REPUBLIC OF KENYA

COUNTY GOVERNMENT OF TAITA TAVETA

COUNTY TREASURY

BUDGET REVIEW AND OUTLOOK PAPER

SEPTEMBER 2013

Foreword

The new Public Financial Management Act 2012 has ushered in a paradigm shift in budget making. Apart from introducing reforms in our public financial management system, the new law will entrench the Medium Term Expenditure Framework budgeting.

The County Budget Review and Outlook Paper (CBROP) present the fiscal outcome for 2012/13 and how this affects the financial objectives set out in the 2013 Budget Policy Statement (BPS). The updated macroeconomic outlook therein also provides us with a basis to revise the 2013/14 budget in the context of the Supplementary Estimates, as well as set out the broad fiscal parameters for the next budget and medium term.

Very briefly, we went through the challenges of last financial year and closed the year satisfactorily. While the macroeconomic environment has improved significantly since March 2013, there are still many challenges due to the fact that this is a new government, under a new political dispensation and hence new ways of doing things which in itself is a challenge. Under these circumstances, we remain steadfast in maintaining macroeconomic stability, even in the face of expenditure pressures associated with the fact that our people have remained marginalized for a long time hence lacking very basic services and salary demands from every avenue.

More important, greater transparency and high quality management of public finances at both levels of government (that is, sub county and county governments) will be necessary to achieve the aspirations of the Taita Taveta people of a better tomorrow. The fiscal framework presented in this 2013 CBROP provides a strong basis for building our common future under the new constitutional dispensation. More details will be provided in the next Budget Policy Statement expected shortly.

HON. FLORA M. MAGHANGA-MTUWETA.
COUNTY EXECUTIVE MEMBER FOR FINANCE AND PLANNING

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Abbreviations and Acronyms

ASALs - Arid and Semi Arid Lands
BOPA - Budget Outlook Paper
BPS - Budget Policy Statement
CBROP - County Budget Review and Outlook Paper
BSP - Budget Strategy Paper
EAC- East African Community
ERSWEC - Economic Recovery Strategy for Wealth and Employment Creation
FY- Financial Year
GDP- Gross Domestic Product
GoK - Government of Kenya
KNBS- Kenya National Bureau of Statistics
MDG- Millennium Development Goals
MTEF- Medium Term Expenditure Framework
MTP - Medium-Term Plan
NFA - Net Foreign Assets
NDA- Net Domestic Assets
PERs - Public Expenditure Review
PFM- Public Financial Management
PPP - Public Private Partnership
SWGs - Sector Working Groups
VAT- Value Added Tax

LEGAL BASIS FOR THE PUBLICATION OF THE COUNTY BUDGET REVIEW AND OUTLOOK PAPER

The County Budget Review and Outlook Paper is prepared in accordance with Section 118 of the Public Financial Management Act, 2012**;**

(1) A County Treasury shall:

- (a) prepare a County Budget Review and Outlook Paper in respect of the county for each financial year; and
- (b) submit the paper to the County Executive Committee by the 30th September of that year.

(2) **In** preparing its county Budget Review and Outlook Paper, the County Treasury shall specify;

- (a) the details of the actual fiscal performance in the previous year.
- (b) the updated economic and financial forecasts with sufficient information to show changes from the forecasts in the most recent County Fiscal Strategy Paper;
- (c) information on:
  - (i) any changes in the forecasts compared with the County Fiscal Strategy Paper; or
  - (ii) how actual financial performance for the previous financial year may have affected compliance with the fiscal responsibility principles, or the financial objectives in the County Fiscal Strategy Paper for that financial year; and
- (d) reasons for any deviation from the financial objectives in the County Fiscal Strategy Paper together with proposals to address the deviation and the time estimated for doing so.

(3) The County Executive Committee shall consider the County Budget Review and Outlook Paper with a view to approving it, with or without amendments, within fourteen days after its submission.

(4) Not later than seven days after the County Budget Review and Outlook Paper is approved by the County Executive Committee, the County Treasury shall;

- (a) Arrange for the Paper to be laid before the County Assembly; and
- (b) as soon as practicable after having done so, publish and publicize the Paper.

FISCAL RESPONSIBILITY PRINCIPLES IN THE PUBLIC FINANCIAL MANAGEMENT ACT, 2012.

