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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED LOAN IN THE AMOUNT OF US$230 MILLION

PROPOSED CREDIT IN THE AMOUNT OF US$520 MILLION

TO THE

REPUBLIC OF KENYA

FOR THE

SECOND ACCELERATING REFORMS FOR AN INCLUSIVE AND RESILIENT RECOVERY
DEVELOPMENT POLICY FINANCING

FEBRUARY 15, 2022

Macroeconomics, Trade And Investment Global Practice
Eastern and Southern Africa Region

Republic of Kenya

GOVERNMENT FISCAL YEAR

July 1 – June 30

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of January 31, 2022)

Kenya Shilling (KES) 113.57 = US$1.00

ABBREVIATIONS AND ACRONYMS

AfDB	African Development Bank	MoWSI	Ministry of Water, Sanitation and Irrigation
CBK	Central Bank of Kenya	MTP	Medium-Term Plan
COVID-19	Coronavirus Disease 2019	MW	Megawatts
CPF	Country Partnership Framework	NAWASIP	National Water Sector Investment Program
CPS	Country Partnership Strategy	NEMA	National Environment Management Authority
DPF	Development Policy Financing	NHIF	National Hospital Insurance Fund
DPG	Development Partners Group	NPHI	National Public Health Institute
DSA	Debt Sustainability Analysis	OAG	Office of the Auditor-General
DSSI	Debt Service Suspension Initiative	PFM	Public Financial Management
DUC	Differentiated Unit Costs	PforR	Program for Results
E-GP	Electronic Government Procurement	PIM	Public Investment Management
EIA	Environmental Impact Assessment	PPA	Power Purchase Agreement
EMCA	Environmental Management and Coordination Act	PPAD	Public Procurement and Asset Disposal
EPRA	Energy and Petroleum Regulatory Authority	PPP	Public Private Partnership
ERS	Economic Recovery Strategy	PS	Principal Secretary
GDP	Gross Domestic Product	RFP	Request for Proposals
GRID	Green, Resilient and Inclusive Development	RFQ	Request for Qualifications
HCI	Human Capital Index	SDFP	Sustainable Development Finance Policy
ICT	Information and Communications Technology	SDR	Special Drawing Rights
IDA	International Development Association	SOE	State-Owned Entity
IFC	International Finance Corporation	SSA	Sub-Saharan Africa
IFMIS	Integrated Financial Management Information System	TA	Technical Assistance
IMF	International Monetary Fund	UHC	Universal Health Coverage

IPF	Investment Project Financing	US	United States
KES	Kenyan shilling	US$	United States dollar
KIHBS	Kenya Integrated Household Budget Survey	VAT	Value-Added Tax
KPLC	Kenya Power and Lighting Company	WBG	World Bank Group
LCPDP	Least Cost Power Development Plan	WRA	Water Resources Authority
M&E	Monitoring and Evaluation	WSS	Water Supply and Sanitation
MDAs	Ministries, Departments and Agencies		

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REPUBLIC OF KENYA

SECOND ACCELERATING REFORMS FOR AN INCLUSIVE AND RESILIENT RECOVERY DEVELOPMENT POLICY FINANCING

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Programmatic	If programmatic, position in series
P176903	Yes	2nd in a series of 2

Proposed Development Objective(s)

Contributing to Kenya's inclusive and resilient recovery from the COVID-19 crisis by strengthening (1) fiscal management, (2) operational efficiency in the electricity sector while placing Kenya on an efficient green energy path, and (3) the governance framework for Kenya's natural and human capital (environment, land, water and healthcare).

Organizations

Borrower:	THE REPUBLIC OF KENYA
Implementing Agency:	THE NATIONAL TREASURY AND PLANNING

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	**750.00**

DETAILS

International Bank for Reconstruction and Development (IBRD)	230.00
International Development Association (IDA)	520.00
IDA Credit	520.00

