equivalent.

1.2 **Kenya's economic growth has been robust over the last decade.** Since 2011, gross domestic product (GDP) growth has averaged 5.6 percent, which is 1.8 percentage points higher than the average for Sub-Saharan African countries during this period (3.8 percent) and two percentage points higher than the growth rate of the Kenyan economy in the previous decade (3.6 percent). On the supply side, though all sectors have contributed, the rapid increase in the services sector (especially the information and communications technology and financial sub sectors) has accounted for more than half of the increase in GDP growth, followed by industry and to a lesser extent agriculture. On the demand side, increased private consumption and increased public spending have supported growth. Thanks to the robust growth performance and declining fertility, GDP per capita has accelerated in recent years from US$920 in 2009 to US$1,794 in 2018, thereby enabling Kenya to attain middle-income status.

1.3 **Kenya's robust growth performance has led to a reduction in poverty.** Poverty at the international line of US$1.90/day has fallen from 43.7 percent in 2006 to 36.8 percent in 2015 (the latest available data). With consumption growth among households at the bottom of the income distribution (3-4 percent) outpacing growth among higher income households, economic growth in Kenya has been pro-poor (World Bank, 2018)[1]. Further, robust consumption growth in rural areas has led to a more pronounced decline in poverty among rural households relative to their urban counterparts. Gains in monetary poverty reduction were accompanied by progress along several dimensions of non-monetary poverty. Kenya's Human Development Index (HDI), which aggregates education, inequality and life-expectancy indicators, rose by 0.1 points between 2005 and 2017[2]. The World Bank Human Capital Index (HCI) places Kenya third in Sub-Saharan Africa, after Seychelles and Mauritius.

1.4 **Notwithstanding progress, significant development challenges remain.** With a third of Kenyans still living under a US$1.90 a day, poverty levels remain high. Further, higher economic growth in Kenya has not translated into poverty reduction as rapidly as it has in regional peers (World Bank, 2018). Given the pre-dominance of poverty in rural areas and the importance of agriculture in rural economies, reforms should aim to increase farmer incomes and enhance food security, thereby accelerating the pace of poverty reduction.

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[1] World Bank 2018, Kenya Poverty and Gender Assessment 2015/2016

[2] UNDP 2018, hdr.undp.org/sites/all/themes/hdr_theme/country-notes/KEN.pdf

1.5 **Addressing the non-monetary dimensions of poverty remains critical.** A significant portion of Kenyans still lack access to basic services such as health care, affordable housing and safe drinking water. For instance, it is estimated that some 61 percent of Kenyans living in urban areas live in slums, which has deleterious impacts on productivity and health outcomes.

1.6 **The Government recognizes these remaining challenges and is working towards addressing them.** It is doing so within the context of its medium-term development plan encompassing food security, affordable housing, universal health coverage, and manufacturing for job creation. The plan also addresses the remaining challenges to inclusivity in the growth process. Further, given the narrowing of the fiscal space, the GoK recognizes the importance of crowding in the private sector to help it achieve its development goals whilst rebuilding fiscal buffers to sustain macroeconomic stability.

1.7 **This DPF proposes to support selected components of the government's medium-term plan (MTP).** The policy and institutional reforms under this DPF are clustered under four pillars that are foundational to creating an enabling environment for the delivery of the government's inclusive growth agenda. These are: (i) crowd in private sector investment and financing for the delivery of affordable housing; (ii) enhance farmer incomes and food security; (iii) create fiscal space to support the government's inclusive growth agenda; and (iv) crowd in private investment and leverage digitization to support the government's inclusive growth agenda. This operation complements other interventions supported by the World Bank that support the government's "Big Four" agenda: proposed Kenya Affordable Housing Finance Project (P165034); Kenya Climate Smart Agriculture Project (P154784); National Agricultural and Rural Inclusive Growth Project (P153349); proposed Kenya Marine Fisheries and Socio-economic Development Project (P163980); and the Program to Strengthen Governance for Enabling Service Delivery and Public Investment in Kenya (GESDeK) (P161387). The operation also complements interventions by other development partners in support of the "Big Four" agenda.

2. MACROECONOMIC POLICY FRAMEWORK

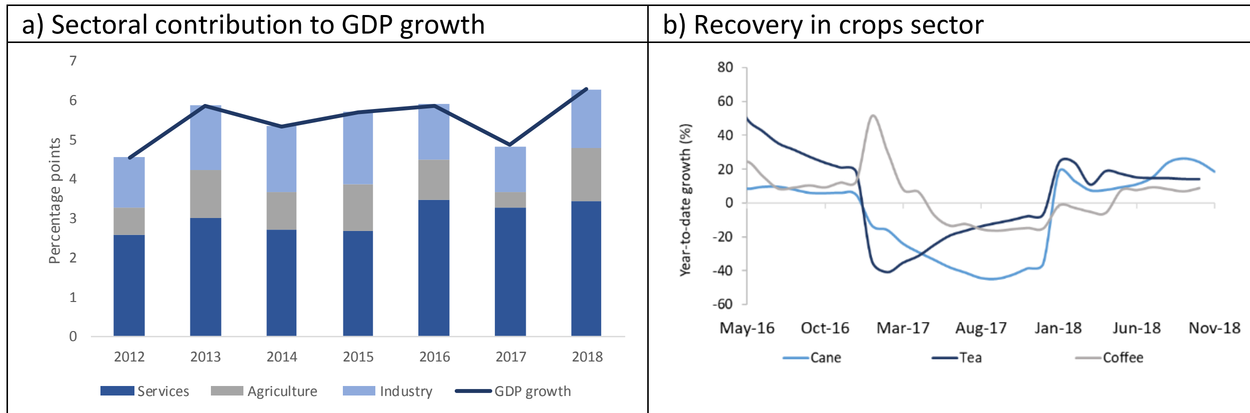
2.1. RECENT ECONOMIC DEVELOPMENTS

2.1 **Economic growth has been strong in recent years.** Real GDP growth averaged 5.7 percent between 2013-2018, above the average Sub-Sahara Africa growth rate of about 3.3 percent during the same period. In 2017 a severe drought, political uncertainty due to a prolonged election, and weak credit to the private sector led to growth falling to an eight year low of 4.9 percent. In 2018, the economy rebounded to a GDP growth rate of 6.3 percent, reflecting better rains, improved business sentiment and easing of political uncertainty (Table 1).

2.2 **On the supply-side, the rebound in the economic activity has been broad-based, with the most significant increase coming from the agricultural sector.** Reflecting favorable rains since Q42017, the agricultural sector has recovered with its contribution to GDP growth rising to 1.4 percentage points in 2018, compared to 0.4 percentage points in 2017 (Figure 1a and 1b). Supported by the recovery in business sentiment, recovery in private consumption and a pick-up in external demand, the contribution of the industrial sector rose to 1.5 percentage points of GDP growth in 2018 compared to 1.2 percentage points in 2017. The services sector, which accounts for approximately 58.5 percent of GDP, remained

resilient throughout the downturn in 2017 and continued its robust growth in 2018 (Table 1).

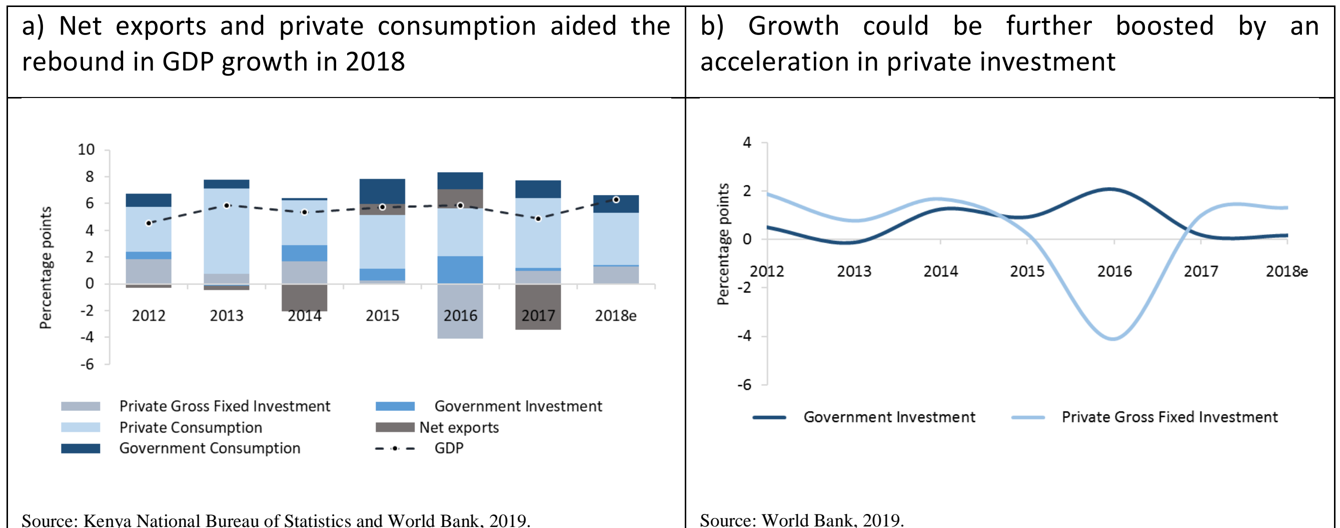
Figure 1: The contribution of agriculture to GDP growth and broad recovery in key crops



Source: Kenya National Bureau of Statistics and World Bank, 2019

2.3 On the demand side, the pick-up has been supported by the recovery in net exports, still strong private consumption and moderate investment growth. The return to positive export growth in 2018 compared to a contraction in 2017 increased the contribution of exports to economic growth. The slowdown in import demand together with the expansion in exports thereby helped to minimize the drag to growth from net exports (Figure 2a). Supported by improved incomes from agricultural harvests, lower food inflation (estimated at 1.6 percent in 2018 relative to 13.5 percent in 2017) and strong remittance inflows, private consumption (the largest component of aggregate demand) growth remained robust. This is evidenced in a solid 12 percent real growth in sales of items for which value added tax (VAT) is applicable. Consistent with the ongoing fiscal consolidation, government consumption growth significantly moderated in 2018. In contrast with the moderation in the contribution of public investment (a key driver in earlier years) to GDP growth, a nascent rebound in private investment occurred in 2018 (Figure 2b), driven by the easing of political uncertainty after the 2017 elections and the concomitant improvement in business sentiment.

Figure 2: The improvement to net exports, still robust private consumption and a nascent recovery in private investment is supporting the rebound of the Kenyan economy



Source: Kenya National Bureau of Statistics and World Bank, 2019.

Source: World Bank, 2019.

2.4 Inflation has remained within the government's target range (5±2.5 percent). Headline inflation averaged 4.7 percent in 2018 compared to 8.0 percent in 2017, representing the lowest inflation rate over the last seven years (Figure 3a). Sufficient rains and a rebound in agriculture brought down food inflation in 2018. The low food inflation in turn offset a temporary acceleration in energy prices resulting in a lower overall consumer price index. Further, core inflation, which excludes food and energy prices, has remained below 5 percent reflecting an economy where underlying demand pressures are still low. The benign inflationary pressure has also been supported by a stable local currency trading within a narrow band (100/US$ to 103/US$), thereby serving as a nominal anchor to inflationary expectations.

2.5 The Kenyan Shilling (KES) has remained generally stable and foreign exchange reserve buffers are adequate. A relatively lower import bill, strong remittance inflows, a rebound in tourism, and government borrowing in foreign currency have continued to support a stable exchange rate market with a moderate appreciation of the KES against the US Dollar in 2018. The 2018 Eurobond proceeds supported portfolio inflows while external borrowing by nonfinancial corporates remained steady. Although official foreign exchange reserves have decreased from US$8,540 million (5.6 months of import cover) in September 2018 to US$8,241 million (5.3 months of import cover) in February 2019, the level remains adequate and provides a comfortable buffer against short-term external shocks.

2.6 The recovery of the Kenyan economy is occurring amidst subdued credit growth. Thus far, the recovery of real sector activities has not translated to a rebound in credit growth to the private sector. As of February 2019, credit growth stood at 3.4 percent, well below its ten-year average of about 19 percent. In real terms the growth in credit is negative. The implementation of interest rate caps, beginning in the last quarter of 2016, is a key factor making it difficult for credit growth to recover[3]. With interest rate caps

[3] Kenya passed the Banking (Amendment) Act No. 3 of 2016 which introduced Section 33B of the Banking Act. Section 33B provided a ceiling of 4 percent over the rate set by the CBK on interest changed by financial institutions regulated under the Banking Act and a floor on deposit rates of at least 70 percent of the base rate set by the CBK. The Act was subsequently amended

Table 1: Kenya: Selected Economic Indicators, 2012- 2020

	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021
								Est.	Proj.	Proj.
Output and prices	**(Annual percentage change, unless otherwise indicated)**									
Real GDP	4.6	5.9	5.4	5.7	5.9	4.9	6.3	5.8	6.0	6.1
Agriculture	3.1	5.4	4.4	5.3	4.7	1.9	6.4	4.8	4.6	4.3
Industry	4.2	5.3	6.1	7.3	5.9	3.8	5.3	5.4	5.4	5.7
Services	4.7	5.4	6.0	6.0	6.3	6.3	6.6	6.3	6.8	6.9
Private consumption	4.5	8.4	4.3	5.2	4.8	7.6	5.9	6.8	7.1	7.1
Government consumption	6.9	6.1	1.7	11.5	5.6	5.1	1.0	5.8	5.6	5.8
Gross fixed capital investment	12.4	2.1	14.5	5.3	-9.4	6.3	4.6	5.6	5.7	5.9
Exports, goods and services	6.8	-2.2	5.8	6.2	-2.2	-6.8	4.0	6.8	7.1	7.1
Imports, good and services	5.2	-0.4	10.4	1.2	-3.4	8.7	2.6	8.9	9.0	9.0
GDP deflator	9.4	5.2	8.1	10.0	8.1	2.7	2.8	7.9	8.1	8.2
CPI (period average)	9.4	5.7	6.9	6.6	6.3	8.0	4.7	5.7	6.5	7.0
Money and credit	**(Annual percentage change, unless otherwise indicated)**									
Broad money (M3)	14.1	15.5	16.7	14.1	3.7	9.5	8.5	27.7	20.1	18.8
Credit to non-government sector	10.4	20.1	22.2	16.0	4.1	2.4	12.6	17.9	19.8	19.8
Policy rate (CBR)	11.0	8.5	8.5	11.5	10.0	10.0	9.4	..	..	..
NPLs (percent of total gross loans)	..	..	..	6.8	9.1	10.6	..	..	..	..
Central government (fiscal year i.e 2012 = 2012/13)	**(Percent of GDP, unless otherwise indicated)**									
Total revenue & grants	19.7	19.7	19.5	19.2	18.9	17.6	18.7	18.8	18.9	19.2
Tax revenues	15.6	16.8	16.4	16.4	15.9	14.3	15.4	15.5	15.8	16.1
Non-tax revenues	3.7	2.4	2.5	2.3	2.7	3.0	2.9	2.8	2.7	2.6
Grants	0.5	0.5	0.5	0.5	0.4	0.3	0.5	0.5	0.4	0.4
Expenditure	25.1	25.6	28.1	27.2	27.6	24.4	25.1	23.8	22.8	22.4
Current	18.1	14.8	14.8	15.6	15.2	15.4	15.1	14.6	14.2	14.1
Capital	6.8	6.3	8.7	7.0	8.4	5.3	6.3	5.9	5.7	5.7
Transfer to counties	0.2	3.8	3.9	4.1	3.7	3.5	3.1	2.8	2.5	2.3
Primary balance	-3.0	-3.4	-5.1	-4.0	-5.3	-3.1	-2.5	-1.3	-0.3	0.2
Overall balance including grants	-5.7	-6.1	-8.1	-7.3	-8.8	-6.8	-6.3	-5.1	-3.9	-3.3
Excluding SGR	-5.4	-5.9	-6.3	-6.9	-7.4	-6.1	-5.3	-4.6	-3.3	-2.7
Financing	5.7	6.1	8.1	7.3	9.1	7.2	6.3	5.1	3.9	3.3
Net domestic borrowing	3.8	4.0	4.4	3.1	4.1	3.1	3.1	2.4	1.7	1.6
Foreign financing	1.9	2.1	3.7	4.1	5.0	4.0	3.2	2.7	2.2	1.7
Public debt stock (fiscal year i.e 2012 = 2012/13)	**(Percent of GDP, unless otherwise indicated)**									
Public gross nominal debt	42.1	47.8	48.8	55.5	57.5	57.3	56.5	55.1	52.7	49.8
External debt	18.7	22.4	24.4	27.6	30.0	29.1	28.7	28.1	27.1	25.6
Domestic debt	23.3	25.3	24.4	27.9	27.6	28.2	27.8	27	25.6	24.2
Public net nominal debt	38.5	43.7	44.6	49.3	51.9	51.5	51.5	50.6	48.7	46.2
External sector	**(Percent of GDP, unless otherwise indicated)**									
Exports (goods and services)	22.2	19.9	18.3	16.6	14.0	13.2	13.5	13.6	13.8	14.0
Imports (goods and services)	35.5	33.2	33.0	27.6	22.8	24.1	25.6	26.8	27.9	28.9
Current account balance (including grants)	-8.4	-8.8	-10.4	-6.7	-4.9	-6.2	-5.0	-6.5	-6.8	-7.2
Gross international reserves										
In billions of US$	7.2	8.5	9.7	9.8	9.6	9.6	..	..	..	
In months of imports cover (36 months import)	4.3	4.5	5.1	4.8	5.0	4.9	..	..	..	
Memorandum items:										
GDP at current market prices (Billion of Kenyan shillings)	4,261.4	4,745.1	5,402.6	6,284.2	7,023.0	8,144.4	8,905	10,657	12,209	14,009
US$ billion	50.4	55.1	61.4	64.0	69.2	78.8	87.9	102.1	114.7	129.1
GDP per capita (nominal US$)	1,155	1,229	1,335	1,450	1,525	1,690	1,839	2,001	227	2,478

Sources: World Bank, IMF, Central Bank of Kenya, Kenya National Bureau of Statistics, and National Treasury, 2019

in 2018 to provide some clarity to the section 33B to indicate the "base rate" referenced is the Central Bank Rate. The amendment also removed the floor on deposits.

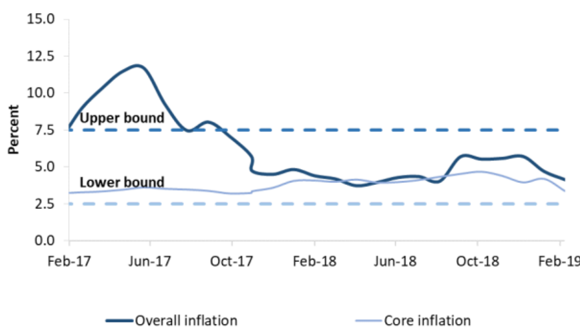
tied to the policy rate, the effectiveness of monetary policy in supporting growth is compromised. Over the past year the policy rate has been reduced by some 100 basis points. While this serves to benefit "blue chip" Kenyan borrowers (i.e. government and large corporates) small and medium-sized enterprises, the back-bone of the Kenyan economy continue however to be priced out given the higher risk premium attached to them[4].

2.7 While capital adequacy and profitability indicators across the banking system remain high, the level of non-performing loans (NPL) is elevated. High levels of NPLs, estimated at 12.8 percent in February 2019 continue to constrain lending across key sectors (trade, manufacturing, construction, and transport and communications sectors). While headwinds from the low-growth environment in 2017 affected bank profitability, return on assets remained sizeable and capital adequacy ratios remain high at 18.1 percent in February 2019. Nonetheless, smaller banks face a difficult operating environment as interest rate controls have significantly eroded operating margins.