In line with the Constitution, the new Public Financial Management (PFM) Act, 2012, sets out the fiscal responsibility principles to ensure prudency and transparency in the management of public resources. The PFM law (Section 15) states that:

1) Over the medium term, a minimum of 30% of the national budget shall be allocated to development expenditure
2) The County government's expenditure on wages and benefits for public officers shall not exceed a percentage of the total revenue as prescribed by County Executive Member for Finance.
3) Over the medium term, the County is not allowed to borrow any funds.
4) Fiscal risks shall be managed prudently
5) A reasonable degree of predictability with respect to the level of rates and tax bases shall be maintained, taking into account any tax reforms that may be made in the future.

I. INTRODUCTION

Background

This County Budget Review and Outlook Paper (CBROP) is the first to be prepared under the Public Financial Management Act, 2012 and the first in the Taita Taveta County Government. In line with the law, the CBROP contains a review of the fiscal performance of the financial year 2012/13, updated macroeconomic forecast, and deviations from the County Budget Policy Statement submitted to County Assembly in April 2013.

Objective of CBROP

The objective of the CBROP is to provide a review of the previous fiscal performance and how this impacts the financial objectives and fiscal responsibility principles set out in the last Budget Policy Statement (BPS). This together with updated macroeconomic outlook provides a basis for revision of the current budget in the context of Supplementary Estimates and the broad fiscal parameters underpinning the next budget and the medium term. Details of the fiscal framework and the medium term policy priorities will be firmed up in the next BPS.

The CBROP will be a key document in linking policy, planning and budgeting. In the interim, this year's CBROP is embedded on the updated first MTP priorities, in addition to taking into account emerging challenges and transition to a devolved system of government. Following the launch in August 2013, the Sector Working Groups have begun reviewing programmes for the next financial year, 2014/2015.

The new PFM law enacted in 2012 has set high standards for compliance with the MTEF budgeting process. Therefore, it is expected that the sector ceilings for the in provided in the previous BPS will form the indicative baseline sector ceilings for the next budget of 2014/15. However, following the fiscal outcome of 2012/13 and the updated macroeconomic framework these sector ceilings have been modified as indicated in the annex of this CBROP.

II. REVIEW OF FISCAL PERFORMANCE IN 2012/13

A. Overview

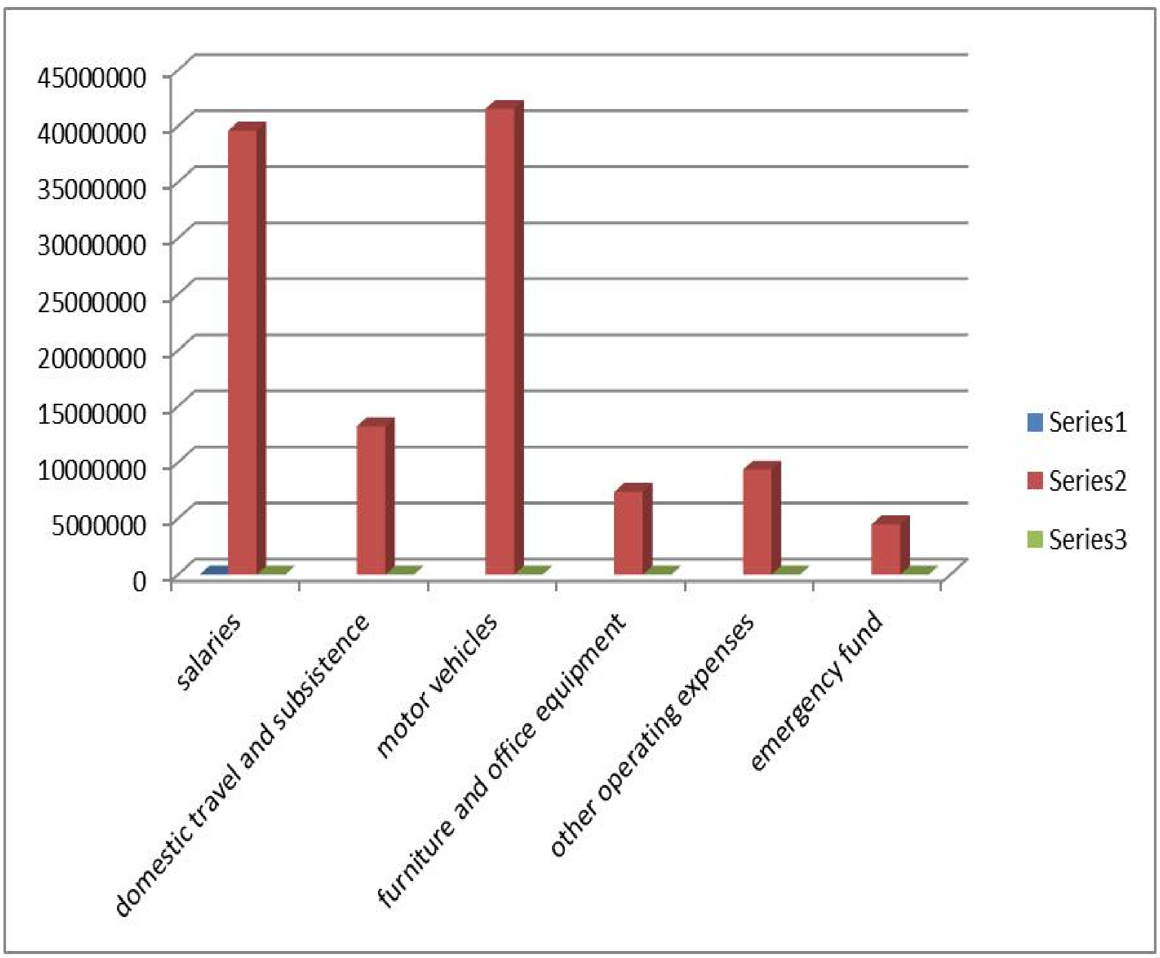
Due to the elections and unpredictable political climate the economy has not been operating optimally. The revenue collections have been dwindling by the months. However a significant improvement was seen in the months of June to August when the county treasury took a deliberate move to reinforce and ensure compliance in revenue collection.