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

Substantial

Results

Indicator Name	Baseline (2020 unless otherwise specified)	Target (by 2023)
1. More transparent procurement spending: Number of Government Ministries, Departments and Agencies procuring all of their goods and services on the E-GP platform.	0	5
2. A more efficient public investment portfolio: Number of projects complying with PIM Regulations.	0	30 ongoing projects; and all new projects included in the Budget
3. A more liquid debt capital market: Minimum benchmark bond size.	Not applicable	Bonds with remaining maturity up to 5 (10) years: KES 50 (75) billion
4. More financially sustainable electricity distribution: Proportion of KPLC revenues to the revenue requirements computed by KPLC and agreed with EPRA.	87 percent	90 percent
5. More efficient electricity supply: Pipeline electricity capacity terminated or deferred to better match supply and demand.	Not applicable	400 MW
6. Cleaner electricity supply: Percentage of electricity generated from fossil fuels.	11 percent (2019)	5 percent
7. Accelerated private investment in infrastructure: Number of PPP projects that have achieved at least one additional milestone (RFQ, RFP, negotiations or contract signing).	0	10
8. Mainstreaming of climate change: Number of Counties with County Climate Change Action Plans developed through participatory methodologies endorsed by county governments.	8 of 47	25 of 47
9. A more transparent land market: Number of County Value Maps prepared and submitted to Parliament.	0 of 47	15 of 47
10. Water and sanitation access gap narrowed: Number of people gaining access to improved water and sanitation services.	0	300,000
11. WSS gender equity knowledge gap filled: national data and information system capturing gender-disaggregated WSS data annually.	Not in place	In place
12. Enhanced water resource management: Proportion of the Water Resources Authority (WRA)'s annual operating costs financed through water abstraction revenues.	20 percent	70 percent
13. Expanded access to healthcare: Number of poor and vulnerable households covered through government-financed health insurance subsidies.	223,968	1,000,000
14. Enhanced health system capacity, including against pandemics: Capacity to respond to public health events and emergencies based on IHR States Parties Annual Reporting Tool.	43 percent (2019)	65 percent

IBRD AND IDA PROGRAM DOCUMENT FOR A PROPOSED LOAN AND CREDIT TO THE REPUBLIC OF KENYA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation is the second in a programmatic series of two Development Policy Financing (DPF) operations, to support Kenya's recovery from the Coronavirus Disease 2019 (COVID-19) crisis, and steer a course towards green, resilient and inclusive development.** Its purpose is to support critical policy and institutional reforms, prioritizing those made urgent by the crisis (e.g., in hard-hit sectors such as healthcare), whilst maintaining a line of sight to the government's medium-term development agenda. It aims to strengthen the performance of state-owned entities (SOEs) in keystone sectors, make government spending and service delivery more transparent and effective, and enhance the policy platform for inclusive, sustainable growth. As part of the World Bank Group's overall partnership with the government, and building on previous DPF operations, the program extends the strong reform momentum achieved in recent years, ensuring that this is not stalled by the pandemic. This is critical to preserving and building on Kenya's significant recent development gains, including in human development (achieving the highest Human Capital Index [HCI] score in continental sub-Saharan Africa, 0.547 in 2020) and in energy access and sustainability (access to electricity almost doubled in the last decade, to 75 percent of households in 2018, based on a nearly 90 percent green energy mix). The proposed operation will contribute to the World Bank Group's global COVID-19 crisis recovery effort, and to achieving the objectives of the World Bank Group Country Partnership Framework (CPF) FY22-27 for Kenya (under preparation).

2. **Kenya's economy has shown considerable resilience to the crisis, helped by its relatively high degree of diversification, supportive policies, and ongoing reforms.** However, the pandemic has hit some sectors hard, disrupted critical services, and exacerbated pre-existing weaknesses in the public finances and the performance of some large SOEs. Staging a full recovery and returning to an inclusive, sustainable development path will require appropriately-paced fiscal consolidation, more progress on strengthening strategic public institutions, delivering quality public services and accelerating human capital development, as well as policy changes to support green growth and increase climate resilience. Reforms are also needed to enhance the functioning of markets and crowd in private sector investment, to generate more economic opportunities and jobs, drive growth, and thereby make it easier to strengthen the fiscal position.

3. **The pandemic has increased poverty and required additional social protection measures.** Poverty increased sharply in 2020 due to jobs and earnings losses. Although the economy has been recovering and poverty reduction has resumed, the overall poverty rate is not expected to fully recover and fall below its pre-crisis level until well into 2022 (the poverty rate is projected to be 34.1 percent at the end of 2022 compared to 34.4 percent in 2019 at the US$1.9/day line). In contrast to the pre-crisis poor who are predominantly rural, work in agriculture, and have little education, people pushed into poverty by the crisis tend to live in urban areas, work in manufacturing and services, have higher levels of education, and are younger. The crisis has thus called for the continued improvement of the existing social safety net, and the reforms supported by the proposed operation will contribute to restoring the fiscal space needed to sustain and ultimately increase social spending.