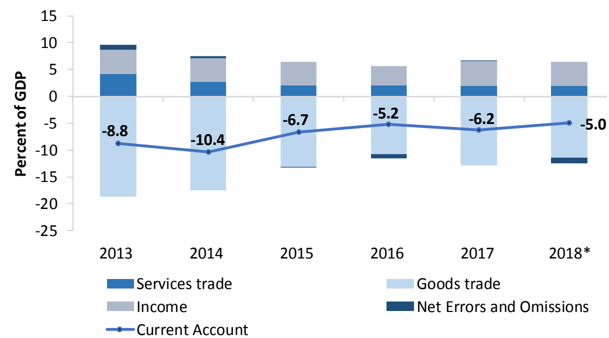
2.8 The current account deficit narrowed in 2018 and remains adequately financed. In the twelve months to December 2018, the current account deficit narrowed to 5.0 percent of GDP compared to 6.2 percent of GDP in 2017 due to stronger diaspora remittance inflows, improved exports of tea and horticulture, and strong receipts from tourism (Figure 3b). At the same time. the trade deficit decreased slightly as export receipts benefitted from a broad pick-up in global commodity prices for tea and horticulture. The current account deficit continues to be adequately financed by the surplus in the financial account, resulting in a buildup of official reserves.

Figure 3: Inflation has remained within the target band while the current account deficit has decreased

a) Inflation remains within target range



b) Current account deficit has narrowed



Source: Kenya National Bureau of Statistics, Central Bank of Kenya (CBK) and World Bank, 2019.

2.9 After years of expansion, fiscal consolidation is underway. Driven by higher infrastructure spending, the roll-out of devolution, and structural factors such as rising interest payments, the share of government expenditure rose to 27.6 percent of GDP in FY 2016/2017 (Table 2) from 25.6 percent in FY2013/2014. However, the growth in revenues did not keep apace; total revenues and grants declined by almost one-percentage point to 18.9 percent of GDP in FY2016/2017 relative to FY2013/2014, thereby

[4] World Bank 2017, Kenya Economic Update (December 2017).

resulting in the widening of the overall fiscal deficit to a peak of 8.8 percent of GDP in FY2016/2017 (Figure 4a). In FY 2017/2018, the government commenced fiscal consolidation with the overall fiscal deficit declining to 6.8 percent, the fastest pace of fiscal consolidation since 2010 and surpassing the targeted budget deficit of 7.2 percent of GDP.

2.10 A slowdown in government spending was a key driver to the lower fiscal deficit. Government spending decreased from 27.6 percent of GDP in FY2016/2017 to 24.4 percent in FY2017/2018 with development expenditure contracting from 8.4 percent of GDP to 5.3 percent of GDP (or by 3 percentage points) over the same horizon. In FY2018/2019, government spending is estimated at approximately 25.1 percent of GDP with a projected pick-up in capital spending to 6.3 percent of GDP (Table 2). Nonetheless, with limited discretionary budget (total expenditure and net lending less non-discretionary budget), the scope for achieving fiscal adjustment through expenditure cuts without hurting priority spending is narrowing. Still, given the need to protect development spending, it is important that the GoK also undertakes policies to rationalize recurrent expenditure. With this context, policy actions to automate and enhance debt management supported by this operation, will help reduce net interest payments. In addition, the Government Owned Entities Bill of 2015, when passed by Parliament, will support a framework for the restructuring of state-owned enterprises (SOEs) (including mergers and dissolution) into leaner and efficient enterprises that help crowd in private investment, reduce contingent fiscal liabilities, and accelerate Kenya's growth in the medium term[5].

2.11 Fiscal out-turns for H1 FY2018/2019 show both revenue collection and expenditure falling below target. Tax revenue underperformed by 0.5 percent of GDP to close at 7.2 percent of GDP for the H1 of 2018/2019, due to a shortfall in both income taxes and excise duties. Excise duties underperformed on account of low withholding tax on winnings from betting and a decline in corporate tax instalments from commercial banks (even with high reported profits) due to deductibles carried forward from the previous year. Expenditures fell below target (by 0.6 percent of GDP) due to delays in budget implementation. Consequently, the fiscal deficit at the end of July-December 2018 was 2.9 percent of GDP relative to the target of 2.5 percent of GDP.

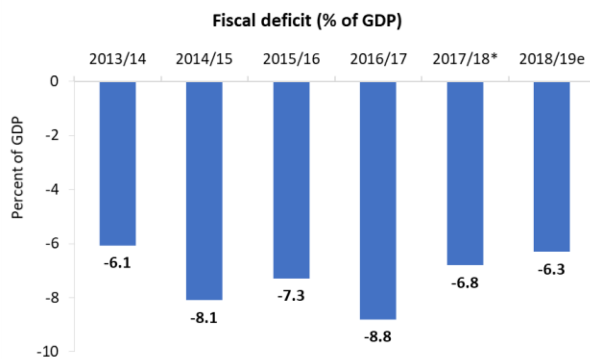
2.12 Stepping up domestic revenue mobilization efforts remains key to achieving planned fiscal consolidation. To enhance revenue for the current FY2018/2019, the Finance Act of 2018 introduced several tax measures including an 8 percent value added tax on petroleum products, a presumptive tax of 15 percent on the single business permit, new withholding taxes on winnings (betting and gaming), and other measures. Since the Finance Act 2018 was passed in September 2018 and a number of the revenue generating measures only came into effect in January 2019, the full impact of the new revenue measures is yet to be realized. The government estimates a cumulative yield of approximately 0.9 percent of GDP in additional revenues. The plugging of tax loopholes, especially through rationalizing exemptions as contained in the draft Income Tax Bill, should also help to boost revenues when passed. Over the longer-term a further broadening of the tax base and a re-calibration of the sources of growth from a strong public sector driven growth model to one driven by strong private investment (including private investment in support of the government's inclusive growth agenda) should boost fiscal revenues and further support the needed fiscal consolidation.

[5] As of June 2017, the outstanding balance of national government loans to parastatals was KES 811.4 billion, higher than the total development expenditure.

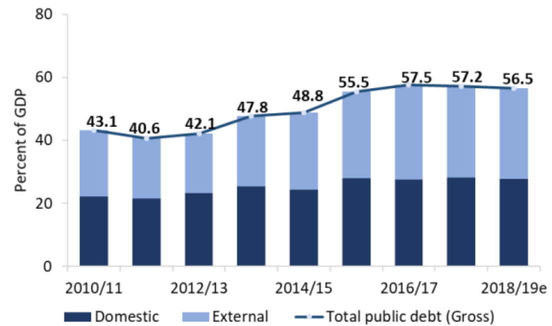
2.13 The ongoing fiscal consolidation is supporting a moderation in the rise in the debt stock. Because of years of fiscal expansion, overall public debt rose from about 42.1 percent of GDP in June 2013 to 57.5 percent of GDP in June 2017 and moderated in 2018 (Figure 4b). In terms of composition, the surge in total public debt was attributed to an increase in both external and domestic debt, as government borrowed to finance large infrastructure projects. The underperformance in revenue generation also contributed to increased borrowing. As of June 2018, the split between external and domestic debt in the total debt stock is about 51:49. However, reflecting higher domestic interest rates, debt servicing charges on the domestic debt stock are about three times higher than from the external debt stock. In February 2018, Kenya successfully issued a US$2 billion Eurobond (US$1 billion for 10 years and US$1 billion for 30 years at 7.25 and 8.25 percent respectively). This issuance is expected to lengthen the maturity profile of loans as well as help refinance upcoming bullet payments on external debt obligations. However, vulnerability to developments in international markets have also increased.

Figure 4: The authorities have embarked on a fiscal adjustment program

a) Fiscal consolidation is underway



b) The stock of public debt has moderated



Source: The National Treasury, 2019.

Table 2: Kenya - Key Fiscal Indicators (% of GDP), 2012/13 - 2021/22

	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/2021	2021/22
							Estimate	Projection	Projection	Projection
Total Revenue and Grants	**19.7**	**19.7**	**19.5**	**19.2**	**18.9**	**17.6**	**18.7**	**18.8**	**18.9**	**19.2**
Total Revenue[1]	19.2	19.2	19.0	18.7	18.6	17.3	18.3	18.3	18.5	18.8
Revenue[2]	17.2	18.1	17.7	17.7	17.1	15.5	16.5	16.5	16.7	17.0
Income tax	8.3	8.9	8.7	8.6	8.2	7.3	7.7	7.8	8.0	8.2
VAT	4.1	4.6	4.5	4.4	4.4	4.1	4.3	4.4	4.5	4.6
Import Duty	1.3	1.3	1.3	1.2	1.2	1.1	1.2	1.2	1.2	1.2
Excise Duty	1.9	2.0	2.0	2.1	2.2	1.9	2.1	2.1	2.1	2.2
Other Revenues	1.7	1.3	1.3	1.3	1.1	1.2	1.1	1.0	0.9	0.9
Railway Levy	0.0	0.0	0.0	0.0	0.2	0.2	0.2	0.2	0.2	0.2
Appropriation in Aid	2.0	1.1	1.3	1.0	1.3	1.6	1.5	1.6	1.5	1.5
Grants	0.5	0.5	0.5	0.5	0.4	0.3	0.5	0.5	0.4	0.4
Expenditure and Net Lending	**25.1**	**25.6**	**28.1**	**27.2**	**27.6**	**24.4**	**25.1**	**23.8**	**22.8**	**22.4**
Recurrent	18.1	14.8	14.8	15.6	15.2	15.4	15.1	14.6	14.2	14.1
Wages and salaries	6.1	5.5	5.1	4.7	4.4	4.4	4.2	4.1	3.9	3.6
Interest Payments	2.7	2.7	2.9	3.3	3.5	3.7	3.8	3.8	3.6	3.5
Domestic Interest	2.4	2.3	2.4	2.7	2.8	2.7	2.7	2.5	2.5	2.5
Foreign Interest	0.2	0.3	0.6	0.7	0.8	1.0	1.1	1.2	1.1	1.0
Pensions	0.6	0.6	0.6	0.8	0.8	0.7	0.9	1.0	1.0	1.0
Operations and Mantainance &Oth	8.7	6.0	6.1	6.7	6.4	6.5	6.1	5.7	5.7	6.0
Development	6.8	6.3	8.7	7.0	8.4	5.3	6.3	5.9	5.7	5.7
Transfer to Counties	0.2	3.8	3.9	4.1	3.7	3.5	3.1	2.8	2.5	2.3
Equalization fund	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Deficit including grants (cash basis)	**-5.7**	**-6.1**	**-8.1**	**-7.3**	**-8.8**	**-6.8**	**-6.3**	**-5.1**	**-3.9**	**-3.3**
Financing	**5.7**	**6.1**	**8.1**	**7.3**	**9.1**	**7.2**	**6.3**	**5.1**	**3.9**	**3.3**
Domestic Financing	3.8	4.0	4.4	3.1	4.1	3.1	3.1	2.4	1.7	1.6
Foreign Financing	1.9	2.1	3.7	4.1	5.0	4.0	3.2	2.7	2.2	1.7
Primary balance	-3.0	-3.4	-5.1	-4.0	-5.3	-3.1	-2.5	-1.3	-0.3	0.2
Deficit including grants excluding SGR	-5.4	-5.9	-6.3	-6.9	-7.4	-6.1	-5.3	-4.6	-3.3	-2.7

Source: National Treasury and Ministry of Planning (Quarterly Economic and Budget Reviews, Medium Term Budget Policy Statement 2018)
Notes: (1) Total Revenue is a sum of Revenue, Railway Levy and Approrpiation-in-Aid.
Note: (2) Revenue is a sum of Tax Revenues (Income Tax, VAT, Import Duty, Excise Duty) and Other Revenues.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

2.14 Given the slack in the economy, the pick-up in economic activity that started in 2018 is expected to continue over the medium term. With a negative output gap still persisting, there is room for GDP growth in Kenya to pick-up even above its potential GDP growth over the near to medium term[6]. Against this backdrop, and coupled with ongoing reform efforts which should help boost total factor productivity growth, GDP growth is projected at 5.8 percent in 2019, rising to 6.0 and 6.1 percent, respectively in 2020 and 2021 [Table 1]. Growth in 2019 is expected to be driven by favorable agricultural output, a pick-up in industrial activity and still strong performance in the services sector. Aggregate demand is also projected to strengthen, because of the recovery in private investment and improved business sentiment. The government projects real GDP growth at 6.2 percent for 2019, rising steadily to 6.5 percent by 2021. A reform dividend from the implementation of the "Big Four" agenda will support growth over the near to mid-term. However, fiscal slippages, higher oil prices, and a volatile external environment pose downside risks to the outlook.

[6] Potential GDP growth is estimated between 5.4 to 5.7 percent.

2.15 The outlook assumes higher agricultural output over the medium term, supported by favorable weather conditions and improved productivity. Agriculture remains a key driver of the Kenyan economy. Normal weather patterns, coupled with the ongoing policy and institutional reforms in the agricultural sector, will boost productivity, and contribute to a steady increase in the contribution of agriculture to GDP growth in the medium term. Specifically, improvements in input markets such as better availability of fertilizer as well as improved policies for irrigation and water management will help increase output and reduce vulnerability to droughts. Furthermore, establishing a functioning warehouse receipt system and a Commodities Exchange will address post-harvest losses (up to 35 percent), enhance farmers income and support food security.

2.16 The growth in the manufacturing sector will be supported by ongoing policy actions to boost private investments directly and linkages with the agriculture sector. The gradual pick-up in manufacturing is supported by its close linkage to agro-based processing as well as recovery in non-food manufacturers. In addition, manufacturing is part of the "Big Four" priority sectors and the government has identified three special economic zones (Dongo-Kundu, Naivasha, and Eldoret) and is finalizing an investment policy framework to further attract and retain investors into manufacturing in Kenya.

2.17 Performance in the service sector is projected to remain broadly stable over the medium term. The services sector, which accounts for approximately 58.5 percent of GDP, is projected to grow at an average rate of 7.0 percent over the medium term. Wholesale and retail trade is also expected to remain strong as aggregate demand recovers. Information and communications technology (ICT)-related reforms such as increasing broadband connectivity and access will lower the cost of doing business and improve total factor productivity in the medium term.[7]

2.18 Inflation is expected to stay within the government's target band of 5±2.5 percent. Barring unanticipated price shocks, this provides scope for a more accommodative monetary policy stance to support growth as needed. A slightly wider current account deficit over the medium term is driven by improvements in key commodity exports, stronger remittance inflows, and tourism receipts (Table 3).

2.19 The authorities have expressed their commitment to narrowing the fiscal deficit over the medium term. Reflecting this commitment, the medium-term fiscal framework projects that the overall fiscal deficit including grants will narrow from 6.8 percent of GDP in FY 2017/2018 to 6.3 percent in FY2018/2019 and stabilize at 3.9 percent of GDP in FY 2020/2021[8]. On the expenditure side, the authorities aim to achieve this through moderation of spending and postponement of lower-priority capital projects. Furthermore, the completion of phase I of the Standard Gauge Railway (SGR), the single largest public infrastructure project in recent years, should contribute towards the moderation in public spending.[9] On the revenue side, policy measures including a widening of the tax base by reducing VAT exemptions on petroleum products, rationalization of corporate income taxes through the revised Income Tax Act and the imposition of the Presumptive tax in an attempt to capture potential tax payers in the

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[7] A growth accounting model developed for Kenya shows that until 2012, growth in Kenya was driven primarily by factor accumulation (labor and capital). During the period 2013-2017, the contribution of total factor productivity to growth began steadily increasing and is expected to average about 26 percent during the period 2018-2021.
[8] The governments' intentions are outlined in its Budget policy statement (February 2019) and the Budget estimates for FY 2018/19, which have been approved in Parliament.
[9] The second phase of the SGR is estimated to be less expensive than the first phase.

informal sector (over 75 percent of enterprises are in the informal sector) should help increase tax revenues. Complementing these policy measures, the GoK is also carrying out a series of administrative measures to improve collection, including enhanced scanning, implementation of an electronic cargo tracking system, and increasing use of databases to detect non-compliance.

2.20 Still, this pathway to medium term fiscal consolidation remains subject to significant challenges. These challenges could emerge from continued revenue underperformance relative to the budget, pressures on recurrent spending (wage agitations, transfers to SOEs, interest payments), and a persistence in weak tax buoyancy as well as unexpected shocks to the economy (e.g. droughts in 2017 led to an increase in the provision of subsidized imported maize). Were these to persist, they would most likely lead to a less ambitious fiscal consolidation than planned for. The International Monetary Fund (IMF) estimates that without further domestic revenue mobilization efforts the status quo could lead to a less ambitious fiscal consolidation pathway of about 1.5 percentage points of GDP through FY 2021/2022. Furthermore, development spending could bear the brunt of the needed expenditure adjustments given the sensitivities around aspects of recurrent expenditure including interest payments, and national government loans to parastatals.

2.21 The regressive nature of the interest rate cap is a downside risk to the macroeconomic outlook and the achievement of the program objectives. The interest rate cap was intended to reduce the cost of credit, thereby making credit accessible to a wider range of borrowers. However, after years of implementation, the decline in credit growth to the private sector has continued with several unintended negative consequences to the economy (Box 1).[10] Further, interest rate controls could adversely impact the achievement of the program objectives if it stifles efforts to raise longer-term financing instruments to boost the demand for affordable housing. The Executive arm of government is cognizant of the importance of allowing banks to appropriately price risks and has made efforts to modify or remove the interest rate caps (see Box 1).

[10] World Bank. 2017. Kenya Economic Update, Edition 16: *Poised to Bounce Back? Reviving Private Sector Credit Growth and Boosting Revenue Mobilization to Support Fiscal Consolidation*.

Box 1: DEVELOPMENTS ON INTEREST RATE CONTROLS IN KENYA

Background: A law capping interest rates became effective in September 2016. The Banking (Amendment) Act No. 3 of 2016 introduced Section 33B of the Banking Act and put a ceiling on lending rates by banks and financial institutions at 4 percentage points above the Central Bank Rate (CBR), with a floor on term deposit rates equal to 70 percent of the CBR. This new legislation was in response to the public view that lending rates in Kenya were too high, and that banks were engaging in predatory lending behavior. The floor on deposit rates was removed through an amendment in 2018.

Impact: Interest rate controls has had unintended negative consequences in Kenya. A World Bank (2017) study shows interest rate caps have:

- negatively affected bank lending to small borrowers, households and SMEs—with the proportion of new borrowers falling by more than half from a peak of 13 percent in March 2016 to roughly 6 percent after the caps, likely impacting entrepreneurship and new job creation;
- resulted in a re-allocation of credit from the private to the public sector. Private sector credit growth remains very weak, with impacts on access to credit by small borrowers including small scale farmers and low-income households; and
- impaired monetary policy transmission and implementation.

However, quantifying the impact of the interest rate caps on overall lending to SMEs is challenging given the lack of definitive figures on the growth of loans from fintechs, savings and credit cooperatives (SACCOs), trade credit and other potential sources of credit that are not subject to the caps.

Efforts to repeal interest rates caps: The Executive's proposal to remove interest caps contained in the Finance Bill 2018 was unsuccessful as it faced political backlash from Parliament. Given the political economy issues, reforms to the cap is likely to take time. However, more recently, on March 14, 2019, a Kenyan High Court ruled that interest rate controls as stipulated in Section 33B of the Banking Act is unconstitutional for being vague, ambiguous, imprecise and indefinite. The court has provided lawmakers a window of 12 months to make appropriate amendments.

2.22 Beyond the interest rate cap, unlocking credit growth to small and medium enterprises (SMEs) would benefit from both macroeconomic and micro level reforms. The removal of the interest rate cap alone will not be enough and needs to be simultaneously complemented by a deeper set of reforms to support credit expansion in a sustainable and affordable manner. On the macroeconomic side, reforms to support the reduction in fiscal deficit and enhance the management of public debt supported by this operation, is key to lowering benchmark interest rates and ultimately bank lending rates. On the microeconomic front, accelerating a number of measures being implemented by the government could contribute towards improving credit access to SMEs and eventually pave the way for the removal of the interest rate cap. These include the implementation of the movable collateral registry, and the universal adoption of credit scoring and sharing which would help counteract perennially high interest rates for borrowers and improve bank lending policies.[11] In addition, reforms that strengthen consumer protection and increase financial literacy are essential to addressing predatory lending. In this regard, efforts

[11] World Bank technical assistance is supporting the GoK to strengthen credit information sharing mechanism through credit bureaus and the implementation of Kenya's electronic movable asset collateral registry to help reduce the costs for SMEs. However, renewed effort is needed to accelerate the implementation of these reforms.

underway by the various financial sector regulators to develop conduct regulations under their respective legal frameworks, including for non-deposit taking credit providers and Fin techs (which have grown exponentially in recent years) are commendable. Further, the Banking Sector Charter introduced by the CBK to provide direction to the banking sector to, inter alia, increase access to affordable and appropriate financial services to the unbanked and under-served population can also help to improve access to credit. Finally, ongoing efforts to develop a credit guarantee scheme to support SMEs could help boost credit to the SMEs.