There is some level of certainty in the political and economic arena and hence we are looking at a more robust economic period. Expenditure has mainly been on recurrent vote lines and set up costs this being a new government. We expect the trend to continue as we embark on the process of capacity building.

Though we had planned to invest over 40% of our total budget on development projects; we are looking at the possibility of reducing it to the minimum 30% required by the PFM Act. This deviation has been necessitated by the fact that some staff and recurrent costs of the transferred functions had not been factored in the Taita Taveta Budget 2013/2014.

Expenditure and Revenue

In the period March to June 2013 a total of Kshs 124,608,716 was received from the National Treasury and 17,000,000 generated from the county. A total of Kshs 33,854,718 was spent by the County Assembly and Kshs 81,739,437.49 was spent by the County Executive including the former county councils. A total of Kshs 115,594,155.49 was spent by the Taita Taveta County. Purchase of motor vehicles account for 36% of the expenditure followed by salaries at 34% of the total expenditure. Travel and subsistence expenses follow at 11% and other set up costs like purchase of office furniture and equipment stand at 8%. This trend is expected to continue with staff costs rising significantly as the county moves to fill all the constitutional offices. Travel and subsistence costs are expected to continue rising as new staff continue to be employed and hence need for training and capacity building on the new system of governance.



Overall balance and financing

The County received Kshs 124, 608,716 and raised 17,000,000 in local revenues. The county was able to raise 12% of the total revenues for this period. In the budget 2013/2014 the county plans to generate Kshs 244,000,000 out of the total budget of Kshs 2,664,870,449. This forms 9% of the total revenues. Though this looks like a herculean task. The finance bill 2013 puts measures that will ensure this target is achieved. The Bill seeks to push out those citizens who do not need to pay rates and moves to concentrate its efforts on those activities that will maximize its revenues. The bill seeks to tax businesses and not individuals struggling to make a living by setting a minimum amount of goods which qualify for paying tax and charges. More revenue sources have been identified and stringent enforcement measures have been put in place.

C. Implication of 2012/13 fiscal performance on financial objectives contained in the 2013 BPS

The performance in the FY 2012/13 has affected the financial objectives set out in the latest BPS and the Budget for FY 2013/14 in the following ways:

(i) the macroeconomic assumptions underpinning the 2013/14 budget and medium term will need to be modified in light of the slower-than-envisaged real GDP growth and the significant deceleration in inflation;

(ii) the base for revenue and expenditure projections has changed implying the need for adjustment in the fiscal aggregates for the current budget and the medium-term; and

(iii) arising from (i) and (ii), as well as taking into account the slower pace of execution of the budget by MDA, the baseline ceilings for spending agencies will be adjusted and then firmed up in the next Budget Policy Statement in November/December 2012.

While our economic growth is still resilient, the outcome of the first quarter of 2012 and the weakening global growth calls for caution in the growth forecast. According to latest quarterly GDP data released by KNBS in June 2012, the economy grew by 3.5 percent in the first quarter of 2012 compared to a growth of 5.4 percent in the same period in 2011. The IMF has also revised the global economic projections in July 2012, indicating a less optimistic outlook. While we expect the economic to remain resilient, our projections remain cautious. We expect real GDP growth to be 5.1 percent in 2012, representing a slight revision downwards from the 5.2 percent projected in the BPS 2012. This is expected to pick gradually to about 5.6 percent in 2013 and to about 6.0 percent in the outer years, reflecting continued normal weather and strong growth in the sub-region. In addition, inflation is expected to continue to decelerate and thus the GDP deflator—a key macroeconomic assumption in budget forecasting—will also ease.

The implication of a lower expansion in nominal output (reflecting revised real GDP growth and deflator) is expected to erode the tax base upon which revenue projections for FY 2012/13 and the medium term is based. The elasticity of revenue with respect to output fluctuation is equal to or greater than one. A decline in GDP growth leads to a proportionate decrease in revenue. This means that out revenue projections needs to be cautious and in line with the revised macroeconomic assumptions. Consequently, the initial MTEF ceilings provided in the BPS will need to change reflecting the updated macroeconomic forecast. Therefore, the Second and Third year ceiling in the last BPS have been modified to reflect the new developments in the resource envelope.

Underperformance in VAT local, excise and import duty in 2011/12 has implications in the base used to project the revenue for these tax items in the FY 2012/13 and the medium term. Therefore, in updating the fiscal outlook the new base has been taken into account. In addition, the proposed VAT law is expected to address the challenges relating to VAT withholding and refund system and make the VAT law more efficient and easy to comply with by tax payers. This is expected to enhance revenue yield from this tax. The under-spending in both recurrent and development budget for the FY 2011/12 has implication on the base used to project expenditures in the FY 2012/13 and the medium term. Appropriate revisions have been undertaken in the context of this BROP, taking into account the outturn in expenditures in 2011/12. The slow uptake of external resources remains a challenge. The National Treasury will work closely with the implementing agencies to fast track absorption.

Given the above deviations, the revision in revenues and expenditures will be based on the revised macroeconomic assumptions contained in this BROP and which will be firmed up in the context of the next BPS. The Government will not deviate from the fiscal responsibility principles, but will make appropriate modification to Budget Review and Outlook Paper, 2012 the financial objectives contained in the latest BPS to reflect the changed circumstance. Measures to revamp agriculture through irrigation are expected to support our favourable growth prospects. In addition, we also expect our exports to benefit from favourable growth in the sub region, which is projected to be well above the global growth. Meanwhile, stability in interest rates and exchange rates is expected to promote access to credit for private sector and boost investments and consumption to stimulate growth.

III. RECENT ECONOMIC DEVELOPMENTS AND OUTLOOK

The macroeconomic environment has continued to improved, after the shocks in the second half of 2013. Going forward, the macroeconomic outlook remains favourable although risks remain.

A. Recent Economic Developments

Growth in Real GDP remains resilient but downside risks remain

Real GDP grew by 3.5 percent in the first quarter of 2012, compared to 5.4 percent during a similar period in 2011. This growth was mainly attributed to impressive recovery in sectors such as Electricity and Water, Transport and Communication, Agriculture and Forestry. Financial Intermediation, Building and Construction, as well as Wholesale and Retail sectors registered weak growth in the first quarter of 2012. Data for the second quarter is expected to be released by end of September 2012 but leading economic indicators points to continued growth, although it remains slower than anticipated. Leading indicators for Agriculture and forestry shows coffee deliveries expanded by 84 percent to 24,933 metric tonnes for the period between January and May 2012 from 13,562 metric tonnes delivered over the same horizon in 2011. However, tea deliveries declined by 11 percent from 178,462 metric tonnes in June 2011 to 158,173 metric tonnes in 2012. Horticultural exports declined by 8% from 190,766 metric tonnes in July 2011 to 174, 903 metric tonnes in July 2012. Manufacturing sector slowed down to grow by 3.8% in the first quarter of 2012, compared to a growth of 6.6% in the first quarter of 2011. Processed milk and sugar decreased among manufactured foods and beverages as a result of a decline in the supply of inputs. Leading indicators for the second quarter indicate a positive but slightly weak growth with cement production growing by 5% from 1,633,018 tonnes by end June 2011 to 1,717,366 tonnes by end June 2012. Local power consumption increased by 5% from 3,108 Kwh millions by June 2011 to 3,259 Kwh millions by June 2012.