Table 3: External Financing Requirements and Sources (2015-2021)

Table 3: Kenya: External Financing Requirements and Sources, 2015–2021

In Million of U.S. dollars, unless otherwise indicated	2015	2016	2017	2018	2019	2020	2021
	Act.	Act.	Act.	Act.	Projections		
External financing requirements	**-4,904**	**-4,301**	**-6,582**	**-7,844**	**-8,132**	**-8,211**	**-9,546**
Current account (excluding official transfers)	-4,288	-3,385	-4,868	-4,362	-5,843	-6,774	-7,799
Scheduled amortization (official)	-978	-565	-1,822	-2,370	-1,283	-1,128	-1,102
Build-up of gross official reserves(-=increase)	361	-38	241	-1,112	-1,006	-309	-645
Financing sources	**4,904**	**4,301**	**6,582**	**7,844**	**8,132**	**8,211**	**9,546**
Official Development Assistance	2,408	2,346	2,443	2,510	2,944	3,290	3,676
IMF credit (net)	-107	-91	-77	-64	-42	-21	-10
Official commercial financing	759	-209	2,617	3,757	1,865	506	669
Private financing (net)	1,844	2,255	1,599	1,641	3,365	4,436	5,211

Source: World Bank staff calculations based on data from National Treasury, Kenya National Bureau of Statistics and IMF, 2019.

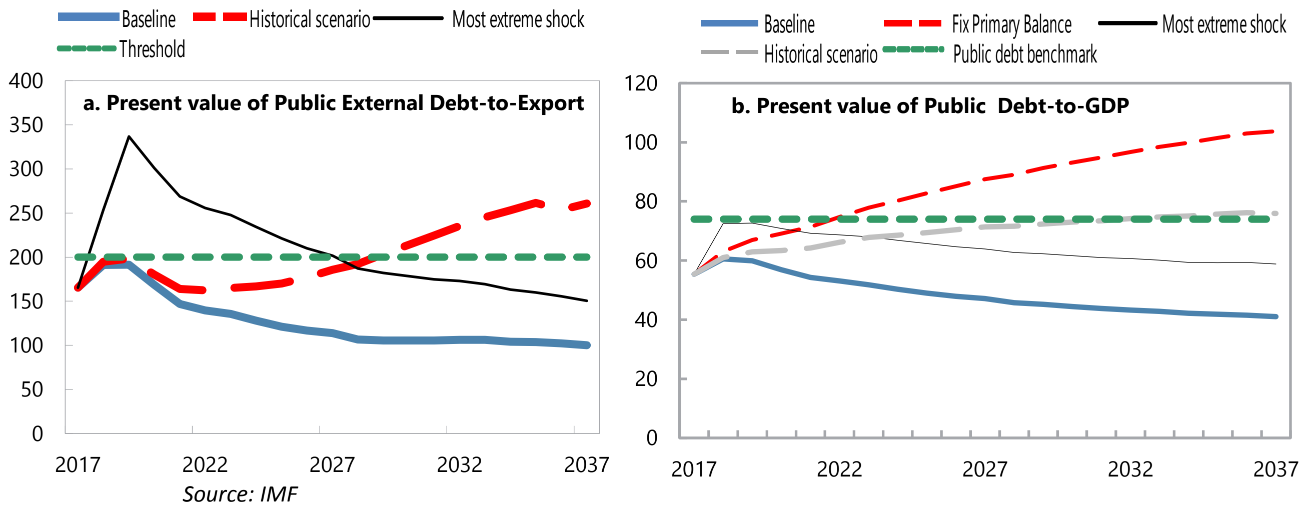
2.23 Though the current account deficit is projected to moderately increase, it is expected to be adequately financed over the medium term. Exports are projected to improve marginally over the medium term as growth in Kenya's trading partners improves and prices of its main exports (tea, coffee, horticulture) hold steady. Receipts from tourism are projected to continue to remain robust. However, the trade balance is expected to remain negative while the current account deficit is projected to widen between 2018 and 2021. The projected widening of the current account deficit will be driven by a higher import bill arising from pick-up in domestic demand and a recovery in oil prices towards the end period of the forecast horizon. The baseline projection assumes that, although official commercial financing is likely to drop, the increase in capital inflows from official development and private sources (Eurobonds, syndicated lending) will be sufficient to finance the projected current account deficit. Stable capital flows will ensure that external financing needs are met in the medium term, and that the GoK can refinance upcoming bullet payments on external debt obligations and gradually build-up foreign exchange reserves (Table 3).

2.24 Kenya's Debt Sustainability Analysis (DSA) shows that the risk of external debt distress has increased from low to moderate. Kenya's overall public debt is estimated at about 57.3 percent of GDP at end-June 2018 in nominal terms. Most debt has financed infrastructure to address bottlenecks and boost growth. In the baseline, overall public debt (in present value terms) peaks in 2018 (Figure 5), and gradually declines thereafter on the assumption that the authorities deliver on the envisaged medium-term consolidation (Table 1). The increase in risk rating reflects the breach of three external debt indicators—external debt service-to-export ratio, external debt service-to-revenue ratio, and the present value of external debt to export ratio—for an extended period under the most extreme shock scenario

(Figure 5a)[12]. While the first indicator is also breached under the baseline scenario, such a breach is temporary and marginal— related to a bullet Eurobond repayment. However, against the background of continued access to international markets and a comfortable level of official foreign reserves, Kenya should be able to meet its near-term repayment obligation. About half of Kenya's public debt is owed to external creditors. Most of Kenya's external public debt remains on concessional terms[13].

2.25 Stress-testing scenarios highlight the need to follow through on the intended medium-term fiscal consolidation. If the primary balance were to remain at its 2017 level, the present value (PV) of public debt-to-GDP would remain on an upwards trajectory and breach the 74 percent benchmark in 2022 (Figure 5b). Furthermore, under an extreme exchange rate shock scenario, the PV of debt-to-GDP would bring overall public debt to only about 1 percentage point of GDP away from its threshold, reflecting vulnerability of public debt to large changes in the exchange rate. To address these vulnerabilities, the Government is reducing the fiscal deficit over the medium term, and strengthening its debt management capacity to manage large repayments on commercial borrowing and avoid the crowding out of the private sector. At the same time, the GoK is also leveraging the availability of concessional financing, including through this operation, to lower the cost and lengthen the maturity profile of its debt.

Figure 5: Present Value of Public Debt under Alternative Scenario's, 2017-2037



Source: IMF

2.26 The overall medium-term outlook is still subject to downside risks relating to both domestic and external developments. On the domestic front, subdued growth in private sector credit, a recurrence of adverse drought shocks and fiscal slippages leading to macroeconomic instability could potentially reverse some of Kenya's recent gains (macro-stability, robust growth, poverty reduction). On the external front, a spike in oil prices, uncertainty and rising global trade tensions, and tightening of global financial market conditions due to ongoing normalization of monetary policy in advanced economies may result in reversal of capital flows from emerging and frontier markets, including Kenya. Tighter global financial conditions

[12] The two shocks are: (i) Figure 5a: an export shock defined as export values remaining permanently at its lowest level while the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly offsetting the adjustment in import levels); (ii)Figure 5b: a one-time depreciation of 30 percent taking place in 2018.
[13] The DSA was concluded in June 2018 before the FY2018 data became available.

represent an immediate risk to the GoK's ability to refinance upcoming debt repayments at favorable rates.

2.27 Fiscal slippages represent a vulnerability to the economy. While the GoK's path of fiscal adjustment is ambitious and achievable, this will require a bold reform agenda in revenue mobilization (including widening the tax base), curtailing the expansion in recurrent spending and improving debt management. Over the medium-term, reforms supported by this operation to streamline tax exemptions, improve efficiency in spending (including public procurement) and re-calibrate the sources of growth from a strong public sector driven growth model to one driven by strong private investment, should boost fiscal revenues, reduce leakages in public spending, and lend support to the needed fiscal consolidation.

2.3 THE ADEQUACY OF THE MACROECONOMIC FRAMEWORK

2.28 The macroeconomic policy framework is considered adequate for the proposed operation. With GDP growth at almost 6 percent, Kenya remains one of the fastest growing economies in the region and among lower middle-income economies. Further, notwithstanding both domestic and external shocks, the macroeconomic environment remains remarkably stable with inflation mostly contained with the target corridor and the exchange rate being range-bound within a narrow corridor. At 5.3 months of import cover, Kenya has sustained a healthy level of external reserves. Further, improvements in its business regulatory environment (Kenya's ranking in the 2019 World Bank Doing Business Report improved 19 places from 80 to 61) has earned the country a spot among the global reformers. Kenya continues to be rated as a strong policy performer among low and middle-income countries in the World Bank's Country Policy and Institutional Assessment. It has a track record of carrying through reforms as evident in its ambitious devolution program and the sustaining of a stable macroeconomic environment despite the headwinds.

2.29 The authorities are committed to continuing fiscal consolidation. The authorities have committed to a reduction in the overall fiscal deficit to 6.3 percent of GDP by the end of this fiscal year (June 30, 2019) and a further 1.3 percent of GDP adjustment in 2019/2020 to reduce the deficit to 5.1 percent of GDP (June 30, 2020)[14]. The policy reforms supported by this operation to address revenue underperformance, curb wastages in spending and enhance debt management and transparency will support the government's effort in staying the course of fiscal consolidation. Reform efforts underway to boost inclusive growth, including those supported by this operation, should further strengthen the adequacy of the macroeconomic framework. The GoK also plans to implement measures that will pave the way for the eventual reform of the interest rate cap by supporting the market conduct of lending institutions to promote responsible lending practices.

2.30 Furthermore, the proposed operation has positive macrofiscal linkages. The proposed operation will help strengthen cohesion and coherence around policies to accelerate the implementation of the government's inclusive growth agenda. The availability of concessional financing through the operation will: reduce near term external financing pressures for the GoK; support the implementation of reforms to enhance debt and cash flow management; strengthen the management of scarce public resources; and enhance the delivery of government services. In addition, policies that unleash potential in the agricultural

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14 The governments' intentions are outlined in its Budget policy statement (February 2019).

sector and enhance delivery of affordable housing will help boost shared prosperity.

2.4 IMF RELATIONS

2.31 Discussions are ongoing for a successor IMF Stand-By Arrangement (SBA). The previous 24-month SBA with access to about SDR 1.06 billion expired on September 14, 2018. The program focused on reducing the fiscal deficit and reforms to the interest rate cap. The performance under this program was mixed. Prior reviews were missed because of political headwinds related to the 2017 elections and revenue shortfalls. In addition, the introduction of interest rate caps in September 2016 reduced the effectiveness of the monetary policy framework. The GoK treated the facility as precautionary and did not draw down under the arrangement. A new program would likely carry over the objectives of the prior program—containing the fiscal deficit and defining a credible path to the removal of interest rate caps. Negotiations are still ongoing.

3. GOVERNMENT PROGRAM

3.1 Kenya Vision 2030 is the government's long-term development blue print. It aims to transform Kenya into a middle-income industrialized country offering a high quality of life to all its citizens. Kenya's Vision 2030 is aligned with the Sustainable Development Goals, and is being implemented through successive five-year MTPs with each phase having particular areas of emphasis.

3.2 The current administration has prioritized four main pillars as part of the MTP III. After the elections in late 2017, the current administration spelled out its strategic priority development areas for the next five years. These are reflected in the Third MTP III, 2018-2022. The four main priorities (otherwise referred to as the "Big Four") are: ensuring that all citizens enjoy food security and nutrition; the delivery of at least 500,000 affordable housing units; achievement of universal health coverage; and raising the share of manufacturing to 15 percent of GDP (it has averaged 9.4 percent since 2013). Implementation of these four priority areas is expected to support higher and inclusive economic growth, faster job creation, and a reduction in the cost of living for the poor. The Government recognizes that these objectives will be achieved through sustaining economic growth and macroeconomic stability in addition to implementing reforms aimed at providing an enabling environment for all stakeholders to play their role towards achieving the "Big Four".

3.3 Policy and institutional reforms are an important part of achieving these MTPs. Cognizant of the dwindling fiscal space, the GoK seeks to create an enabling environment that will incentivize the private sector to help deliver on its plans. It also seeks to improve upon the fiscal space to enable more effective public sector contribution in service delivery. In agriculture, the Government seeks to boost food and nutritional security through increased output and agricultural processing. The Government aims to deliver its housing sector priorities through enacting policies that lower the cost of housing, improve access to more affordable mortgages and provide access to lower cost funding. In ICT, it seeks to upgrade the national ICT infrastructure and to improve the regulatory framework. In health, the Government is prioritizing the provision of Universal Health Coverage by implementing programs that increase health insurance coverage and access to quality health care services. Raising the share of manufacturing is expected to be accompanied by an increase in foreign direct investment and significant job creation.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

4.1 **The program development objectives** are to: (i) crowd in private investment and financing for affordable housing; (ii) enhance farmer incomes and food security; (iii) create fiscal space to allow the government to invest in key development programs; and (iv) crowd in private investment and leverage digitization to support the government's inclusive growth agenda.

4.2 **The proposed operation is directly linked to the GoK's "Big Four" inclusive growth agenda.** Two of the pillars of the proposed operation are directly linked to two of the "Big Four" priorities (affordable housing - pillar 1; and farmer incomes and food security– pillar 2), while the other pillars address foundational issues that underpin the achievement of the "Big Four" and the broader inclusive growth agenda. The choice of the two pillars of direct focus in the proposed operation reflects a combination of factors including potential impact on the poor, available analytical evidence to underpin reforms, level of existing World Bank engagement in the respective areas, including complementarity with other World Bank projects, appropriateness of instruments to address the identified challenges, and reform momentum by the Kenyan Government.

4.3 **The third and fourth pillar of this proposed operation are foundational and will be critical for all four of the government's priority areas and the broader inclusive growth agenda.** Given the narrowing of the fiscal space in recent years, the absence of fiscal consolidation could undermine macroeconomic stability, thereby reversing the growth and poverty reduction gains of recent years. Hence, the prior actions to improve revenue mobilization, efficiency of spending, and debt management will enhance the government's capacity to deliver on the "Big Four". Further, the fiscal measures are complemented by other non-fiscal measures (e.g. advancing digitization and improving investment policy) towards the common objective of crowding in private investment and enhancing the government's capacity to deliver on its inclusive growth agenda.

4.4 **The current operation benefits from strong government engagement, as it is well situated within the stated "Big Four" priorities of the government.** Lessons of experience point to the critical importance of government ownership of the reform agenda. The GoK's strength of engagement has been demonstrated through the establishment of a multi-sector working group, complemented by strong central coordination by the National Treasury and Planning, to help advance the policy actions for the Big Four. The Government sees the DPF as an opportunity to help bridge the government's financing gap through concessional financing, while pursuing its own priorities, thereby helping to reduce fiscal pressures.

4.5 **There have been several legislative and institutional reforms to improve good governance and tackle corruption in Kenya over the past decade.** Most of the legislative changes to support good governance and reduce corruption are anchored in the new Constitution (2010) where the principle of good governance is solidly entrenched. Among reforms carried out are: the enactment of the Anti-Corruption Act (2011); the Leadership and Integrity Act (2012); the Public Finance Management (PFM) Act (2012); the Ethics and Anti-Corruption Commission Act (2011); the operationalization of the Assets

Recovery Agency; and the rollout of an Integrated Financial Management Information System (IFMIS).

4.6 There has been a renewed high level commitment to tackling corruption in Kenya in recent years. Measures taken by the current administration in the renewed fight against corruption include:

- strengthening institutions such as the Office of the Director of Public Prosecution and the Ethics and Anti-Corruption Commission that are mandated to fight against corruption;
- the vetting of all Procurement Heads and Heads of Accounts of government agencies to remove corrupt officials; and the conducting of lifestyle audits on public officers, in line with the Public Officer Ethics Act;
- through Executive Order No. 2 of 2018, more stringent disclosure measures have been introduced in relation to public procurement in Kenya. All procuring entities are now required to regularly maintain, update and publicize complete information on all tenders awarded which includes full details on the procurement process as well as the result. The order requires full disclosure of all awarded suppliers, contractors and suppliers to be provided to the public; and that this information is published through various platforms including e-citizen, Public Procurement and Regulatory Authority Websites, procuring entities websites, public notice boards and government publications;
- new enhanced transparency and accountability requirements have been introduced for Accounting Officers of Ministries, Departments and Agencies (MDAs).[15] They are now required to sign a pledge to commit to integrity and transparency of public resources under their supervision; and upon receipt of credible accusations of corruption and the initiation of investigations under enabling legislation, Accounting Officers will be expected to step aside pending conclusion of investigations;
- several high-profile government officials and individuals facing corruption charges;[16] The Government has also signed a framework agreement with foreign countries for the return to Kenya of assets that were acquired using proceeds of corruption and crime, and which are hosted abroad;
- the Judiciary dedicating additional anti-corruption courts to expedite the hearing and fast-tracking of pending cases. The World Bank is supporting the Judiciary through the Judicial Performance Improvement Project (P105269).

4.7 Prior actions supported in this operation contribute to improving good governance in Kenya. In the Agricultural pillar, prior actions that change the way government provides subsidies to farmers (from manual to electronic) improves targeting and thereby reduces rent-seeking opportunities. Similarly, the warehouse receipt system would help make the commodities supply chain efficient, competitive and transparent. The third pillar in this operation supports the creation of fiscal space and the disciplined management of fiscal resources. The prior actions in this pillar could help curb the misuse of public funds, and strengthen transparency, accountability and enforcement mechanisms (e.g. in public procurement). Further, the fourth pillar of this operation supports the advancement of digitization, including in the provision of government services. This enhances service delivery, and reduces the need for face-to-face interactions, thereby reducing opportunities for corruption.

4.8 Beyond this operation and the ongoing Judicial Performance Improvement Project (P105269), other World Bank-supported projects are contributing towards improving good governance in Kenya.

[15] Circular OP/CAB.39/1A from the Executive Office of the President on Transparency and Accountability Prescriptions for Accounting Officers of Ministries, Departments and Agencies, March 2018.
[16] According to the President’s State of the Nation Address in April 2019, eight Cabinet Secretaries and eight Principal Secretaries have stepped aside to give way for investigations and prosecution.

First, the Program to Strengthen GESDeK (P161387) supports the implementation of the PFM Reform strategy at the national level. Second, the Kenya Devolution Support Project (KDSP, P149129) supports the strengthening of county governments in the areas of public financial management human resource management, planning and monitoring and evaluation, and civic education and public participation. Third, the Kenya Accountable Devolution Program (KADP) multi-donor trust fund through the Kenya Governance Improvement Program (KGIP, P157209) supports counties in PFM and human resource management reforms which will have direct impact on public investment and service delivery.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1. Crowd in Private Investment and Financing for the Delivery of Affordable Housing.

4.9 **The current supply of formal housing in Kenya is not keeping up with a rapidly growing urban population.** Roughly 30 percent of Kenya's population lives in cities today, a figure expected to grow to 50 percent by 2050. However, only 50,000 new housing units are currently being constructed every year while demand for urban housing is projected to increase to nearly 300,000 units per year in 2050, from 80,000 in 2010.[17] The estimated accumulated housing deficit is currently estimated at 2 million units. As the supply of housing continues to fall behind demand, affordability has become more challenging, especially in urban centers. As a result, nearly 61 percent of urban households in Kenya are living in housing conditions that meet the United Nation definition of a slum. Given Kenya's continued urbanization, the problem will only exacerbate over the next decade with adverse implications for productivity and human capital performance if the status quo remains. The GoK recognizes this critical need and has included the provision of affordable housing as one of its main development priorities under its "Big Four" agenda. Measures to unlock the delivery of more affordable housing units through private investment will require addressing both the demand and supply side constraints to housing delivery.