Overall, following the outcome of the first quarter, we have slightly revised our earlier growth projection of 5.2 percent for 2012 to about 5 percent. Favourable weather and measures to revamp agriculture through irrigation would safeguard our positive growth projections. We also expect our exports to benefit from favourable growth in the sub region, while declining inflation and stable exchange rate and interest rates are expected to boost investor confidence.

Inflation has consistently dropped since peaking in November 2011

Overall inflation has fallen from the high of 19.7 percent in November 2011 to 6.1 percent in August 2012. Reduction in fuel pump prices by the Energy Regulatory Commission, declining maize and sugar prices, the falling global prices and a stable exchange rate are some of the factors behind the easing of overall inflation. The outlook for inflation is more favourable especially after the adequate rains received in the year that is expected to enhance food supplies. We expect inflation to remain 14 within the target level of 5 percent in months ahead with appropriate monetary policy.

The fall in inflation has allowed room for a slight easing of the monetary policy to support growth. The Central Bank reduced the CBR in September 2012 to 13% from 16.5% in July 2012. This is expected to lead to reduction in interest rates and enhance access to credit by the private sector.

The shilling exchange has firmed up against major international Currencies

The exchange rate has stabilised over the recent months. Against the US dollar, the shilling exchanged at Ksh 83-86 range for the greater part of 2012. Similarly, it has remained stable against other major international currencies. For instance, against the Pound Sterling and the Euro, the shilling exchanged at Ksh132.0 and Ksh 104.2, respectively, compared to Ksh 133.9 and Ksh 111.4 exchanged in January 2012. The strengthening of the shilling against major international currencies reflects increased capital inflows and appropriate macroeconomic policies.

Consequently, official foreign exchange reserves held by the Central Bank of Kenya rose by 26.5 percent to US$ 5.3 billion (or 4.2 months of import cover) by the end of July 2012, from US$ 4.2 billion (or 3.8 Months of import cover) in a similar period last year.

Interest rates have stabilized with drop in inflation

Interbank interest rates eased to 9.1 percent by August 2012 compared with the rate of 28.9 percent in November 2011. This has resulted in low interest rates in the 91-day Treasury bill rates, which fell from 16.1 percent in November 2011 to 10.9 percent in August 2012. Average lending rates by commercial banks at around 20 percent are yet to decline in line with the fall in short term interest rates.

Recent downwards adjustments of the CBR from 18% to 13% are expected to lead to further lowering of interest rates. Meanwhile, the Government borrowing programme is expected to be executed as planned and the cost to decline as evidenced by the sharp fall in 91-days T-bill.

Stock exchange indicators have improved

The NSE share index has improved from 3,225 points in January 2012 to 3,865.8 points in August 2012, representing a growth of 19.9%. Market capitalization has also increased from Ksh 1,002 million to Ksh 1,133 million (or a growth of 13%) over the same period. Recent developments indicate an improved performance in most of the market indices.

External payments position remain favourable with strong capital flows more than offsetting the large current account deficit

The trade deficit worsened by 23.9 percent to US$ 10,122 million by July 2012 from US$ 8,174 million in July 2011. The services surplus registered a growth of 11.6% from US$ 5,351 million in July 2011 to US$ 5,974 million in July 2012, but this was not high enough to offset the trade deficit. As a result, the current account deficit widened from US$ 2,823 million in July 2011 to US$ 4,148 million in July 2012. The deficit in the current account was more than offset by the surplus of US$ 5,005 million in the capital and financial account thereby resulting in the overall balance of payment surplus of US$ 858 million. ... as a result, there has been a build up in official foreign exchange.

With a surplus in the overall balance of payments, official foreign exchange reserves held by the Central Bank of Kenya rose by 26.5 percent to US$ 5,262 million (or 4.2 Months of import cover) in July 2012 from US$ 4,159 million (or 3.8 months of import cover) in July 2011.

Implementation of 2012/13 budget is progressing well after a slow start

Challenges in the movement to new IFMIS platform delayed implementation of the FY 2012/13 budget by almost four weeks. This has now been addressed and government operations are continuing in earnest. However, expenditure pressures have emerged with salary demands from the health and education sectors, in addition to continuing security interventions in Somalia. These poses risk to the stability of the budget for 2012/13 in the face of resources requirement for the preparation of the general election scheduled to be held in March 4, 2013, and transition to decentralized system.
Revenue collection was below target by about Ksh. 13 billion in the first two month of the year. Enhance administrative measures to address VAT shortfall will therefore be required. Meanwhile, domestic borrowing remains on track with tranquillity in the domestic money market.

B. Macroeconomic outlook and policies

The updated macroeconomic framework is cautious given the weaker-than expected recovery in global output and performance in the first quarter of 2012.

Growth prospects

The global economic recovery has weakened further. According to the latest World Economic Outlook (WEO) update released in mid-July 2012 by the IMF, global economy has shown signs of further weakness. Growth in a number of major emerging market economies has been lower than forecast. Global growth is expected to be about 3.5% in 2012 compared to a growth of 3.9% and 5.3% registered in 2011 and 2010, respectively. Against this backdrop and give the weaker-than-anticipated first quarter growth performance, our updated macroeconomic framework is cautious (Table 5).

Nonetheless, with the improved weather conditions, easing of inflation and stable fuel prices and exchange rates, the current growth projections remain within reach, although downside risks remain. Improvement in the investment climate, coupled with further structural and legal reforms as we implementation of the new Constitution are expected to improve competitiveness of the private sector and promote overall productivity in the economy. Successful general elections and implementation of the devolved system of governance is also expected to boost investor confidence and increased private investment. Whereas the revised projected growth is still below the target envisioned in Vision 2030 needed to increase labour absorption, the Government recognizes that further scaling up would require mobilization of larger amounts of resources, raising factor productivity, and moving to a higher value-added and more efficient production structure. The next Second MTP of Vision 2030 will articulate key priority measures to accelerate growth, taking into account limited public resources.

Inflation outlook

We anticipate that the current rise in the overall inflation would continue in the months ahead. Ample supply of food with normal weather conditions combined with stable energy prices will support our inflation forecast to be around the 5 percent target in year ahead and medium term. In addition, appropriate monetary policy should maintain low inflation which, in turn, will stimulate growth in the medium term. Stability in interest rates and improved investor confidence should enable the capital and financial account to be in surplus and offsetting the current account deficit.

C. Medium Term Fiscal Framework

We will continue to pursue prudent fiscal policy to assure macroeconomic stability. In addition, our fiscal policy objective will provide an avenue to support economic activity while allowing for implementation of the new Constitution within sustainable public finances. As such, the Government is committed to a gradual reduction in the overall fiscal deficit (including grants) to 3.5 percent of GDP in the medium term. This will help to bring down the debt-to-GDP ratio to well below 45 percent and contribute to reducing pressure in the current account, in addition to providing adequate room for future countercyclical fiscal policy in the event of a shock. With respect to revenue, the Government will maintain a strong revenue effort at 23-25 percent of GDP over the medium term. Measures to achieve this effort include simplification of the tax code in line with international best practices and improved tax compliance with enhanced administrative measures. In addition, the Government will rationalize existing tax incentives, expand the income tax base and remove tax exemptions as envisaged in the Constitution. In addition to the proposed VAT bill that is under the consideration by Parliament, the Government is reviewing all other tax legislations in order to simplify and modernize them as indicated in the FY 2012/13 Budget Statement.

Following the discovery of hydro carbons (petroleum deposits) in our country, the Government is engaging with stakeholders to develop a comprehensive policy and legislative framework covering licensing, revenue sharing, taxation and sustainable use of the resources. This will ensure that we derived maximum benefit from these national resources. On the expenditure side, the Government will continue with rationalization of expenditure to improve efficiency and reduce wastage. Expenditure management will be strengthened with implementation of the Integrated Financial Management Information System (IFMIS) across Ministries and Departments and subsequently at the county level following decentralization. Above all, the new PFM Act, 2012 is expected to accelerate reforms in expenditure management system. The fiscal stance envisages continued borrowing from domestic and external sources, with the latter being largely on concessional terms. Non-concessional external borrowing will be undertaken in a cautious manner and limited to bankable projects and the stated ceiling in the Medium-Term Debt Strategy Paper. The Government will ensure that the level of domestic borrowing does not crowd out the private sector to allow the expected increase in private investment to pick up. The Government remain committed to accessing international capital market with caution, including floating a sovereign bond when the global financial conditions permit. As was the case previously and in line with the new PFM law, borrowed resource would be used for development expenditures only.