4.10 **Supply side bottlenecks impinging on the provision of affordable housing include outdated regulations that are not responsive to current demands for safe and affordable housing.** The prior actions in this operation are supporting the delivery of affordable housing by addressing some of these supply side bottlenecks as part of a more comprehensive intervention by government.

Prior Action #1. The Recipient has (i) approved, through its Cabinet, amendments to the Sectional Properties Act to allow for individual titling of units in multi-story buildings; and (ii) enacted, through its Parliament, the Building Surveyors Act with the objective to improve building standards, including in low-income housing units.

Indicative Trigger #1. The Recipient has enacted through its Parliament the Physical Planning Bill which makes provision for the planning, use and regulation of land, allowing for changes to restrictive zoning laws that hold back the construction of multi-story buildings in high density areas.

[17] World Bank. 2017. Kenya Economic Update. Housing: Unavailable and Unaffordable. April 2017.

Indicative Trigger #2. The Recipient has: (i) enacted through its Parliament, the Built Environment Bill which provides the basis for building regulations and (ii) through the Ministry of Housing and Urban Development, issued the National Building Regulations ("the building code"), allowing the use of a wider range of construction materials and technology than what is prescribed in the 1968 building code.

4.11 The advancement of the GoK's affordable housing objectives will require multi-story units to be built at scale. Under current registration practices, it is challenging for a developer to obtain titles for individual units in multi-story buildings. Instead the "mother" title of the land is used to register the individual units as leases. This makes it very difficult for the developer to sell units as they build (which would allow them to get cash inflows early), and for the buyers to mortgage their unit. Further compounding the challenges to building of multi-story units are outdated zoning regulations that limit the construction of high-rise units. Hence, to support the delivery of affordable housing at scale by crowding in private investment, it is necessary to introduce a new Sectional Properties Act to facilitate the registration of property titles of individual units in multi-story buildings (**Prior Action #1)** as well as a new Physical Planning Act **(Indicative Trigger #1)** to allow for changes to zoning regulations.

4.12 For sustainability and affordability, it will be important to allow the use of new building technologies and to anchor building regulations in an appropriate piece of legislation. The Built Environment Bill anchors the National Housing Regulations, which were formerly known as the Building Code. This building code was made null and void when the Local Government Act was repealed with the onset of devolution. The National Housing Regulation is the subsidiary legislation that was developed to replace the Building Code and is subsidiary to the Built Environment Bill. Thus, the Regulation needs the Bill to be enacted to be well anchored in the law. Current legislation, dating back to 1968, mandates the use of specific material (e.g. stones and mortar) in the construction of buildings, thereby limiting the use of innovative building technologies that can enable the affordable and sustained scaling-up of the delivery of less expensive housing units. Hence, changes in the regulatory underpinnings of the Built Environment Bill could help advance the affordability of houses through the adoption of innovations in building technologies. Further, affording more flexibility to developers in the range of safe construction materials used in the building process will facilitate the scaling up of affordable housing units. The Built Environment Bill and accompanying regulations seek to incorporate these elements **(Indicative Trigger #2(i)).**

4.13 A stronger regulatory framework to safeguard built structures particularly low-income housing is needed. Due to the rigidity of the existing building code, lower-cost buildings are currently constructed in violation of the Code. Thus, low-income housing is prone to being unsafe and of shoddy construction. A recent audit by National Building Inspectorate of 13,778 buildings in Nairobi and other towns found 690 buildings to be in very dangerous conditions and an additional 9701 to be unsafe for human occupation. All these buildings were determined to be constructed without regard to the Building Code. The enactment of the Building Surveyors Act **(Prior Action #1(ii))** and changes to the National Building Regulations **(Indicative Trigger #2(ii))** address these concerns by including provisions for approvals at different stages of construction, making provisions for only licensed building professionals to engage in specific activities, and holding licensed professionals liable for negligence.

4.14 A stronger regulatory framework could help support the climate resilience of housing. Homes

of the poor are disproportionately harmed by natural disasters such as floods. The development of more robust building regulations which translate safe practices for design and construction into a set of rules and laws with minimum agreed levels of safety and resilience for buildings as envisaged in the Built Environment bill and the proposed building code (Indicative Triggers #2(i) and #2(ii)) could help new housing units to become more resilient to some of the extreme climatic events that are becoming more frequent. These efforts will also be complemented by the improved enforcement measures (Prior Action # 1(ii)). The policy and institutional reforms in this operation complement ongoing efforts by the Global Facility for Disaster Reduction and Recovery (GFDRR) and the World Bank-supported Disaster Risk Management DPF with a Catastrophe Deferred Drawdown Option (Cat DDO, P161562), which provides immediate liquidity if the country declares a state of emergency after a natural disaster. Beyond climate adaptation, the proposed building code supports climate mitigation measures by requiring new building development to generate electricity from renewable energy installations and existing buildings to have renewable energy water heating installations.

4.15 Expected Results. Since the announcement of the affordable housing objective, the GoK has received significant private sector interest. Overall, it is expected that, the construction of affordable housing units will increase by an additional 20,000 units by 2021 (as reflected in an increase in the number of affordable housing building permits and titles issued). Further, the recent Kenya Poverty and Gender Assessment (P160994) observes that there are gender differences in endowments of physical and financial assets. On real estate assets, one reason is that women are often disadvantaged when processes are cumbersome and onerous, (particularly in relation to the titling of units). Hence, with the easing of registration and titling procedures, it is expected that the increase in housing will also lead to increased ownership of titled units by women. At least 30 percent of new titles to affordable housing units are expected to go to women.

Prior Action 2. The Recipient has (i) enacted, through its Parliament, an amendment to the Central Bank of Kenya (CBK) Act to empower the CBK to license and supervise mortgage re-financing businesses; and (ii) submitted, through the CBK, the draft Mortgage Refinance Companies Regulations, dated 2019, to the Attorney General, which provides a framework to operationalize the business of mortgage refinancing.

4.16 On the demand side, a key constraint for low and middle-income buyers of affordable housing is financing. Currently, mortgage lending is funded almost entirely by short-term retail and institutional deposits. To address the shortage of long-term finance, the GoK is spearheading the establishment of a Kenya Mortgage Refinance Company (KMRC), which is being supported by a proposed World Bank Investment Project Financing – Kenya Affordable Housing Finance Project (P165034). Given that Kenya has a deep and liquid capital market with pension funds (18 percent of GDP) and insurance companies interested in long-term quality paper, the preconditions are favorable for the long-term housing finance market. By issuing bonds in the local capital market, KMRC will mobilize private investment from institutional investors. KMRC will provide long-term loans to financial institutions, including to financial co-operatives whose membership cut across the income strata of the Kenyan society, secured against housing loans (including affordable housing), so that financial institutions can lengthen the maturity of their own loans. For KMRC to become operational, there is a need to empower the Central Bank, by amending the CBK Act, to license and supervise mortgage refinance companies and complete the regulatory framework for their operationalization **(Prior Action #2).**

4.17 **Expected Results.** The measures supported under this pillar will crowd in private sector investment and financing in the delivery of affordable housing by unlocking existing demand and supply side constraints. On the demand side, the establishment and operationalization of KMRC is expected to increase private sector financing towards affordable housing, particularly as financial co-operatives - the dominant institutional provider of loans used in the construction of low-income houses-- become shareholders of KMRC. In the baseline there is no financing from the private sector supporting KMRC; by 2021, at least six private sector financial institutions are expected to be KMRC equity shareholders.

Pillar 2. Enhance Farmer Incomes and Food Security

4.18 The agriculture sector is one of the most important sectors of the Kenyan economy. Agriculture contributes about 51 percent to GDP (26 percent directly and another 25 percent indirectly), some 60 percent of employment and 65 percent of the country's exports. Consequently, the sector remains an important driver of the Kenyan economy, and a major channel for poverty reduction. Indeed, agricultural incomes (from crops, livestock and fishing) account for 64 percent of the income sources of the poor and 53 percent of income sources for the non-poor.[18] Beyond the importance of the agricultural sector in boosting farmer incomes, the sector is critical to enhancing food security. According to the Global Hunger Index, Kenya is ranked among countries that face a level of hunger that is serious (in 2018, Kenya was ranked 77th out of 119 countries). The Agricultural Sector Transformation and Growth Strategy (ASTGS), the main strategy that guides agricultural development over the next ten years, has three main anchors: the first seeks to increase the incomes of small-scale farmers, pastoralists and fisherfolks; the second to increase agricultural output and value-added; and the third to boost household food resilience.

Addressing Agricultural Output Market Inefficiencies

4.19 Consistent with the government's strategy of boosting small-scale farmers' incomes, this operation supports two measures to help address output market inefficiencies. These are supporting the legislation for a warehouse receipt system and the establishment of a Commodities Exchange.

Prior Action 3. The Recipient has approved, through its Senate, and submitted to its National Assembly, the proposed Warehouse Receipt System Bill providing the legal framework for the establishment of a warehouse receipt system.

Indicative Trigger #3. The Recipient has: (i) established the Warehouse Receipt Council to operationalize the Warehouse Receipt Act (ii) aligned the strategic grain reserve function of the Nationals Cereals and Produce Board (NCPB) to the Warehouse Receipt System (WRS).

4.20 As outlined in the ASTGS, there is need to improve the post-harvest and marketing challenges that farmers face. Kenya's agriculture sector is constrained by inefficiencies in the commodities supply chain due to limited post-harvest handling infrastructures and inefficient price discovery systems that lead to low farm gate prices and exploitation of small holder farmers. Currently, the National Cereals and Produce Board (NCPB) and Eastern Africa Grain Council (EAGC) are operating pilot systems which involve

[18] World Bank. 2018. Kenya Poverty and Gender Assessment.

certifying warehouses that receive grain deposits and issue tradable and transferable warehouse receipts. However, the systems are challenged by lack of a warehouse receipt system legal and regulatory framework which is meant to create an enabling trading environment for warehouse receipts **(Prior Action #3, Indicative Trigger #3).** In this regard, one of the targeted areas of reforms under the ASTGS is the establishment of structured commodity trading to minimize inefficiencies that continue to be a big drawback to enhanced performance of agricultural value chains and support the aggregation of small holder farmers to benefit from the economies of scale. It is in this regard that the national warehouse receipt system and a Kenya Commodity Exchange are conceptualized as pathways to secure storage and marketing of commodities in an efficient, competitive and transparent manner.

4.21 The warehouse receipt system is expected to provide significant benefits to farmers. The benefit of a properly established warehouse system to Kenyan farmers is expected to include: (i) increased flexibility to farmers of when they choose to sell their produce thereby enhancing incomes; (ii) increased lending to the agricultural sector by providing alternative security (commodity) and mitigating risk to the banks within a structured trading system; (iii) allowing millers and processors to procure grain directly from farmers thus shortening the market chain and reducing transaction cost; (iv) enforcement of standards (e.g. allowed moisture content, free from dust and foreign materials) through the licensing and inspection of warehouses, thereby improving quality and grading in the entire value chain; and (v) reduction of post-harvest losses through professional storage. Small-scale farmers also stand to benefit from aggregation (e.g. through cooperative movements) to sell to large traders at a better price.

Prior Action 4. The Recipient has approved, through its Cabinet, the structure for the establishment of a Commodities Exchange.

Indicative Trigger #4. The Recipient has: (i) through the Capital Markets Authority, submitted to Parliament a regulatory framework for the Commodities Exchange; (ii) through the Capital Markets Authority licensed the Commodities Exchange.

4.22 The establishment of a Commodities Exchange will help to better improve the marketing of agricultural produce in Kenya. Every year, Kenya loses about a third of its produce through post-harvest losses (poor storage and handling) and food wastage, with adverse implications on farmer profitability and incomes. In 2017, the country lost about 1.9 million tons of food worth some KES 150 billion (approximately US$1.5 billion), most of which was due to post harvest losses, even as millions of Kenyans were hit by acute food insecurity due to the drought. In this regard, the capacity of markets to transact in agricultural produce remains one of the main agricultural sector challenges in Kenya. Making agricultural markets work requires bringing together buyers and sellers in a well-coordinated manner and where transaction costs are low, and contracts are enforceable. The establishment of a Commodities Exchange **(Prior Action #4, Indicative Trigger #4)** in Kenya can help address inefficiencies in the supply chain resulting from limited storage capacity, lack of post-harvest services and poor access to input markets. The Commodities Exchange complements the warehouse receipt system as it will require an upgrading of warehouses to approved standards. Establishing a Commodities Exchange in Kenya could also help create a liquid market that provides the producers much-needed direct access to buyers, including a link to international buyers. The International Finance Corporation (IFC) has been providing technical assistance to the State Department of Trade for the establishment of the Commodities Exchange. Further support

to the government for the warehouse receipt system and the operationalization of the Commodities Exchange could also be provided through the World Bank-supported National Agriculture and Rural Inclusive Growth Project (P153349).

4.23 Expected Results. The sector-wide output reforms (warehouse receipt system and the Commodities Exchange) are expected to lead to better price discovery for farmers thereby bolstering incomes as well as smoothing consumption as they use their receipts to secure credit facilities and trade on the Commodities Exchange. Further, better storage facilities envisaged under the warehouse receipt system should help reduce post-harvest losses, thereby boosting food security. In the baseline there are no licensed warehouses under the warehouse receipt system participating in the Commodities Exchange; by 2021, at least 30 licensed warehouses are expected to be participating in the Commodities Exchange.

Addressing Agricultural Input Market Inefficiencies

4.24 This operation supports two measures to help address input market inefficiencies. These are supporting resilience and increased productivity in the agricultural sector through improved irrigation and better targeting of existing fertilizer subsidies.

Prior Action 5. The Recipient has (i) approved, through its Senate, and submitted to its National Assembly, the proposed Irrigation Bill, which supports better use and harnessing of water resources for irrigation through the integration of irrigation in water harvesting, flood control and storage and; (ii) through its Ministry of Agriculture, Livestock, Fisheries and Irrigation (MoALFI), piloted the e-voucher fertilizer subsidy program in four (4) counties with a coverage of at least 20,000 farmers with the aim of restructuring the fertilizer subsidy program from a manual to an e-voucher program.

Indicative Trigger 5. The Recipient has (i) through the MoALFI issued regulations for the implementation of the Irrigation Act; (ii) through the MoALFI rolled out the e-voucher subsidy program to at least 15 counties and covering over 70,000 farmers.

4.25 There is need to reduce farmer and pastoralists' overdependence on rain-fed agriculture. Virtually all (98 percent) agriculture in Kenya is rain-fed, making both farmers and pastoralists, particularly small holders, extremely vulnerable to droughts. Indeed, it is estimated that by 2030, under a business-as-usual scenario, climate change will reduce the yields of staples (maize by 12 percent, rice by 23 percent, and wheat by 13 percent) and diminish the ability of cropland to sustain maize and wheat production. Further, water scarcity due to climate change will result in less productive pasture, lower dairy yields, and higher risks that crop and livestock diseases will spread. Given increasing functions in agriculture at the county level , addressing these challenges will require coordinated interventions at both the national and county levels.

4.26 However, the current institutional set-up does not lend itself to adequately increasing access to irrigation and building resilience. The GoK's main institution for expanding irrigation access is through the National Irrigation Board (NIB). The NIB was established in 1966, with the narrow mandate of developing, promoting and managing national irrigation schemes. In this regard, it manages seven

national irrigation schemes and four research stations. Nonetheless, the irrigation needs of Kenyan farmers extend beyond those that are provided through the large national schemes. The need to have a framework to support the development of irrigation facilities to include both medium scale and small-scale facilities remains critical. With the advent of devolution, this is all the more imperative as counties seek to develop non-national irrigation schemes. Other deficiencies under the earlier mandates include lack of strong emphasis on water harvesting as well as clarity on how the private sector can participate in the provision of irrigation services.

4.27 To address these problems, a National Irrigation Policy was recently approved, and an Irrigation Bill is in Parliament. The new Irrigation Policy envisages better use of existing water resources to substantially increase the area of agricultural land under irrigation by laying out an institutional framework that covers policy formulation, regulation and implementation at national, county and scheme levels. The Irrigation Act **(Prior Action #5, Indicative Trigger #5(i))**, which implements the Policy establishes the National Irrigation Authority (NIA), County irrigation development schemes and community-based irrigation water users association (IRWA). NIA is mandated to provide support to medium, small holder and intercounty irrigation schemes. The new agency will follow an integrated and participatory approach to provide support services to the counties and will assist IRWAs in the design, construction, operation and maintenance of irrigation schemes. County level irrigation development units will support the development of irrigation, consistent with national policies. Governance of small holder irrigation schemes, which hitherto were established as non-legal entities with weaker governance structures, will now be established under the formation of the IRWA's. This will provide for greater accountability and better community level management of water resources. Further provisions for flood management, water harvesting and storage, and cost recovery and return on investment are important tenets for all irrigation schemes. The Act will provide for development of guidelines for the involvement of the private sector in the provision of irrigation.

4.28 Fertilizer subsidy reform is another critical element of the input market that can support better agricultural productivity and resilience. Reviews of Kenya's untargeted fertilizer input subsidy scheme show that apart from being costly, the scheme disproportionately benefits large and medium sized farmers at the expense of small farmers. It is also known to crowd out private investment in the importation and distribution of fertilizers. With the government involved in procuring fertilizer, several sub-optimal outcomes have arisen including delays in importation and distribution (resulting into loss of crops due to late fertilizer application), distribution of unsuitable types of fertilizers (e.g. formulation not matched to soil types or nutrient deficiencies) leading to increases in soil acidity, and rent-seeking opportunities. Indeed, under the current scheme many of the beneficiaries are not even farmers but traders who take advantage of the loopholes in a manually operated system that makes it difficult to verify the true beneficiaries of the subsidized fertilizers. Addressing these inefficiencies will contribute to improving the efficiency of the existing subsidy scheme without expanding the scope of subsidy program.

4.29 Impact evaluations however suggest that when subsidized fertilizers are better targeted at resource-poor small holder farmers, they succeed in raising yields, increasing incomes and reducing food insecurity .[19] This experience suggests there is scope for agricultural productivity gains through the

[19] Nicole M. Mason, Ayala Wineman, Lilian Kirimi and David Mather. 2016. The Effects of Kenya's 'Smarter' Input Subsidy Programme on Smallholder Behaviour and Incomes: Do Different Quasi-experimental Approaches Lead to the Same Conclusions?, Journal of Agricultural Economics, 68, 1,(45-69), (2016).

implementation of a smart subsidy (better targeted) scheme without expanding its scope. For that to occur, it will require the conversion from the manual system to an electronic system where the identity of registered beneficiaries has been properly ascertained. As a first step towards a smart subsidy program, the GoK has commenced a comprehensive farmer registration exercise. This exercise will be complemented by the nation-wide digital ID registration to take place mid-year. To this end, an ICT system has been developed to lay the platform for fertilizer subsidy distribution. The electronic fertilizer subsidy system has been piloted with over 20,000 farmers in over four counties **(Prior Action #5(ii) and Indicative Trigger #5(ii))**. The pilot scheme is to be later rolled out to over 100,000 farmers, as well as private sector providers of agro-chemicals, fertilizers, seeds and other inputs by 2021.

4.30 The use of the e-voucher scheme should help curtail the leakage and rent-seeking opportunities that the fertilizer input subsidy scheme has become associated with. With a smart subsidy program, farmers will have the convenience of applying their vouchers to access inputs at the nearest private or public agro-supply shop, rather than being bound to travel to a public depot further away. In addition, benefits will also arise from farmers accessing inputs that they need rather than having to accept what is provided. Finally, the smart subsidy program, as envisaged, reduces the government's footprint in the fertilizer input business and should help crowd-in private investment in the supply of inputs as well as reduce the government's transaction costs for the provision of subsidized inputs.