D. Risks to the outlook

The risk to the outlook for 2013 and medium-term include further weakening in global economic growth and unfavourable weather conditions should there be any drought in 2013 and years ahead. Also, reversal in the current easing of international oil prices may fuel inflation and weaken growth. Finally, unsuccessful transition to a decentralized system of government could weaken investor confidence and slow down growth. Should these risks materialize the government will undertake appropriate measures to safeguard macroeconomic stability.

IV. RESOURCE ALLOCATION FRAMEWORK

A. Adjustment to 2012/13 Budget

Given the performance in 2011/12 and the updated macroeconomic outlook, the risks to the FY 2012/13 budget include weaker revenue performance in 2012/13 and the medium term. Expenditure pressures with respect to salary demand from the health and education sectors continue to persist, and so are demands for security interventions in Somalia. In addition, implementation pace in the spending units continues to be a source of concern especially with regard to the development expenditures and uptake of external resources. These risks will be monitored closely and the Government would take appropriate measures in the context of the next Supplementary Budget. Adjustments to the 2012/13 budget will take into account actual performance of expenditure so far and absorption capacity in the remainder of the financial year Because of the resource constrains, the Government will rationalize expenditures by cutting those that are non-priority. These may include slowing down or reprioritizing development expenditures in order for the Government to live within its means. Utilization of contingencies funds will be within the criteria specified in the new PFM law.

Any review of salaries and benefits for the public sector workers will be conducted by the Salaries and Remunerations Commission (SRC) in accordance with Article 230 of the Constitution and Regulations on Pay Review and Determination, expected to be published shortly in the Gazette Notice by the SRC. In addition, the Government will consider making decision to put on hold approval of any policy and proposed legislation, which establishes a new public sector agency with personnel and wage implications. All such establishments should await comprehensive restructuring of Government in accordance with the Constitution.

On the Revenue side, the Kenya Revenue Authority (KRA) is expected to institute corrective measures to reverse the revenue lose from VAT. Options could include enhanced compliance audit of large VAT payers, targeted reintroduction of previous withholding mechanism, and speedy implementation of collection of other sources of taxes such as rental income. Public entities holding surplus cash will be expected to surrender them to the Exchequer as soon as possible.

B. Medium-Term Expenditure Framework

Going forward, and in view of the recent macroeconomic circumstance and limited resources, MTEF budgeting will entail adjusting non-priority expenditures to cater for the priority sectors. The Second MTP (2013-2018) is currently under preparation and will guide resource allocation, going forward. In the Meantime, the resource allocation will be based on the updated First Medium Term Plan developed in November 2011.
The priority social sectors, education and health, will continue to receive adequate resources. Both sectors (education and health) are already receiving a significant share of resources in the budget and require them to utilize the allocated resources more efficiently to generate fiscal space to accommodate other strategic interventions in their sectors. The economic sectors including agriculture and livestock will receive increasing share of resources to boost agricultural productivity with a view to deal with threats in food security in the country.

With the Government's commitment in improving infrastructure countrywide, the share of resources going to priority physical infrastructure sector, such as roads, energy and water and irrigation, will continue to rise over the medium term. This will help the sector provide reliable and affordable energy, as well as increased access to water and development of irrigation projects countrywide. Implementation of the Constitution and smooth transition to decentralization will receive greater attention in terms of resources and capacity support to counties. Other priority sectors including internal security, rule of law, youth and development of arid regions, which will continue to receive adequate resources. Reflecting the above medium-term expenditure framework, the table below provides the tentative projected baseline ceilings for the 2013 MTEF, classified by sector. The sector ceilings include devolved funds.

C. County Budgets and the Transfer of Functions

A key challenge in developing the 2013/14 MTEF budget is the allocation of funds during the transition to devolved system of governance. The County Governments will come into operation after elections in March 2013 and there will be not enough time for Counties to develop their plans and budgets for 2013/14 and have them approved by the county assembly without disrupting service delivery. As such, it will be critical to have the County Government institutions constituted and their capacities strengthened in order to enable them perform their assigned functions effectively and efficiently. The national government through the Transition Authority will ensure service delivery to the County Governments is not disrupted in line with provisions in the Constitution. Although asymmetric transfer of functions is provided for in the Constitution, the national government will rapidly builds up capacity at the county level, especially for public financial management, so that counties are empowered to take over their assigned functions as soon as possible. This will avoid a situation whereby some counties have more functions transferred to them because of their stronger capacities while other counties have less functions transferred owing to lack of capacity.