4.31 Expected Results. First, the sector-wide input reforms should help boost productivity and farmers income (by enhancing the efficiency of the current fertilizer subsidy scheme) and resilience to drought (by increasing the percentage of arable land under irrigation). From the baseline of no farmers receiving an e-voucher in 2017, it is expected that there will be at least 100,000 farmers receiving e-vouchers to purchase inputs by 2021, of which at least 35 percent are expected to benefit female farmers. Further, the percentage of arable land under irrigation is expected to increase from two percent in the baseline (2017) to 2.5 percent by 2021.

Prior Action 6. The Recipient has enacted, through its Parliament, the Kenya Coast Guard Service Act, which protects Kenya's territorial waters from illegal exploitation and degradation of marine ecosystems.

Indicative Trigger 6. The Recipient has: (i) through MoALFI, issued regulations implementing the Fisheries Management and Development Act to support sustainable exploitation of fishing stocks; and (ii) submitted to its Parliament the Livestock Bill which supports pastoralists in addressing climate change and facilitates access to markets.

4.32 While output and input market interventions benefit most farmers, in crop production, Kenya can also do more to enhance value-added in its livestock and fisheries subsectors. The livestock sub-sector employs 50 percent of the agricultural labor force and is the primary source of livelihood for an estimated 10 million Kenyans in the Arid and Semi-Arid Lands (ASALs) – a part of Kenya where the poverty rate is more than twice as high as the country average and where livestock provides food. It serves as a major economic asset and represents a form of savings. The fisheries sector employs about 130,000 fisherfolk households.

4.33 This operation seeks to address some of the challenges in the fisheries sub-sectors. In fisheries,

one of the main challenges is the lack of up-to-date information on stocks leading to unsustainable extraction of fisheries resources. Contributing to this is an inefficient licensing system for the sustainable exploitation of fish stocks. Various measures being taken by the government support the sustainable exploitation of Kenya's fishing resources: the establishment of the Kenya Fisheries Service (KeFS), the enactment of the Kenya Coast Guard Service Act **(Prior Action #6)**, the issuance of regulations implementing the Fisheries Management and Development Act **(Indicative Trigger 6(i))**, and operationalization of the multi-agency Kenya Coast Guard Service with a mandate to, inter alia, protect Kenya's territorial waters from illegal exploitation as well as illegal and unregulated fishing and degradation of marine ecosystems. The measures supported in the fisheries sub-sector in this operation contributes towards a more sustainable exploitation of Kenya's fishing stocks, complementing the proposed World Bank-supported Kenya Marine Fisheries and Socio-Economic Development Project (P163980) which seeks to improve the management and value-addition of priority fisheries and strengthen livelihood activities in coastal communities.

4.34 This operation also addresses some of the challenges facing the livestock sub-sector. Despite its potential the livestock sector has underperformed. Factors accounting for the underperformance include cyclical droughts, inferior breeds, poor animal healthcare, poor marketing and lack of traceability, and inadequate extension services. All of these issues are addressed through relevant measures in the Livestock Bill **(Indicative Trigger #6(ii)).** These include, measures providing greater support to better water harvesting and management for pastoralists in arid and semi-arid areas as well as improving the availability of better quality feedlots. This should help reduce rangeland foraging thereby enabling pastoralists to become more resilient to climate change.

4.35 Expected Results. Overall sub-sector specific interventions supported in this operation should further boost output, employment and incomes in the livestock and fisheries sub-sectors. The reduction in the illegal over exploitation of Kenya's fishing resources, especially from foreign elements should help replenish fish stocks in Kenya's waters to the benefit of coastal fisherfolks. This will require a better monitoring and surveillance mechanism. While in this baseline (2017) the mechanism remains weak; it is expected that by 2021 there will be in place a strong surveillance mechanisms which can monitor and provide up-to-date licensing information. Further, with the Livestock Policy and the Livestock Act providing support to increased access to water storage facilities, there is expected to be 20 percent increase in the domestic supply of meat from pastoralists by 2021.

Pillar 3. Create Fiscal Space to Support the Government's Inclusive Growth Agenda.

Prior Action 7. The Recipient has (i) enacted, through its Parliament, the Finance Act 2018 which contains a provision for the removal of VAT exemptions on petroleum products; and (ii) through the Cabinet Secretary of the National Treasury and Planning, adopted a governance framework through which tax exemptions are granted to avoid the creep in tax exemptions and arrest the decline in tax revenues.

Indicative Trigger 7. The Recipient has (i) submitted to Parliament the Income Tax Bill 2019, which streamlines tax exemptions by reducing the number of exemptions offered; and (ii) through the National Treasury has established an institutional framework for cash management.

4.36 This pillar aims to create fiscal space to support the GoK's efforts to deliver on its inclusive growth priorities. This pillar supports fiscal reform measures to boost revenues, strengthen the efficiency of government spending and improve debt management. These measures are expected to help create fiscal space and enhance the capacity of the government to direct resources towards its inclusive growth priorities.

4.37 Reversing the downward trend in revenue mobilization is critical to creating fiscal space to support the "Big Four". While the main thrust of the government's inclusive growth agenda seeks to crowd-in private investment towards "Big Four" areas, fiscal policy remains important to safeguard macro stability, to de-risk private investment and to channel public resources towards the "Big Four" areas. However, in recent years there has been a structural decline in tax revenues as a share of GDP, from 16.8 percent of GDP in FY 2013/2014 to 14.3 percent of GDP in FY 2017/2018. If this persists, it could undermine the advancement of the "Big Four" as the government's ability to provide public goods or to de-risk private investment could be compromised. Further, given the elevated fiscal deficits and debt levels, the decline in tax-to-GDP ratios could also undermine fiscal sustainability.

4.38 Against this background, this operation seeks to support the government's efforts to arrest the decline in revenues. A recent World Bank study points out the need to broaden the tax base, rationalize tax exemptions and put in place a tax governance framework to prevent the creeping up of tax exemptions (World Bank, 2015). The Government is taking measures in this direction. Through the Finance Act of 2018, the GoK removed the exemption status on petroleum products by introducing an 8 percent value added tax on petroleum products **(Prior Action #7(i))**. Prior to the Finance Act of 2018, petroleum products had been exempted from the VAT rate. In addition, the Government has introduced a governance framework for tax exemptions requiring more detailed information before exemptions are granted **(Prior Action #7(ii))**. Further, under the new framework, more stringent reporting requirements for the use of exemptions and regular internal audits have been introduced. Moreover, a comprehensive reform to the Income Tax Act is being carried out given that the last Act was passed in 1974. Under the proposed new Act, there will be further streamlining of Corporate Income Tax (CIT) exemptions, which alone account for about 1.8 percent of GDP **(Indicative Trigger #7(i))**. Beyond these tax policy measures, the Government is doubling its effort at strengthening tax administration and compliance, including through the use of Regional Electronic Cargo Tracking System and the use of third-party databases to address non-compliance challenges.

4.39 For Kenya to manage its debt more robustly and execute the budget in line with policy priorities, it will need to strengthen the institutional framework for cash and debt management and especially the Public Debt Management Office (PDMO). PDMO did not have a duly appointed Head from 2012, which affected its capacity to carry out operations, and had an adverse impact on debt management. This was remedied in January 2019. A better linkage between cash and debt management is needed, which will be addressed through the establishment of an institutional framework for cash management by the National Treasury **(Indicative Trigger#7(ii)).** This entails the establishment of a Cash Management Committee that

includes directorates of the Public Debt Management Office, Accounting Services and Quality Assurance, and Budget, Fiscal and Economic Affairs.

Prior Action 8. The Recipient has (i) signed a memorandum of understanding (MoU) between the Competition Authority of Kenya (CAK) and the Public Procurement Regulatory Authority (PPRA) that allows for information sharing to help carry out effective investigations on collusive behavior in public procurement**;** ***and (ii) through its National Treasury and Planning, verified and reconciled its external debt records to improve upon the accuracy of its electronic debt registry.***

Indicative Trigger 8. The Recipient has (i) submitted to Parliament the Competition Subsidiary Rules that include specific penalties on collusive behavior in public procurement; approved modified standard tender documents to prevent coordination among bidders; and implemented public procurement measures as per Executive Order #2 of 2018; (ii) through its Cabinet has approved the Debt and Borrowing Policy; and (iii) automated primary issuance and secondary trading of government securities to promote transparency and enhance efficiency in the management of government debt.

4.40 Addressing anti-competitive practices in public procurement can yield fiscal savings, reduce the incidence of fraud in public procurement and direct more resources towards priority areas. Public procurement accounts for at least 7 percent of GDP in Kenya. Lack of effective competition and transparency in procurement could lead to substantial losses for the government and reduced opportunities for businesses. A recent Price Waterhouse Coopers report finds that about 34 percent of organizations reported incidences of procurement fraud compared to an average of 25 percent in East Africa and 22 percent globally.[20] Conservative estimates show that ensuring competition in public procurement could allow the government to save up to KES 28 billion per year (0.3 percent of GDP), and this estimate considers only products that have been subject to bid rigging in other jurisdictions. However, due to the dispersed mandates, the GoK has until recently not been able to significantly deter or adequately investigate potential incidences of bid rigging in public procurement. Specifically, while the CAK has investigative capacity to look into anti-competitive practices (including incidences of bid rigging in public procurement) and impose sanctions, it does not have the mandate to request bidding documents. That mandate lies with the PPRA – which does not have sufficient capacity to investigate nor impose sanctions on bid riggers.

4.41 Given this backdrop, the recent signing of a MoU between CAK and PPRA to better investigate bid rigging in public procurement could realize fiscal savings for the government (Prior Action #8(i)). Further, measures related to improved transparency and disclosure could also be undertaken to complement the enhanced cooperation and investigative ability of state agencies to detect and prosecute any malfeasance in public procurement. First, the modification of the standard tender documents to better capture information that helps detect bid rigging, and increasing the fines imposed on bid riggers through changes to the Competition Subsidiary Rules can help deter collusive behavior in public procurement, thereby reducing potential corruption in public procurement and loss to the public purse

[20] PWC 2018. Global Economic Crime Survey: Kenya Report [*https://www.pwc.com/ke/en/publications/economic-crime-survey.html*].

and improving the efficiency of spending**.** Further, the public procurement disclosure measures contained in the Executive Order No. 2 of 2018 including the regular publication of complete information of suppliers and contractors of all tenders awarded is an important step towards the promotion of transparency and accountability of government spending **((Indicative Trigger #8(i))**.

4.42 **In addition to reforms in public procurement, improved debt management can yield fiscal savings, thereby supporting fiscal consolidation.** The recent rise in debt stock (see section 2) has contributed to the increase in debt servicing rising from 2.7 percent of GDP in FY13/14 to 3.7 percent of GDP in FY 17/18. While the high cost of domestic debt is linked in part to high volumes of issuances, issues around debt management policies also play a role in determining the government's cost of capital. In this regard, the operation supports four specific interventions that help improve debt management. These are the verification and reconciliation of the external debt records to improve upon the accuracy of its electronic external debt registry **(Prior Action 8(ii))**; the development of a Comprehensive Debt and Borrowing Policy; an updated primary auction guideline to help shape the strategic vision for Debt Management; and the transition from a manual based trading platform for the primary auctions to an automated one **(Indicative Trigger #8(ii) and #8(iii))**. All of these should help to promote transparency and enhance efficiency in the management of government debt.

4.43 **Expected Results.** The revenue measures supported under this pillar are expected to contribute towards arresting the decline in buoyancy of revenue growth in recent years. The prior actions in revenue are estimated to yield about an additional 0.6 percentage points of GDP in increased revenues per annum. Specifically, revenues generated from the combined VAT and income tax are estimated to rise to 12.1 percent of GDP by 2021 from a baseline of 11.4 percent in 2017. Further, the expenditure control measures (public procurement and debt management reforms) and adoption of a monthly cash plan are envisaged to yield fiscal savings and improve the prioritization of spending. From a baseline (2017) of no investigations by the CAK on potential anti-competitive behavior in public procurement, it is expected that by 2021 there will be at least five investigations related to bid-rigging undertaken jointly by CAK and PPRA. Further, on debt management, in the baseline, there does not exist an electronic primary auction of the government securities; by 2021, it is expected that 70 percent of government securities will be transacted on an electronic platform.

Pillar 4. Crowd in Private Investment and Leverage Digitization to Support the Government's Inclusive Growth Agenda.

4.44 **The fourth pillar of this operation is a cross-cutting pillar.** The GoK's Medium Term Plan recognizes that to achieve its "Big Four" priorities it will require interventions beyond the specific narrow domains of the specific "Big Four" areas. This operation's fourth pillar therefore supports two foundational areas of importance for the advancement of the "Big Four": (i) advancing digitization in Kenya to enhance service delivery and (ii) improving the business environment to crowd-in private investment.

Prior Action 9. The Recipient has (i) through the Cabinet Secretary of Information and Communication Technology approved the Broadband Strategy, which commits to crowd-in private investment to

expand broadband access; and (ii) enacted, through its Parliament, amendments to the Registration of Persons Act to establish a National Integrated Identity Management System, with the mandate to assign a unique national (digital) identification number to all registered persons.

Indicative Trigger 9. The Recipient has, through its Cabinet, approved the Kenya Investment Policy (KIP), which simplifies the process of investor entry and retention and submitted to Parliament regulations implementing the Special Economic Zones Act 2015.

4.45 Kenya's ICT sector is one of the most dynamic in Sub-Saharan Africa with significant progress made in recent years. This includes an increase in: the penetration rate for mobile subscriptions to 91.9 percent in 2017 from 74.9 percent cent in 2013; internet subscriptions per 100 inhabitants (Wireless and Fixed) from 31.6 percent in 2013 to 58.5 percent in 2016; broadband subscriptions per 100 inhabitants (Fixed and Wireless) from 5.9 percent in 2013 to 28 percent in 2016; the number of mobile money subscribers to 70.5 percent of households in 2016 from 62.3 percent in 2013. Further, between 2014 and 2017, mobile commerce transactions with a value of KES 3.2 trillion were recorded and the number of mobile money transfer agents grew from 93,689 in 2013 to 182,472 in 2017. Bandwidth capacity has also increased to 3.2 million Megabytes per second (Mbps) mainly due to the laying of the fiber optic cables in the country.[21] At an average of 12.2 Mbps, Kenya has one of the fastest internet speeds in Africa. These developments have been supported by a conducive and enabling environment that has supported critical investments from both the Government and the private sector.

4.46 While the first Broadband Strategy (2013-2017) contributed to the growth in ICT and Broadband expansion, there still remain critical challenges. Despite investments through the National Optical Fiber Broadband Infrastructure, there remains a digital divide where broadband has not yet reached most parts of rural Kenya and last mile connectivity continues to remain a challenge. Further, broadband charges remain high and there is a shortage of digital skills to enable broadband services to be used effectively.

4.47 The Second National Broadband Strategy (NBS 2023) seeks to address some of these challenges to enable broadband to contribute to Kenya's inclusive growth agenda. The National Broadband Strategy 2023 **(Prior Action #9 (i))** builds on the first strategy and seeks to transform Kenya into a globally competitive knowledge-based society enabled by secure and fast broadband connectivity. Under NBS 2023, the Government aims to increase access to broadband coverage of 3G to 94 percent of the population by 2020 and address some of the demand side challenges in using broadband, including from cybersecurity (Parliament has recently passed a Computer Use and Cyber Security Act) and privacy and data protection (a draft bill is in preparation). NBS 2023 seeks to increase broadband coverage through encouraging cost reduction through network sharing, embracing public-private partnership (PPP) in expanding networks, providing specific incentives to expand coverage in rural and remote areas and developing digital literacy.

4.48 To enhance service delivery, the GoK is seeking to carry out a biometric registration exercise to provide a unique personal digital identifier number for all Kenyans. The benefits of the Biometric ID in support of the inclusive growth agenda could be numerous, including better targeting of subsidies to small-scale farmers, government social protection programs, and e-medical services among several

[21] GoK, MTR III, 2018-2022.

others. Further, unique digital IDs can enhance the growth of e-commerce. In this regard the GoK has amended the Registration of Persons Act, allowing for the establishment of a National Integrated Identity Management System which aims to create, manage and operate a national population register and to assign a unique national (digital) identification number to every person enrolled in the register **(Prior Action #9 (ii)).**

4.49 Beyond advancing digitization, another important cross-cutting area of importance to support the "Big Four" is the need to improve the business environment to better crowd in private investment. Kenya's recent growth performance has been driven by public investment with the response from the private sector being somewhat muted. Indeed, growth in private investment averaged 3.3 percent between 2014 and 2017. Given the narrowing of the fiscal space for the government to achieve its "Big Four" agenda it will be important for it to be able to crowd-in the support of the private sector. A number of the sector-specific interventions (e.g. in agriculture and the housing sector) reflected in this operation already serve to crowd in private investment. However, this could be further enhanced through a broader policy change to address some of the cross-cutting impediments to private investment. Indeed, as a share of GDP, foreign direct investment averaged 0.9 percent in Kenya, well below regional competitors including Tanzania (3.0 percent of GDP) and Rwanda (3.2 percent of GDP).

4.50 Policy and institutional challenges are contributing to the underperformance of private investment. First, investment entry and establishment are governed by a complex web of rules and requirements. For instance, starting a business in Kenya requires registering with multiple agencies, meeting various licensing requirements, and is often sector dependent. Further, it requires dealing with both national and county regulatory requirements. This has created ambiguity and confusion regarding investor management leading to unnecessary delays. Second, investment promotion and facilitation are made more difficult by the inadequate access to investor services, cumbersome manuals, duplicative procedures, and inadequate capacity of the Investment Promotion Agency. Third, there is a lack of a single application window for investors to register a company digitally; timelines in the approval process are not adhered to; and the One Stop Shop is not fully effective. Fourth, Kenya's minimum capital requirement (US$100,000, irrespective of sector) and the need for screening of all foreign direct investment proposals before granting of investment certificates could be stifling low-capital sectors such as ICT.

4.51 Reforms to the policy, regulatory and institutional environment can remove some of the obstacles to private investment. Indeed, the Kenya Investment Policy commits to simplifying the process of investor entry and establishment **(Indicative Trigger #9)**; improve provision of aftercare, retention and advocacy measures; and support the increase in green investments. It seeks to do this by, inter alia, strengthening the capacity of the One Stop Centre to enable investors to receive essential services, assigning a unique identification number for all companies, and restricting the payment of minimum capital requirements to selected sensitive sectors. The KIP also supports the greening of investments by seeking to provide market incentives for low-carbon, climate-resilient investment to steer investments over time to least-cost mitigation options; and establish an open and competitive market for green investment including in green technologies and infrastructure. The implementation of KIP will need to be supported by the creation of the National Investment Council (NIC) and regulations implementing the Special Economic Zones *Act* **(Indicative Trigger #9)**. NIC's mandate will be the establishment of a quick decision-making body on key investment issues, the provision of overall oversight over investment growth, and assistance in resolving high level investment disputes.

4.52 Expected Results. The quantum and productivity of private investment is expected to be enhanced by measures supported under Prior Action #9. In the baseline (2017) it takes 7 procedures and 14 days to register a business in Kenya compared to four procedures and five days in neighboring Rwanda. With the easing of entry conditions for foreign direct investors (FDI) as well as provisions to support their retention, it is expected that by 2021, the number of days it takes to register a business in Kenya will fall by half to seven days. Both the broadband strategy and advancement of digital skills in Kenya are expected to contribute towards digitization in Kenya. In the baseline (2017) about 12.7 million Kenyans have access to broadband coverage; by 2021, the measures supported by this operation are expected to contribute to the expansion of broadband penetration to an additional 1.3 million Kenyans.

4.53 The proposed DPF is supported by significant depth of analytical work and technical assistance, underpinning policy dialogue with the authorities across the program. This reflects analytical work carried out by World Bank Global Practices and the Research Group and technical assistance work carried out within World Bank-supported operations (Table 4).

Table 4: DPF Prior Actions and Analytical Underpinnings

Prior Actions	**Analytical Underpinnings**
Pillar 1. Crowd in Private Investment and Financing for the Delivery of Affordable Housing.	
Prior Action #1 Prior Action #2	World Bank. 2016. Kenya: Expanding Affordable Housing and Housing Finance. Business Plan for the Kenya Mortgage Refinance Company. World Bank. 2017. Kenya Economic Update, Edition 15: Housing, Unavailable and unaffordable. World Bank. 2019. Proposed Kenya Affordable Housing Project (P165034) International Finance Corporation. 2018 (draft). Kenya Country Private Sector Diagnostic.
Pillar 2. Enhance Farmer Incomes and Food Security	
Prior Action #3 Prior Action #4	Republic of Kenya. 2018. Kenya Commodity Exchange: Feasibility Study. A report submitted to the Ministry of East Africa Affairs, Commerce and Tourism.
Prior Action #5	World Bank. 2014. Political Economy Analysis of Kenya's Agricultural Sector. World Bank. 2015. Kenya Agriculture Sector Discussion Note: Transforming Subsistence Agriculture and Building Resilience to Climate Change. World Bank. 2017. Kenya Climate Smart Agriculture Project (P154784). World Bank. 2016. National Agricultural and Rural Inclusive Growth Project (P153349). World Bank. Kenya Agricultural Sector Expenditure Review (P165731, in

	progress). World Bank. 2019. Kenya Economic Update, Edition 19. International Finance Corporation. 2018 (draft). Kenya Country Private Sector Diagnostic.
Prior Action #6	World Bank.2017. Implementation Completion Report on Kenya Coastal Development Project (P094692). World Bank. Proposed Kenya Marine Fisheries and Socio-economic Development Project (P163980, under preparation).
Pillar 3: Create Fiscal Space to support the Government's Inclusive Growth Agenda.	
Prior Action #7 Prior Action #8	Republic of Kenya. 2018. Comprehensive Public Expenditure Review (PER): from Evidence to Policy. Nairobi. A publication by the Monitoring and Evaluation Department/State Department for Planning. World Bank. 2017. Kenya Economic Update, Edition 16: Poised to Bounce Back? Reviving private sector credit growth and boosting revenue mobilization to support fiscal consolidation. World Bank. 2017. Kenya Tax Policy Studies. Value Added Tax: Improving Tax Policy for Strengthening Domestic Revenue Mobilization. World Bank. 2017. Kenya Tax Policy Studies. CIT: Improving Tax Policy for Strengthening Domestic Revenue Mobilization. World Bank. 2018. Own Source Revenue Potential and Tax Gap Study of Kenya's County Governments. World Bank. Kenya Tax Technical Assistance and Public Expenditure Analysis (P168277, in progress).
Pillar 4: Crowd in Private Investment and Leverage Digitization to Support the Government's Inclusive Growth Agenda.	
Prior Action #9	World Bank. 2016. Kenya Economic Update, Edition 14. Beyond Resilience: Increasing Productivity of Public Investments. International Finance Corporation.2013. Kenya Regulatory Reform (00593208); World Bank. 2018. A Single Digital Market for East Africa. International Finance Corporation. 2018 (draft). Kenya Country Private Sector Diagnostic.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

4.54 The DPF is consistent with the World Bank Group's (WBG) Country Partnership Strategy (CPS) FY14-FY20 for Kenya[22]. Both the DPF and the CPS are underpinned by the Kenya's Vision 2030 agenda, as operationalized through the respective MTPs. The CPS has three domains of engagement: (i)

[22] Country Partnership Strategy for the Republic of Kenya (Report 87024-KE) discussed by the Executive Directors on June 5, 2014; and Performance and Learning Review of the Country Partnership Strategy for the Republic of Kenya (Report 113547-KE) considered by the Executive Directors on July 17, 2017, which extended the CPS to FY20.

competitiveness and sustainability – growth to eradicate poverty; (ii) protection and potential – human resource development for shared prosperity; and (iii) consistency and equity – delivering a devolution dividend. The CPS recognizes good governance as a common platform that underpins all three domains of engagement. This DPF helps to advance the objectives set out in the CPS. Given the links between affordable housing and economic growth, and human capital, the first pillar of the DPF contributes towards both the growth and human resource development domains of the CPS engagement. By enhancing farmer incomes and food security, the second pillar of the DPF contributes towards sustainable economic growth and poverty reduction. Further, measures supporting the expansion of fiscal space, crowding in private investment and enhancing the capacity of the public sector to deliver on the inclusive growth agenda contained in the other pillars are consistent with fiscal sustainability, economic growth and good governance goals of the CPS.

4.55 This DPF complements the World Bank's support to Kenya being provided through Investment Project Financing (IPF) and Program for Results (PforR) operations. The Performance and Learning Review of the Kenya Country Partnership Strategy[23], the draft Kenya Country Private Sector Diagnostic and emerging pathways from the Systematic Country Diagnostic (SCD) (under preparation) point to the increasing importance of policy and institutional reforms to accelerate the pace of achievement of the twin goals. Indeed, the impact of ongoing World Bank-supported operations could become even more effective when complemented by policy and institutional reforms—particularly in the agriculture and affordable housing sectors, and in crowding in private capital through fiscal and debt management measures.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

4.56 The Development Partners Forum is the existing architecture for both the Government and Development Partners to dialogue on Kenya's development priorities and challenges. The Development Partners Forum has jointly committed to supporting the priorities and objectives the GoK identified in the manifesto of the "Big Four" agenda and anchored in the GoK's MTP III 2018-2022. The preparation of MTP III was informed by extensive consultations at national and county levels involving various stakeholders. The legislative process requires an extensive public consultation with key stakeholders including counties and evidence that the feedback received has been incorporated to the extent possible. The pillars of this DPF have been based on a consultative process with development partners and other stakeholders. Specifically, the World Bank hosted meetings to discuss this operation with the Development Partners in February 2018, August 2018, February and March 2019 and held several bilateral meetings with other partners. The DPF complements other budget support programs likely to run concurrently including the European Union (EU) budget support linked to the PFM reform strategy and a potential IMF precautionary financing to the GoK. Several other partners, including the Canada, Denmark, European Commission, Finland, France, Germany, Japan, Norway, the Netherlands, Sweden, the United Kingdom, the United States, the African Development Bank, in coordination with the World Bank, are providing financial and non-lending support in several areas covered by the operation (public investment management (PIM), PFM, Revenue mobilization, Agriculture, Affordable housing). The feedback from stakeholders has been useful for the design of the operation and will continue to feed into future discussions with the

[23] Performance and Learning Review of the Country Partnership Strategy for the Republic of Kenya (Report 113547-KE) considered by the Executive Directors on July 17, 2017.

Government.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

5.1 **The overall impacts of the policy and institutional reforms under this proposed programmatic DPF series are expected to be largely positive.** The poor are expected to disproportionately benefit from interventions on affordable housing, improvements to agricultural value-added and resilience, and increased coverage of broadband services. Further, the net impact of fiscal reforms is expected to be positive**.**

5.2 **Increased access to affordable housing is likely to have significant positive economic impacts.** Unlocking the residential housing market can help to significantly reduce the current deficit of over 2 million housing units. Beyond reducing the housing deficit, the removal of demand and supply side constraints is expected to unleash private investment in the construction of affordable housing units, which should help create a wide range of income opportunities through the construction sector and related industries as evidenced in Colombia, India, and South Africa. In Colombia, it is estimated that five additional jobs are added for every US$10,000 spent on housing construction. In India, each housing unit creates 1.5 direct and eight indirect jobs; in South Africa, each housing unit creates 5.62 jobs for every housing unit (World Bank, 2017).[24]

5.3 **Beyond the economic benefits, studies have found that there is a positive correlation between improved housing conditions and human capital outcomes.** Affordable housing can improve health outcomes by freeing up family resources for nutritious food and health care expenditures[25]. Studies have shown that crowded housing can negatively impact physical health through the increased exposure to infectious diseases, but also through increased levels of psychological distress, feelings of helplessness and higher blood pressure. For instance, improved housing conditions in Mexico led to significant decreases in the incidence of parasitic infestations, diarrhea, and the prevalence of anemia, as well as a significant improvement in the cognitive development of treated children. Affordable housing also leads to positive educational outcomes by reducing homelessness among families with children[26]. Affordable housing projects can also improve educational outcomes by providing a forum for residential-based after-school programs.

5.4 **The reforms supported in this operation are likely to contribute towards safer and greener buildings.** There have been several building collapses in Kenya in recent years leading to loss of lives and property. Unfortunately, the overwhelming majority of these building collapses have occurred in poorer neighborhoods where shoddy construction work is more prevalent. With the reforms that this operation

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[24] World Bank 2017, Kenya Economic Update (April 2017).

[25] Maqbool, N., Viveiros, J., and Ault, M. 2015. The Impacts of Affordable Housing on Health: A Research Summary. Center for Housing Policy, Insights from Housing Policy Research.

[26] Maya Brennan, May 2011. The Impacts of Affordable Housing on Education: A Research Summary. Insights from Housing Policy Research. Center for Housing Policy. Mary Cunningham and Graham MacDonald, 2012. Housing as a Platform for Improving Education Outcomes among low-Income Children. Urban Institute.

supports, including reforms to the building code and professional conduct of building professionals, it is expected that the incidence of building collapses will be reduced, and the overall safety of the built environment will improve. Further, changes to the 1968 building code allowing for the use of climate friendly technologies should also contribute towards a greener built environment.

5.5 The agriculture reform measures supported under this operation are expected to increase value-addition and commercialization of the agriculture sector, thereby boosting farmer incomes and enhancing food security. The recent Kenya Poverty and Gender Assessment (P160994) finds that farmers with higher agricultural productivity and with the ability to sell their output in markets were less poor, suggesting that increased output and commercialization in the agricultural sector offers important pathways out of poverty. The establishment of the warehouse receipt system and the Commodities Exchange are expected to improve commercial opportunities for farmers and help reduce post-harvest losses (up to 35 percent for certain crops) and improve farm gate prices. Reforms to input markets are also expected to increase productivity. A recent study finds that in Kenya, if irrigation volumes increased by 20 percent, output could rise by some 8.1 percent. Similarly, if the deficiency in the application of fertilizers were improved by some 30 percent (compared to optimal levels), agricultural production would increase by 8.8 percent [27].

5.6 The fiscal reforms supported under this operation should help bring about fiscal savings and improve the efficiency of spending. The fiscal reforms should have a net positive impact. Conservative estimates show that ensuring competition in public procurement in Kenya, even when considering only products that have been subject to bid rigging in other jurisdictions, could allow the Government to save up KES 28 billion per year (0.3 percent of GDP, World Bank, 2018). Further, with the fertilizer input support program being transformed into a smart input subsidy program through the issuance of e-vouchers, the efficiency of spending in the agricultural sector should improve as small holder farmers are better targeted to receive support.

5.7 Simulations suggest that the VAT increase on petroleum products has a minimal impact on both household consumption and poverty. Household consumption decreased by 0.53 and 1.07 percentage points for the poor and wealthiest quintiles, respectively. Thus, the change in the VAT regime is progressive. It resulted in a 0.3 percentage point increase in the poverty headcount and a 0.18 percentage point increase in the poverty gap, both of which are larger for urban households. The small impact is mainly a result of the low consumption share of petroleum products in total expenditure across all households.

5.8 The cost to mitigate the negative impact of the VAT increase is around 1 percent of the projected increase in revenue. The increase in VAT on fuel products is estimated to increase government revenue by around KES 34 billion annually. The additional revenue could be used to offset any negative impact for the poor, through approaches such as the expansion of targeted social protection. For example, a perfectly targeted cash transfer could offset any negative impact of the policy and would cost around KES 368 million or about 1 percent of the increased revenues. The GoK is committed to expanding its social protection programs. Indeed, the number of beneficiaries of GoK's cash transfer schemes increased from

[27] Boulanger, Pierre & Dudu, Hasan & Ferrari, Emanuele & Mainar, Alfredo & Proietti, Ilaria, 2016. "*Are input policies effective to enhance food security in Kenya? A CGE Analysis*," *2016 Fifth International Conference, September 23-26, 2016, Addis Ababa, Ethiopia* 246954, African Association of Agricultural Economists (AAAE).

about 1.65 million people in 2013 to about 5 million people in 2019 (of which about 2.3 million are women).

5.9 The expansion of broadband coverage in Kenya will be beneficial to consumers, governments and firms. Research shows that the benefits of the digital economy for emerging economies are potentially large. That is because access to digital products and services that help optimize processes and production, reduce transaction costs, and transform supply chains can create significant competitiveness and productivity-boosting opportunities. It also offers new opportunities for entrepreneurship and job creation. For consumers, the benefits are associated with access to a wider range of goods and services at competitive prices. Governments also benefit from the digital economy when public services are delivered more efficiently and with greater transparency. Further with the extension of broadband coverage, more poorer consumers will have access to broadband access with the concomitant benefits.

5.2. ENVIRONMENTAL ASPECTS

5.10 In the housing sector, the policy actions supported by the DPF are expected to result in overall positive environmental impacts. The update of the 1968 building code and accompanying regulations will result in safer and greener buildings. Improved building standards and use of higher quality, greener construction material is expected to reduce low quality construction especially in low-income (multi-story) housing to provide buildings that are safe for human occupation and to create a greener built environment. In addition, the use of new and greener building technologies will result in a greener built environment. The updating of the required regulations and codes will ensure conformity and consistency with the Kenya Occupational Safety and Health Act (OSHA, 2007). New low-income multi-story units and other buildings that will be constructed to meet the demand for affordable housing will not be constructed on riparian areas and will need to comply with the national environmental and institutional framework and the relevant National Environmental Management Agency (NEMA) regulations.

5.11 In the agriculture sector, the policy actions, institutional reforms and supporting legislation supported by the DPF are expected to enhance farmer incomes and food security without significant adverse effects on the environment and natural resources. The proposed measures are expected to improve post-harvest losses, address marketing challenges and minimize inefficiencies faced by farmers. These reforms will support the creation of an enabling environment for warehouse receipts system, establishment of a structured commodity trading mechanism and the strengthening of farmer cooperatives. Activities under the sector will need to promote the use of biological inputs and fertilizers and rationalize the use of chemical pesticides. Standards for warehouses will be enforced through licensing and inspection thereby improving quality and grading in the entire value chain.

5.12 The e-voucher fertilizer subsidy program is not expected to cause adverse impacts on the environment and other natural resources. This is so because the program is intended to increase efficiency in the distribution of fertilizers in the supply chain including by eliminating the middlemen rather than expanding the use of fertilizers.

5.13 This operation supports the sustainable fishing and conservation of fisheries resources – with a positive impact on the environment. The enactment of the Kenya Coast Guard Act supported by this operation as well as the establishment and operationalization of KeFS which oversees the sustainable exploitation of Kenya’s fishing resources will lend support to the sustainable exploitation of fish stocks in

Kenya.

5.14 The irrigation-related policy actions and institutional reforms could potentially lead to expansion in production and potential negative environmental impacts if relevant mitigating actions are not considered. The proposed increase of the arable land to be brought under irrigation could potentially lead to environmental impacts such as deforestation, land degradation, water logging and salinization of the soils, increased water borne and water-related diseases and reduction in biodiversity. Prior to implementing activities under the Irrigation Act, an Integrated Environment Impact Assessment (IEIA) is required, as stipulated in the under the second schedule of the Environmental Management and Coordination Act (EMCA). This should provide for effective environment management, supervision and implementation of mitigation measures for potential environmental impacts.

5.15 The application of VAT on petroleum products has environmental benefits. Recent research shows that environmental tax reforms enhance welfare.[28] First, one channel through which environmental tax reforms (e.g. VAT on petroleum products) raises welfare is by reducing pollution, and thereby contributing towards the improvement in public health.[29] Second, taxation on motor fuels in particular reduces congestion and road accident rates because of reduced vehicle use.[30] Further, environmental tax reforms help to shift employment from polluting to non-polluting industries.[31]

5.16 Overall, it is observed that the national environmental institutional framework in Kenya is broadly aligned with international standards. The Framework is defined by the 2013 National Environment Policy and the 1999 EMCA (amended in 2015) that established the NEMA. The Ministry of Environment and Forestry (MoEF) is responsible for establishing policy guidelines on environmental, forest, and protection and conservation of the natural resources. NEMA coordinates the environmental management activities undertaken by other lead agencies and promotes the integration of environmental considerations into development of policies, plans, programmes and projects. Since 1999, NEMA has adopted the EIA as a management tool to screen projects that may likely pose adverse impacts on the environment and other natural resources. The second schedule of the EMCA requires that government, donor and private sector proponents to undertake full EIA and submit EIA reports to NEMA prior to being issued a license. In addition, NEMA requires Strategic Environmental Assessments (SEAs) to be carried out for the assessment of sectoral policies, plans and programs.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

5.17 Kenya's fiduciary framework is adequate to support the proposed operation. The 2017 Public Expenditure and Financial Accountability (PEFA) results noted improvements in key areas (13 performance indicators) when compared to the 2012 PEFA. In terms of impacts on budgetary outcomes,

[28] Pigato, M. 2019. Fiscal Policies for Development and Climate Action. The WBG.
[29] Markandya, A., González-Eguino, M., Escapa, M. 2012. "Environmental Fiscal Reform and Unemployment in Spain." In Carbon Pricing, Growth and the Environment, edited by Lawrence Kreiser, Ana Sterling, Pedro Herrera, Janet Milne, and Hope Ashiabor, 3–15. Edward Elgar Publishing.
[30] Parry, I., Veung, C., Heine, D. 2015. How Much Carbon Pricing Is in Countries' Own Interests? The Critical Role of Co-Benefits." Climate Change Economics 6 (4). *http://www.worldscientific.com/doi/abs/10.1142/S2010007815500190*.
[31] Beck, M., Rivers, N., Wigle, R., Yonezawa, H. 2015. "Carbon Tax and Revenue Recycling: Impacts on Households in British Columbia." Resource and Energy Economics 41 (August): 40–69. *https://doi.org/10.1016/j.reseneeco.2015.04.005*.

aggregate fiscal discipline remained positive, there was little change in strategic resource allocation, while service delivery improved mainly due to implementation of the IFMIS strategy. At the national level, the most significant improvements related to improved budget classification, the timeliness in budget preparation, expenditure controls, and financial reporting. Progress is being made in improving the framework for public investment management, debt and cashflow management, procurement, financial reporting and audit. The only area where performance has fallen, as measured by the PEFA, is the timeliness of audits. The quality of budget documentation, the extent of central government operations outside fiscal reports, reporting on fiscal risk, and asset management are some of the weakest areas of PFM performance. PFM performance was found to be weaker at the county level compared to the national level with budget reliability, underperformance of revenues and the management of public investments being particularly weak. A number of these issues are being addressed under the GoK's new PFM reform strategy including the use of technology to address governance challenges.

5.18 Kenya maintains good standards of budget transparency. The general budget is made available on the National Treasury's website. In addition, the budget policy statement— a document that states the government's budgets plans and the main priorities on which it will spend its resources— is also made publicly available. In addition, the National Treasury and the Office of the Controller of Budget produce regular budget implementation reviews namely the Quarterly Budget and Economic Review (QBER) and the National Government Budget Implementation Report.

5.19 The GoK's PFM system, together with GoK's commitment to improve PFM performance through various initiatives, provides reasonable assurance that the GoK can manage the country's budget resources appropriately. The strengths of the PFM system include a relatively strong budget system that is transparent and accurate; reengineering, roll-out and use of IFMIS in all line ministries and counties; well trained and qualified accountants and budget officers in the National Treasury and MDAs; and functioning Internal Audit Department (IAD) and independent Supreme Audit Institution, the Office of the Auditor General (OAG). Areas for improvement include delays in roll-out of some of the IFMIS modules; integration of IFMIS with some GoK information technology (IT) systems remains pending; errors in annual financial statements resulting in audit report qualifications for a majority of MDAs; and delays in submission of audit reports to Parliament. GoK is working on PFM improvements with support from development partners. The World Bank is providing support to the National Treasury on PFM improvements through the Program to Strengthen GESDeK (P161387) and the Kenya Accountable Devolution Project (P149129) by use of targeted Disbursement Linked Indicators addressing the areas of weakness. As a result, there have been further strengthening in the areas of (i) annual audit report whereby the OAG has adopted improved audit methodology and developed quality assurance manuals with support from the African Organization of English-speaking Supreme Audit Institutions (AFROSAI-E). The new audit methodology was rolled out during the FY17/18 audit; (ii) significant improvement in timeliness of submission of financial statements by MDAs and counties to OAG, which has resulted in improved timeliness of audit report issuance. For instance, the FY17/18 audit reports for counties were issued by OAG in March 2018 (i.e. within nine months after the financial year end) as compared to 15 months for FY16/17; (iii) IFMIS has been updated through integration with the debt management system.