Extensive work has gone into costing the devolved functions for purpose of determining expenditure patterns in the counties based on the assigned functions. Also the Commission on Revenue Allocation (CRA) has proposed a formula for sharing of revenue between national and county government and among counties. It is therefore anticipated that the Transition Authority will build on these efforts to facilitate phased transfer of the functions.

The next Budget Policy Statement will elaborate on the framework to ensure a smooth transition to devolved system.

D. 2013/14 Budget framework

The 2013/14 budget framework is set against the background of the updated medium-term macro-fiscal framework set out above. Real GDP is expected to increase by 5.8 percent in FY 2013/14 underpinned by continued good performance across all sectors of the economy. The projected growth assumes normal weather pattern during the year and improved investor confidence in the economy. Inflation is expected to remain low and stable, reflecting continued implementation of a prudent monetary policy and stable food and oil prices, as well as the shilling exchange rate.

Revenue projections

The 2013/14 budget will target revenue collection including Appropriation-in- Aid (AIA) of 24.3 percent of GDP. As noted above, this performance will be underpinned by on-going reforms in tax policy and revenue administration. As such, total revenues including AIA are expected to be Ksh 1,034.9 billion.

Expenditure Forecasts

In 2013/14, overall expenditures are projected at 29.5 percent of GDP (or Ksh 1,259.3 billion), down from the estimated Ksh1,263.3 billion (32.7 percent of GDP) in the FY 2012/13 budget owing to one-off items including expenditure on general elections.

Recurrent expenditures are expected to decline slightly from 21.7 percent of GDP in the FY 2012/13 to 19.8 percent of GDP in the FY 2013/14, on account of adjustment of one-off items and growth in nominal GDP.

- Domestic interest payments are expected to decrease relative to GDP to 2.2 percent in 2013/14 from 2.5 percent in 2012/13, while pension expenditures will stabilize at about 1 percent.
- The wage bill is expected to stabilize at 7.3 percent of GDP in the FY 2013/14.
- Transfers to parastatals and semi-autonomous government agencies will remain at the 2012/13 nominal value.
- Expenditure ceilings on goods and services for sectors/ministries are based on funding allocation in the FY 2012/13 budget as the starting point. The ceilings are then reduced to take into account one-off expenditures in FY 2012/13 and then an adjustment factor is applied to take into account the general increase in prices.

The ceiling for development expenditures including donor funded projects will increase in nominal terms to Ksh 400.6 billion (9.4 percent of GDP) in the FY 2013/14 from Ksh 363.7 billion (9.6% of GDP) in 2012/13. Most of the outlays are expected to support critical infrastructure that will crowd in private sector investment. About 40 percent of development budget will be funded by project loans and grants from development partners, while the balance of 60 percent will be financed through domestic resources.

A contingency provision of Ksh 5 billion and Ksh 7.0 billion for constitutional reform will be provided in the budget for 2013/14. Ksh 4.2 billion has also been set aside as conditional grants to marginal areas.

Overall Deficit and Financing

The overall budget deficit (including grants) in 2013/14 is projected to be Ksh 176 billion (equivalent to 4.2 percent of GDP). Net external financing amounting to Ksh 88 billion (2.1 percent of GDP) is expected to cover part of this budget deficit, leaving about the same amount of Ksh 88 billion (2.1 percent of GDP) to be financed through domestic borrowing.

V. CONCLUSION AND NEXT STEPS

The fiscal outcome for 2011/12 together with the updated macroeconomic forecast have had ramification of the financial objectives elaborated in the last BPS submitted to Parliament in April 2012. Going forward, the set of policies outlined in this BROP reflect the changed circumstances and are broadly in line with the fiscal responsibility principles outlined in the PFM law. They are also consistent with the national strategic objectives pursued by the Government as a basis of allocation of public resources. Details of the strategic objectives are provided in the updated first MTP. Meanwhile, preparation of the second MTP is under way. The policies and sector ceilings annexed herewith will guide the line ministries in preparation of the 2013/14 budget. The implications of the devolved system on the MTEF budget will be elaborated in the next Budget Policy Paper.The next Budget Policy Statement (BPS) will be finalised by November/December 2012, well ahead of the February 2013 deadline as per the new PFM law. Finalization by this date will allow Parliament to consider the BPS before its dissolution of 60 days before the general elections, scheduled for March 4, 2013.