5.20 The IMF 2015 safeguards assessment report of the CBK found that CBK continues to maintain effective operational controls and all recommendations from the previous safeguards assessment have been implemented. Nevertheless, some weaknesses were noted including lack of a functioning Board due

to lapse of tenure, which affected functioning of the Audit Committee; challenges imposed by the constitutional requirement to replace the entire stock of currency; and delays in implementation of internal audit report recommendations. These challenges have now been addressed; and the CBK has a functioning Board, has reconstituted the Audit Committee, and is in the process of rolling out the new generation currency. The FY17/18 OAG audit report did not flag any weaknesses in the CBK's internal audit function and internal controls. The CBK received clean audit reports from the OAG. The most recent audit report of FY17/18 was completed by the OAG and the audit certificate issued on September 26, 2018.

5.21 Credit disbursement will follow the World Bank's procedures for development policy lending. With respect to the flow of funds, the World Bank will disburse the funds to an account opened by the National Treasury in the CBK which will form part of the foreign exchange reserves. After the deposit of the funds, the CBK would immediately credit the disbursed amounts to the Treasury Single Account (TSA) as part of the overall exchequer funds. The funds would then be available to finance budgeted expenditures. The GoK may use the proceeds as follows: (i) make budgeted foreign currency payments directly from this foreign currency bank account; (ii) transfer amounts from the foreign currency bank account to a local currency bank account of the GoK, which the GoK then uses to make payments for its budget expenditures; or, (iii) a combination of these approaches.

5.22 The accounting of the credit proceeds will be in line with existing PFM arrangements. Government procedures will be followed to administer, record, and audit transactions relating to the credit proceeds and related payment.

5.23 Once the funds enter the GoK's foreign exchange reserves and the budget, they will be comingled with the GoK's other funds. Therefore, the World Bank will not require tracking of the end use of the DPF funds. This means that disbursements of the credit will not be linked to any specific purchases and no procurement requirements must be satisfied, except that the Borrower is required to comply with the standard negative list of excluded items that may not be financed with World Bank credit proceeds, as defined in the Financing Agreement. If any portion of the credit is used to finance ineligible expenditures as so defined in the Financing Agreement, the World Bank has the right to require the Government to promptly, upon notice from the World Bank, refund the amount equal to such payment to the World Bank. Amounts refunded to the World Bank will be cancelled from the credit.

5.24 GoK will provide written confirmation (within 30 days after credit disbursement) that: (i) the credit proceeds were received into an account of the GoK that is part of the country's foreign exchange reserves (including the date and the name/number of the GoK's bank account in which the amount has been deposited); and (ii) an equivalent amount has been accounted for in the GoK's budget management system (including the Chart of Accounts name/account number, the date, and the exchange rate used).

5.25 Audit Arrangements: Since the control environment is assessed to be adequate, there is no mandatory requirement for annual audit. However, the World Bank reserves the right to have an audit conducted, if in the opinion of the Bank, the control environment ceases to be effective at any time during implementation. In such a case, the National Treasury, on request from the World Bank, shall have the bank account into which the IDA funds are credited (both the US$ and local currency) and related transactions, audited on the basis of audit terms of reference (ToR) acceptable to the World Bank. The audit report shall be submitted to the World Bank within a period of four months after the World Bank's

request for the audit. The audit will be conducted by the OAG which has been assessed as having the technical capacity, and independence to perform the audit.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

5.26 The National Treasury and Planning will be the coordinating institution for monitoring and evaluation among all the participating ministries for this DPF. The institutional and policy reforms supported by the programmatic DPF series fall under the purview of 10 ministries and agencies. These are: CAK; CBK; MoALFI; Ministry of Lands and Physical Planning; Ministry of Transport, Infrastructure, Housing, Urban Development and Public Works; The National Treasury and Planning; Ministry of Information, and Communication Technology; Ministry of Interior and Coordination of National Government; Ministry of Industry, Trade and Co-operatives and the Public Procurement and Regulatory Agency. The National Treasury and Planning has chaired the multi-sector Coordinating Committee established for overseeing the preparation of the operation. This Committee will remain in place during the implementation of the program. The Committee will also be responsible for monitoring of results indicators and evaluation activities.

5.27 The results framework presented in Annex 1 will be used as a monitoring tool by both the GoK and the World Bank. Data availability and quality are appropriate to monitor progress towards the achievement of the results indicators. The National Treasury and Planning will be responsible for the overall coordination and monitoring of the reform program supported by the DPF and will furnish information to the World Bank, as required, to monitor outcomes in the results framework. Most of these results indicators are based on routinely published information by the GoK. For those that are not, the National Treasury and Planning will liaise with focal points in the other ministries involved as needed to provide such information at a frequency and in a format satisfactory to the World Bank. The World Bank may provide implementation support and periodic monitoring and dialogue with the relevant line ministries and other stakeholders to ensure timely implementation and adequate monitoring of indicators and outcomes of the program.

5.28 Grievance Redress. Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or triggers under a World Bank DPF may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit *www.inspectionpanel.org.*

6. SUMMARY OF RISKS AND MITIGATION

6.1 **The overall program risk rating is moderate**, taking into account the GoK's strong commitment to pursuing reform actions to achieve its "Big Four" agenda, and the implementation mechanisms in place across a range of MDAs with complementary support from development partners. The GoK has shown remarkable leadership in pursuing its reform agenda and coordinating the reforms supported by this operation. Major risks and mitigation measures are discussed below.

6.2 **Macroeconomic risk is rated substantial.** While Kenya's macroeconomic outlook is strong, there remain several key risks. First, monetary policy continues to be impaired by the interest rate cap. This poses risks to the macroeconomic outlook and the achievement of the program objectives. Further, interest rate caps have contributed to rationing of lending by commercial banks to SMEs and individuals perceived as riskier, although alternate sources of credit may be partially filling this gap. The lack of access to credit by this segment—including small scale farmers and low-income households— could reduce the benefits of the reforms supported by this operation. Second, deviations from the projected fiscal consolidation path could jeopardize Kenya's hard-earned macroeconomic stability and raise the debt to GDP ratio. On the external side, tighter global financial conditions represent an immediate risk to the GoK's ability to refinance upcoming debt repayments at favorable rates.

6.3 **Efforts are underway to mitigate these macroeconomic risks.** On the domestic front, progress with ongoing fiscal consolidation, and continuous revenue effort including reforms supported by this operation, will reduce the risk of ad-hoc expenditure cuts. With regards to risks from interest rate caps, the GoK has been working actively to provide solutions that will de-risk SME lending; and eventually pave way for the removal of interest rate caps. Some of the key interventions that the Government has employed include: strengthened credit information sharing mechanisms through credit reference bureaus; and the establishment of Kenya's electronic movable asset collateral registry, which will reduce the cost for SMEs to register their assets and thereby improve their access to finance. External risks from tightening global financial conditions will also be mitigated by Kenya's healthy external reserves and use of more concessional borrowing facilities.

6.4 **Political and governance risk is rated substantial.** The improvement in the overall political environment following the presidential election of October 2017 has mitigated political risks to implementing reforms in Kenya; yet pockets of vulnerability remain. There is renewed high level commitment to tackle corruption in Kenya that presents an opportunity to learn from past efforts and respond to the radical shift in Kenya's governance arrangements arising from devolution reforms. However, political and governance risks, could complicate the envisaged adjustment path particularly if revenue enhancement measures and efforts to further rationalize recurrent spending face political resistance. Therefore, it is important for the GoK to create awareness of the economic rationale for the proposed reforms including the benefits of enhanced macroeconomic stability in a manner that is easily understood by the general public. The World Bank and other donors support measures to improve governance in Kenya by addressing the bottlenecks to improved economic management and service delivery. The DPF is complemented by operations such as the Program to Strengthen GESDeK (P161387) that supports the implementation of the PFM Reform strategy at the national level. The Kenya Devolution Support Project (P149129) supports the institutional strengthening of county governments including on PFM, and the Kenya Accountable Devolution Program (KADP), a multi-donor trust fund, support counties

in PFM and directly impacts on service delivery. The DPF and these complementary operations will help maintain the positive trajectory in Kenya's fiduciary and other governance systems.

6.5 Stakeholders risk is rated moderate. Citizens at large are likely to back the reforms supported by this operation, as several of the policy and institutional reforms have gone through the constitutionally required stakeholder engagement. The World Bank has also engaged with development partners on this operation. At the same time, the implementation of an ambitious reform agenda can result in vested interests within sectors attempting to stall reforms (e.g. reforms to fertilizer distribution and reforms to the National Produce and Cereal Board). Mitigating stakeholder risks will require sustained political commitment, phasing and sequencing proposed reforms based on the political and institutional feasibility and building institutional capacity to manage and sustain the reform process. This highlights the need for effective communications around the government's policy actions to engage stakeholders, build ownership and support for the government's policy priorities and strengthen receptiveness to these reforms.

6.6 Technical design and institutional capacity risks are rated moderate: As Kenya seeks an economic development model that relies on enhanced private sector participation, the technical capacity of the ministries and government agencies to carry out the required reforms whilst minimizing policy missteps will be a key ingredient of success. Technical assistance from several stakeholders, including the WBG and other development partners are expected to mitigate the technical capacity risks at the national and county levels. In most of the areas covered by this program, parallel technical assistance through ongoing programs supported by the World Bank and other partners will continue to support the implementation of reforms and build institutional capacity.

Table 6.1: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	Substantial
2. Macroeconomic	Substantial
3. Sector Strategies and Policies	Moderate
4. Technical Design of Project or Program	Moderate
5. Institutional Capacity for Implementation and Sustainability	Moderate
6. Fiduciary	Moderate
7. Environment and Social	Moderate
8. Stakeholders	Moderate
9. Other	
Overall	Moderate

ANNEX 1: POLICY AND RESULTS MATRIX

Kenya Inclusive Growth and Fiscal Management Development Policy Credit

Prior actions and Indicative Triggers		Results		
Prior Actions under DPF 1	**Indicative Triggers for DPF 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 1. Crowd in Private Investment and Financing for the Delivery of Affordable Housing				
Prior Action 1. The Recipient has (i) approved, through its Cabinet, amendments to the Sectional Properties Act to allow for individual titling of units in multi-story buildings; and (ii) enacted, through its Parliament, the Building Surveyors Act with the objective to improve building standards, including in low-income housing units.	**Indicative Trigger 1.** The Recipient has enacted through its Parliament the Physical Planning Bill which makes provision for the planning, use and regulation of land, allowing for changes to restrictive zoning laws that hold back the construction of multi-story buildings in high density areas. **Indicative Trigger 2.** The Recipient has: (i) enacted through its Parliament, the Built Environment Bill which provides the basis for building regulations and (ii) through the Ministry of Housing and Urban Development, issued the National Building Regulations ("the building code"), allowing the use of a wider range of construction materials and technology than what is prescribed in the 1968 building code.	Number of Housing units with building permits that meet the affordable housing threshold (as defined in Development Framework Guidelines of the GoK).	20,000 (2017)	40,000 (2021)
		Number of affordable housing titles issued (including individual or joint ownership agreements), *of which women*	5000 (est.2017) of which 1,000 for women	25,000 (2021) of which 7,500 for women.
Prior Action 2. The Recipient has (i) enacted, through its Parliament, an amendment to the Central Bank of Kenya (CBK) Act to empower the CBK to license and supervise mortgage re-financing businesses; and (ii) submitted, through the CBK, the draft Mortgage Refinance Companies Regulations, dated 2019, to the Attorney General, which provides a framework to operationalize the business of mortgage refinancing.		Number of private sector shareholders in KMRC	0 (2017)	6 (2021)

Prior actions and Indicative Triggers		Results		
Prior Actions under DPF 1	**Indicative Triggers for DPF 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 2. Enhance Farmers Income and Food Security				
Prior Action 3. The Recipient has approved, through its Senate, and submitted to its National Assembly, the proposed Warehouse Receipt System Bill providing the legal framework for the establishment of a warehouse receipt system.	**Indicative Trigger 3**. The Recipient has (i) established the Warehouse Receipt Council to operationalize the Warehouse Receipt Act. (ii) aligned the strategic grain reserve function of the NCPB to the Warehouse Receipt System.	Number of licensed warehouses under the Warehouse Receipt System participating in the Commodities Exchange.	0 (2017)	30 (2021)
Prior Action 4. The Recipient has approved, through its Cabinet, the structure for the establishment of a Commodities Exchange.	**Indicative Trigger 4.** The Recipient has: (i) through the Capital Markets Authority, submitted to Parliament a regulatory framework for the Commodities Exchange; (ii) through the Capital Markets Authority licensed the Commodities Exchange.			
Prior Action 5. The Recipient has (i) approved, through its Senate, and submitted to its National Assembly, the proposed Irrigation Bill, which supports better use and harnessing of water resources for irrigation through the integration of irrigation in water harvesting, flood control and storage and; (ii) through its Ministry of Agriculture, Livestock, Fisheries and Irrigation (MoALFI), piloted the e-voucher fertilizer subsidy program in four (4) counties with a coverage of at least 20,000 farmers with the aim of restructuring the fertilizer subsidy program from a manual to an e-voucher program.	**Indicative Trigger 5**. The Recipient has (i) through the MoALFI issued regulations for the implementation of the Irrigation Act; (ii) through the MoALFI rolled the e-voucher subsidy program to at least 15 counties and covering over 70,000 farmers.	Percent of arable land under irrigation.	2 (2017)	2.5 (2021)
		Number of farmers benefitting from e-vouchers, *of which women*	0 farmers (2017)	100,000 farmers (2021) (of which 35,000 female)
Prior Action 6. The Recipient has enacted, through its Parliament, the Kenya Coast Guard Service Act, which protects Kenya's territorial waters from illegal exploitation and degradation of marine ecosystems.	**Indicative Trigger 6.** The Recipient has: (i) through MoALFI, issued regulations implementing the Fisheries Management and Development Act to support sustainable exploitation of fishing stocks;	Availability of strong fisheries surveillance system with up-to-date licensing information.	No (2017)	Yes (2021)
	and (ii) submitted to its Parliament the Livestock Bill which supports pastoralists in addressing climate change and facilitates access to markets.	Domestic supply of meat (in thousand metric tons).	619 (2017)	743 (2021)

Prior actions and Indicative Triggers		Results		
Prior Actions under DPF 1	**Indicative Triggers for DPF 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 3. Create Fiscal Space to Support the Government's Inclusive Growth Agenda				
Prior Action 7. The Recipient has (i) enacted, through its Parliament, the Finance Act 2018 which contains a provision for the removal of VAT exemptions on petroleum products; and (ii) through the Cabinet Secretary of the National Treasury and Planning, adopted a governance framework through which tax exemptions are granted to avoid the creep in tax exemptions and arrest the decline in tax revenues.	**Indicative Trigger 7.** The Recipient has (i) submitted to Parliament the Income Tax Bill 2019, which streamlines tax exemptions by reducing the number of exemptions offered; and (ii) through the National Treasury has established an institutional framework for cash management.	VAT and Income tax revenues as a share of GDP. Availability of monthly cash plan.	11.4 percent (2017) No (baseline)	12.1 percent (2021) Yes (2021)
Prior Action 8. The Recipient has (i) signed an MoU between the Competition Authority of Kenya (CAK) and the Public Procurement Regulatory Authority (PPRA) that allows for information sharing to help carry out effective investigations on collusive behavior in public procurement; and (ii) through its National Treasury and Planning, verified and reconciled its external debt records to improve upon the accuracy of its electronic debt registry.	**Indicative Trigger 8.** The Recipient has (i) submitted to Parliament the Competition Subsidiary Rules that include specific penalties on collusive behavior in public procurement; approved modified standard tender documents to prevent coordination among bidders; and implemented public procurement measures as per Executive Order #2 of 2018 (ii) through its Cabinet has approved the Debt and Borrowing Policy; and (iii) automated primary issuance and secondary trading of government securities to promote transparency and enhance efficiency in the management of government debt.	Number of investigations related to bid rigging undertaken jointly by CAK and PPRA. Share of government securities transacted on electronic platform.	0 (2017) 0 (2017)	5 (2021) 70 percent (2021)

Pillar 4. Crowd in Private Investment and Leverage Digitization to Support the Government's Inclusive Growth Agenda				
Prior Action 9. The Recipient has (i) through the Cabinet Secretary of Information and Communication Technology, approved the Broadband Strategy, which commits to crowd-in private investment to expand broadband access; and (ii) enacted, through its Parliament, amendments to the Registration of Persons Act to establish a National Integrated Identity Management System, with the mandate to assign a unique national (digital) identification number to all registered persons.	**Indicative Trigger 9.** The Recipient has, through its Cabinet, approved the Kenya Investment Policy, which simplifies the process of investor entry and retention and submitted to Parliament regulations implementing the Special Economic Zones Act 2015.	Broadband penetration (number of subscriptions, in millions). Days to register a business.	12.7 (2017) 14 (2017)	14 (2021) 7 (2021)

ANNEX 2: LETTER OF DEVELOPMENT POLICY

REPUBLIC OF KENYA
THE NATIONAL TREASURY AND PLANNING

Telegraphic Address: 22921
FINANCE-NAIROBI
Fax No.: 330426
Telephone: 252299
When replying please quote

P.O. Box 30007
NAIROBI
KENYA

Ref: NT/PDMO/RMD/09/02/01

March 12, 2019

Kristalina Georgieva
President
World Bank Group
1818 H Street, N.W.
Washington D.C. 20433
United States of America

Dear Ms. Kristalina,

RE: KENYA: LETTER OF DEVELOPMENT POLICY

1. On behalf of the Government of the Republic of Kenya, I write to request for a Development Policy Operation (DPO-1) credit from the International Development Association. This Development Policy Operation (DPO-1) is the first of a two-series programmatic Development Policy Operation Credit in support of the Government of Kenya's inclusive growth agenda. The Government's medium term inclusive growth agenda prioritizes four areas comprising of: raising the share of manufacturing to GDP, food security and nutrition; universal health coverage and affordable housing.

2. This Development Policy Operation helps to advance the Government inclusive growth agenda by supporting policy and institutional reforms that (i) crowd-in the private sector for the delivery of affordable housing; (ii) enhance farmer incomes and food security; and (iii) create fiscal space to advance the priorities supporting inclusive growth.

Macroeconomic Performance and Developments

3. Kenya's economic growth has remained strong and resilient even under emerging global challenges. The economic growth strengthened from an average of 4.6 percent in the period 2002 to 2007 to an average of 4.7 percent and 5.6 percent over the 2008 to 2012 period and the 2013 to 2017 period respectively. Growth is projected at 6.2 percent in 2019 from an estimated growth of 6.0 percent in 2018. The improvement in economic growth has also translated into a significant reduction in poverty; poverty rate has declined from 46 percent in 2005 to 36 percent in 2015 (latest data). The robust performance of the Kenyan economy in recent decades, has been underpinned by strong public and private sector investment and appropriate economic and financial policies.

4. Economic growth is projected to expand by 6.1 percent in FY 2018/2019, 6.2 percent in FY 2019/2020, 6.4 percent in FY 2020/21 and 7.0 percent by FY 2022/23. This growth will be supported by a pickup in agricultural and manufacturing activities underpinned by improved weather conditions, strong service sector, stable macroeconomic environment, ongoing public infrastructural investments and sustained business and consumer confidence. In addition, measures being undertaken by the Government under "The Big Four" Plan to boost the manufacturing sector; enhance food security and nutrition; build affordable housing; and achieve Universal Health Coverage are expected to enhance growth, create jobs and promote inclusive growth.

5. Kenya continues to maintain macroeconomic stability. Month on month inflation at 4.7 percent in January 2019 and 4.1 percent in February 2019 remains low, stable and within the Government target range of 5+/-2.5 percent as a result of prudent monetary and fiscal policies. Interest rates have remained fairly low and stable due to ample liquidity in the money market. Kenya shilling exchange rate remains stable and competitive against major international currencies supported by a continued decline in the current account deficit. The current account deficit is estimated at 5.2 percent of GDP in 2018 and is expected to narrow to 5.1 percent of GDP in 2019. This decline reflects strong growth in diaspora remittances and tourism receipts, higher tea and horticultural exports, slower growth in imports due to lower food and Standard Gauge Railway–related equipment imports and the decline in international oil prices.

Fiscal Performance

6. To ensure debt is maintained within sustainable levels, the Government will continue in its fiscal consolidation plan. The plan has seen a gradual reduction of fiscal deficit from 9.1 percent in FY 2016/17 to 7.2 percent in the FY 2017/18. The consolidation is supported by enhanced revenue mobilization and rationalization of recurrent expenditure while protecting capital expenditure. These measures are expected to reduce the fiscal deficit further to 6.3 percent of GDP in FY 2018/19 and 3.1 percent of GDP over the medium term which is in line with the East African Monetary Union protocol target ceiling of 3.0 percent of GDP.

7. On the expenditure front, the achievement of "The Big Four" Plan hinges on prudent management of the available public resources. As such, the Government will continue to strengthen expenditure control and improve the efficiency of public spending through public financial management reforms. Further, there have been efforts to improve the efficiency of spending through the establishment of the Public Investment Management Unit which will enhance efficiency in identification and implementation of priority social and investment projects. In particular, the implementation of PIM regulations under the Public Finance Management Act will streamline the initiation, execution and delivery of public investment projects.

8. The Government will also continue to curtail resources going to lower-priority areas using the adopted zero-based budgeting approach. These resources will be redirected to support "The Big Four" Plan programmes and other critical sectors such as education, infrastructure, energy and social protection.

9. Notwithstanding the need for fiscal consolidation, the Government remains committed to safeguard its social protection programs. Social grants remain a vital lifeline for millions of the people living in poverty. The Government has taken decisive steps to care for and share with the community by enhancing support for the disadvantaged and enabling members of the public to enjoy the fruits of

economic success. Currently the equivalent of more than 0.3 percent of GDP is inviested on social protection through cash transfer programmes to the vulnerable groups. Going forward, the Government will continue to extend cash transfers to vulnerable groups including older persons, Orphans and Vulnerable Children and Persons with Severe Disabilities under the National Social Safety Net (Inua Jamii) Programme.

10. On the revenue front, measures being taken to enhance revenue mobilization include the Tax Laws (Amendment) Act 2018 and the Finance Act 2018 whose revenue yield is estimated at about 0.9 percent of GDP. In addition, the modernized Income Tax Bill 2018 currently undergoing legal drafting, will ease administrative bottlenecks, improve compliance and boost revenue collection, thereby supporting our fiscal consolidation efforts. Further administrative measures put in place include: enhanced scanning to detect concealment and increase efficiency in cargo clearing through procurement of additional scanners and full integration of all scanners; use of Regional Electronic Cargo Tracking System to ensure all goods reach the desired destinations and avoid dumping; use of third-party information to identify non-compliant property developers and ensure they are included in the tax base; and detection of non-compliance through i-Tax data matching.

Deficit Financing Policy

11. The main sources of deficit funding for the Government are from domestic and external official creditors. The Government will utilize and maximize the official external sources for loans on concessional terms. However, since Kenya`s graduation to lower middle-income economy, access to concessional funding is shrinking. For this reason, the Government will continue to access commercial windows of multilateral institutions as well as Export Credit Arrangements and other commercial loans. These non-concessional loans will be limited to development projects with high financial and economic returns and in line with Vision 2030 and "The Big Four" Plan.

12. The domestic debt market has deepened to be a significant source of budgetary resources. The Government will continue issuance of Treasury Bills and long dated Treasury Bonds. The issuance of long dated Treasury Bond benchmark instruments seeks to reduce the domestic debt rollover risk, lengthen maturity structure, foster secondary trading and transparent pricing and lower overall cost of borrowing. The Government is committed to continue issuing retail products like M-Akiba bond with the aim of targeting the small retail investors giving them opportunity to participate in building the economy. In addition, to increase efficiency and transparency in the domestic debt market, the financial reforms will continue to be implemented.

Agenda Policy Priorities in Support of the Government's inclusive Growth

13. The Government remains committed to an inclusive growth agenda which is anchored on Vision 2030 and being implemented through the Third Medium Term Plan which outlines four priority areas - "The Big Four". In this regard, the Government has taken decisive steps to harness the implementation of various policies and programmes under each of the four pillars namely: (i) supporting job creation by increasing value addition and raising the manufacturing sector's share to GDP; (ii) focusing on initiatives that guarantee food security and nutrition to all Kenyans; (iii) providing universal health coverage thereby guaranteeing quality and

affordable healthcare to all Kenyans; and (iv) supporting construction of at least five hundred thousand (500,000) affordable new houses to Kenyans. To enable achievement of "The Big Four" Plan, the Government has initiated key policies, legal and institutional reforms across all the Big Four sectors. In addition, the National Government is collaborating with County Governments to create an enabling environment that attracts investments in "The Big Four" programmes.

Achieving Food Security and Nutrition

14. Achieving food security and nutrition remains a priority for the Government. Challenges crippling the agriculture sector, particularly for small-scale farmers, emanate from inefficiencies in both input and output markets. Small scale farmers have limited access to affordable high-quality inputs including seeds and fertilizers. Other challenges include increased frequency and severity of droughts and floods, outbreak of pests and diseases affecting crop and livestock and declining smallholders' farm size. On the output side challenges to agricultural production and food security emanate from under investment in post-harvest infrastructure, including drying facilities, logistics and warehouses thereby leading to high levels of post-harvest losses forcing farmers to sell their produce at low prices during harvest period, without the opportunity for a proper price discovery mechanism.

15. To enhance food and nutrition security, the Government has aligned its policies, programs and projects under the agriculture sector towards increasing food production, boosting smallholder productivity, and reducing post-harvest losses and the cost of food. The recently launched Agricultural Sector Transformation and Growth Strategy seeks to address these challenges

16. The strategy commits to transform the agricultural sector into a vibrant commercial and modern agricultural sector. The policy has an important focus on increasing small-scale farmer, pastoralist and fisher folk incomes and boosting household food resilience. The commercialization of agriculture will be supported through better linkage of farmer co-operatives and groups through a well-regulated warehouse receipt system and a commodities exchange. Further, partnerships with the private sector intermediaries to help improve access to provide more farmers with better access to affordable, appropriate inputs, irrigation equipment, improved post-harvest handling and aggregation, and access to markets.

17. To reduce over reliance on rain fed agriculture, the Government will increase land under irrigation. Specifically, the Government targets to: develop 85,000 acres of irrigation area under National Expanded Irrigation program to increase production and productivity; increase area under smallholder irrigation by 1,617 acres and increase water storage for irrigation by 125 million cubic metres through development of water pans under household irrigation water harvesting project so as to bridge the gap between production and consumption. In line with this, the Government is fast-tracking the enactment of the Irrigation Bill that will hasten the development and issues of coordination of irrigation facilities in the country.

18. To mitigate losses among smallholder farmers and boost their productivity, the Government will upscale crop and livestock insurance with the goal of cushioning farmers against climate related risks. This will also contribute to stabilization of farmers' incomes, increased investment in agriculture through leveraged access to finance and enhanced farmers' risk mitigation.

19. To promote the growth of the livestock sub-sector, the Government will expedite the review of the National Livestock Policy; Finalization of Livestock Feeds Policy, Livestock Breeding Policy, Livestock Feeds Regulations and enactment of the Dairy Industry Bill. To increase fish production, the Government will expedite the review of the National Oceans and Fisheries Policy, 2008; develop regulations to operationalize the Fisheries Management and Development Act (FMDA), 2016; develop the necessary fisheries infrastructure and Fish Ports (Fish processing and cold storage facilities, jetties, Fish landing sites, Market and Auction Centres); build capacity for deep sea fishing; enhance capacity for fisheries and marine research; enhance fish quality assurance through accreditation of fish quality laboratories in Nairobi, Mombasa and Kisumu; promote aquaculture innovations and technology transfer; and provide regulatory and institutional framework for the coordination and development of the blue economy. The Government will also operationalize the institutions established by the FMDA, 2016 namely: the Kenya Fisheries Services; the Kenya Fish Marketing Authority; the Fish Levy Trust Fund; the Kenya Fisheries Advisory Council; and the Kenya Fishing Industries Corporation Order, 2018.

Affordable Housing

20. As a key pillar in "The Big Four" Plan, the Government aims to meet a constitutional right enshrined in Article 43(1) (b) of the Constitution of Kenya on the right to accessible adequate housing. Currently, more than 6.4 million Kenyans are living in slums due to unavailability of affordable housing. For this reason, through the affordable housing project the Government targets to support provision of at least 500,000 affordable houses to Kenyans by 2022.

21. To this end, the Government is strengthening the legal framework and policy foundation that have hindered the development of affordable houses by overhauling several old legislation. These include the Sectional Properties Bill to allow for less cumbersome titling procedures for multi storey units; the Built Environment Bill and reforms to the National Building Regulations allowing for the use of wider range of newer and greener technologies and building materials; and improvements to building safety through the passing of the Building Surveyors Act. The Government will also finalize the Physical Planning Bill 2017 and regulations, review the Physical Planner's Registration Act and align Rating Act, Valuation for Rating Act and Survey Act to the Constitution. Further, the Government will continue to invest in land registration, processing and issuance of tittle deeds, implement National Land Management Information System by digitizing the remaining 39 land registries for effective and efficient access to land data.

22. To mobilize capital to finance the affordable housing project, the Government has established the National Housing Development Fund which will offer certainty of sales in the form of an off-take undertaking to developers, and provide accessible finance for house buyers through a National Tenant Purchase Scheme. The Housing Fund is a Public Private Partnership led housing model that will help crowd in private investment in the housing sector through off-taker agreements.

23. To increase access to affordable housing finance, the Government, with support from the World Bank has established the Kenya Mortgage Refinance Company (KMRC) to leverage funds from Development Partners and the private sector to provide secure long-term funding to financial institutions thereby increasing the availability and affordability of mortgage loans to Kenyans. KMRC which was incorporated in April 2018 has started raising capital.

Health

24. Although health is not one of the pillars of support in this Development Policy Operation, the Government is committed to the achievement of Universal Health Coverage. To make universal health coverage a reality, the Government, with support from the World Bank launched the pilot phase of the universal health programme in four Counties namely, Kisumu, Machakos, Nyeri and Isiolo. The representative sample of four Counties will generate the required feedback to guide the countrywide rollout of the universal health programme.

25. In addition, the Government will enhance and modernize NHIF systems to increase its uptake, improve its governance structure and service delivery. To increase enrolment and retention of NHIF, the Government will use customer-centric distribution system including religious organizations, Self-Help Groups, Ajira Agent Platforms and Banks, among others. Further, to increase specialized treatment, the Government will continue to avail and improve specialized medical equipment and infrastructure to hospitals across the country.

Advancing Digitization

26. Even though ICT is not one of the Big Four pillars, the application of digital technologies is foundational to the achievement of the Big Four Agenda. The Government's Medium Term Plan III recognizes ICT as one of the key enablers for the achievement for its development goals. ICT is important as a means of reducing the cost of doing business enhancing efficiency in service delivery, and opening new frontiers for employment creation and business opportunities.

27. As Kenya moves to the next level of a knowledge-based economy, the Government is keen on further developing capabilities in the areas of science, technology and innovation. Towards this end, the Government is in the process of finalizing the ICT Policy. The ICT Policy provides the overarching framework for which many of the key strategies and frameworks are being developed or will be developed. The Policy envisages the speeding up of the development of new generation mobile, high speed internet access, enhanced usage of ICT in the provision of government services, implementation of the national big data strategy and enhancement of national cyber security and data protection. The guiding principles of the ICT Policy include Universal Access, prioritizing the interests of the private sector to foster entrepreneurship, innovation; and the protection of citizens rights and duties.

28. The operationalization of the ICT policy over the next 5 to 10 years is reflected in the Broad Band Strategy and ICT Master Plan, both of which have clear implementation programs. The Broad Band Strategy commits to crowd-in private investment to expand broad band access and limiting public intervention to non-commercial activity. To accelerate access particularly and the last mile connectivity the strategy envisages the use of the Universal Service Fee/Fund to expand coverage of the basic broadband infrastructure e.g. building backbone networks.

29. The digital revolution exposes us to risks such as cybercrimes and fraud which may result to data corruption or loss. Given these risks, strengthening the fight against cybercrimes is critical. Towards this end, the Computer Misuse and Cybercrimes Act, 2018 was enacted. Further the Computer Misuse and Cybercrimes Act 2018 establishes the National Computer and Cybercrimes Coordination Committee and facilitates international co-operation in dealing with computer and cybercrime matters. The Act also spells out stiff punishment to cybercriminals - provides for timely and effective detection, prohibition, prevention, response, investigation and

prosecution of computer and cybercrimes. In addition, the Government has enacted the National Integrated Identity Management System, which is mandated to assign a unique national (digital) identification number to all registered persons. This is expected to enhance governments ability to deliver services to citizens. In addition, the government has prepared a Data Protection Bill. The Data Protection Bill proposes to establish the Office of the Data Protection Commissioner to enforce safe handling of data.

Strengthening Governance

30. The Government has scaled up the fight against corruption by implementing various legal, policy and institutional reforms in order to seal the loopholes used to embezzle public funds. To succeed in the fight against graft, the Government has strengthened all the institutions mandated to fight against corruption so that they may bring all corruption suspects to book in record time, instill good governance and recover corruptly acquired assets. In particular, the Government has transformed the Judiciary by building and improving court infrastructure across the country and recruiting more judges and magistrates.

31. To rid the public service from corruption, the Government has plugged the gaps in procurement by aligning the public procurement processes through the Public Procurement and Disposals Act. In addition, the Government vetted all Procurement Heads and Heads of Accounts, to rid it off the corrupt officials in procurement, accounting and the approval chain. Guidelines have been issued to all Government entities, requiring all Accounting Officers of Ministries, Departments Agencies and Parastatals to publish and publicize all procurement contracts on their websites, the State portal and tender notice boards. Further the recent signing of an Memorandum of Understanding between the Competition Authority of Kenya and Public Procurement Regulatory Authority allows for information sharing to help carry out effective investigations on collusive behavior in public procurement.

32. The Government has also extended the crackdown on corruption to all public officers in line Ministries and State Corporations. The recent arrests and prosecutions of persons including senior Government officials, business persons, and ordinary Kenyans alike sends a strong message that engaging in corruption attracts dire consequences.

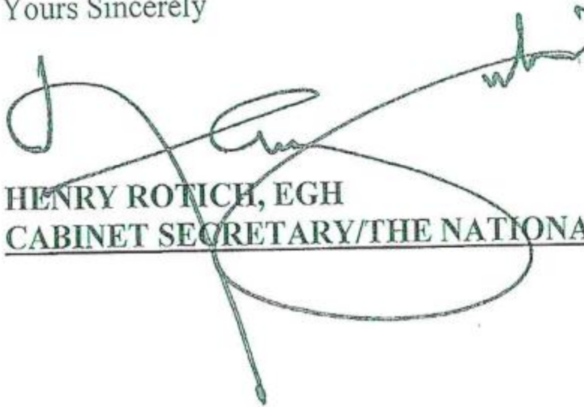
33. Further, the Government conducted lifestyle audits on all public officers complementing it with a robust wealth declaration system for routine asset disclosures. This is in line with Section 26(1) of the Public Officer Ethics Act, which states that each state or public officer is required to bi-annually, submit to their relevant responsible commission a declaration of income, assets and liabilities of him/herself, spouse(s) and dependent children under the age of 18 years. In this regard, the Government is strengthening compliance with this provision and is putting in place mechanisms, aided by technology, for easy processing and follow up of wealth declarations.

34. To further fight graft, the Government has improved governance across all public institutions. The improvement in governance was also reaffirmed by the Mo Ibrahim Index of African Governance which was released in October 2018. In the release, Kenya was ranked position 11 in Africa and among the top 3 most improved economies in Africa. Remarkable improvements were mainly registered in the three categories namely: sustainable economic opportunity; human development participation; and independence of the Judiciary.

Conclusion

35. The policies and actions in this letter will go a long way towards achieving its inclusive growth agenda as outlined in the third Medium Term Plan and consistent with the Sustainable Development Goals. Against this background, we request the World Bank's assistance to support the realization of this program.

Yours Sincerely



HENRY ROTICH, EGH
CABINET SECRETARY/THE NATIONAL TREASURY AND PLANNING

ANNEX 3: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1. Crowd in Private Investment and Financing for the Delivery of Affordable Housing		
Prior Action #1: The Recipient has (i) approved, through its Cabinet, amendments to the Sectional Properties Act to allow for individual titling of units in multi-story buildings; and (ii) enacted, through its Parliament, the Building Surveyors Act with the objective to improve building standards, including in low-income housing units.	Positive	Positive
Prior Action #2: The Recipient has (i) enacted, through its Parliament, an amendment to the Central Bank of Kenya (CBK) Act to empower the CBK to license and supervise mortgage re-financing businesses; and (ii) submitted, through the CBK, the draft Mortgage Refinance Companies Regulations, dated 2019, to the Attorney General, which provides a framework to operationalize the business of mortgage refinancing.	Positive	Positive
Pillar 2. Enhance Farmer Incomes and Food security		
Prior Action #3: The Recipient has approved, through its Senate, and submitted to its National Assembly, the proposed Warehouse Receipt System Bill providing the legal framework for the establishment of a warehouse receipt system.	Positive	Positive
Prior Action #4: The Recipient has approved, through its Cabinet, the structure for the establishment of a Commodities Exchange	Positive	Positive
Prior Action #5: The Recipient has (i) approved, through its Senate, and submitted to its National Assembly, the proposed Irrigation Bill, which supports better use and harnessing of water resources for irrigation through the integration of irrigation in water harvesting, flood control and storage and;	Potentially negative (if mitigating actions are not considered)	Positive

(ii) through its Ministry of Agriculture, Livestock, Fisheries and Irrigation (MoALFI), piloted the e-voucher fertilizer subsidy program in four (4) counties with a coverage of at least 20,000 farmers with the aim of restructuring the fertilizer subsidy program from a manual to an e-voucher program.		
Prior Action #6: The Recipient has enacted, through its Parliament, the Kenya Coast Guard Service Act, which protects Kenya's territorial waters from illegal exploitation and degradation of marine ecosystems.	Positive	Positive
Pillar 3. Create Fiscal Space to Support the Government's Inclusive Growth Agenda.		
Prior Action #7: The Recipient has (i) enacted, through its Parliament, the Finance Act 2018 which contains a provision for the removal of VAT exemptions on petroleum products; and (ii) through the Cabinet Secretary of the National Treasury and Planning, adopted a governance framework through which tax exemptions are granted to avoid the creep in tax exemptions and arrest the decline in tax revenues.	Positive	Negative
Prior Action #8: The Recipient has (i) signed an MoU between the Competition Authority of Kenya (CAK) and the Public Procurement Regulatory Authority (PPRA) that allows for information sharing to help carry out effective investigations on collusive behavior in public procurement; and (ii) through its National Treasury and Planning, verified and reconciled its external debt records to improve upon the accuracy of its electronic debt registry.	Positive	Positive
Pillar 4. Crowd in Private Investment and Leverage Digitization to Support the Government's Inclusive Growth Agenda.		
Prior Action #9: The Recipient has (i) through the Cabinet Secretary of Information and Communication Technology, approved the Broadband Strategy, which commits to crowd-in private investment to expand broadband access; and (ii) enacted, through its Parliament, amendments to the Registration of Persons Act to establish a National Integrated Identity Management System, with the mandate to assign a unique national (digital) identification number to all registered persons.	Positive	Positive