4. **The proposed operation supports policy reform and provides budget support at a time of continuing, heightened uncertainty for Kenya, as elsewhere.** The economy has been recovering fast and real gross

domestic product (GDP) is estimated to have increased by 5.9 percent in 2021 (after contracting by 0.3 percent in 2020). This is supporting renewed job creation and poverty reduction. Government revenues have also rebounded, facilitating fiscal consolidation efforts. However, some sectors (such as tourism) still face major difficulties, and further pandemic-related setbacks may occur. This could exert renewed pressure on households and the public and private sectors, whose buffers and coping capacities have already been depleted. The fifth, and to date the largest, wave of confirmed COVID-19 cases peaked at the end of December 2021. The government aims to fully vaccinate the adult population by the end of 2022, but there remains a long way to go, with only about 20 percent of adults having been fully vaccinated by the end of January 2022.

5. **The proposed DPF operation supports the government's efforts to strengthen aspects of Kenya's policy and institutional framework critical for a resilient, inclusive and green recovery.** It extends the strong medium-term reform momentum which has been maintained despite the pandemic shock, and prioritizes those measures which are critical to the recovery, and to green, resilient and inclusive development (GRID). The program clusters the reforms into three pillars: (i) Fiscal and debt reforms to make spending more transparent and efficient, and enhance domestic debt market performance; (ii) Electricity sector and public private partnership (PPP) reforms to strengthen the cornerstone utility (Kenya Power and Lighting Company, KPLC), place Kenya on an efficient, green energy path, and boost private infrastructure investment; (iii) Strengthen environmental and natural resource governance, combat climate change, and improve healthcare including pandemic response.

6. **The supported reforms complement and reinforce each other to address the drivers behind fiscal vulnerabilities and help chart a market-oriented path towards GRID.** Improving the transparency and efficiency of public spending, including on debt-financed investment projects, addresses underlying factors which have contributed significantly to the large fiscal deficits which have opened up in recent years. The energy, health and education sector reforms all contribute to the fiscal dimension of the reform program by strengthening the performance of critical state-owned entities and reducing the fiscal costs and risks they generate. Crucially, reducing debt risks and restoring fiscal space also requires a strong, sustained economic growth trajectory. The DPF therefore supports improvements to Kenya's policy and institutional framework to expand the role of markets and allow for private sector-led growth. This includes measures to improve the functioning of the domestic debt capital market, moving to competitive auction-based clean energy investment, and supporting a more functional, transparent market for land. To help ensure that growth is both inclusive and sustainable, the program includes a strong focus on strengthening the human and natural capital that underpins the economy and access to expanding opportunities, as well as support to accelerating climate change mitigation and adaptation in Kenya.

7. **Kenya is highly vulnerable to climate change, amplifying the challenge to achieve an inclusive and sustainable recovery.** Droughts, excessive rain and floods, and heatwaves, already inflict significant socioeconomic costs, and are projected to increase in frequency and intensity. Overall, water scarcity is expected to increase, causing crop- and livestock-loss, forest fires, damage to fisheries, and reduced hydropower generation and industrial production. Deforestation and watershed degradation have exacerbated the likelihood of, and impact from, both floods and droughts, contributing to water scarcity and pollution. Heavy rains, floods, droughts, soil erosion, and sea level rise put both urban and rural infrastructure at risk, particularly for poor and vulnerable groups. Changes in temperature and rainfall patterns are expected to weigh on crop yields and disrupt traditional pastoralist livelihoods. There are

high and growing risks from climate impacts on health, including increases in vector- and water-borne diseases such as malaria and cholera; nutritional effects of food shortages including acute malnutrition and stunting; and morbidity and mortality resulting from extreme weather events.[1]

8. **The government is implementing an ambitious climate change agenda, including through reforms supported by this DPF series.** Recognizing the additional challenges posed by climate change, the government has set out ambitious climate change mitigation and adaptation goals, put in place legislative and regulatory frameworks for the country to progress towards these goals (including through efforts at both National and County Government level), and progress is being made in implementation. Kenya already obtains about 90 percent of its electricity from renewable energy sources, and the government's strategic sector priorities have a focus on supporting green, climate-smart investments. The reforms supported by this operation have a strong climate change focus through the changes they will bring in the energy sector, environmental and water resource management, and the capability of the healthcare sector to confront growing climate-related challenges.

9. **This operation complements other ongoing projects supporting the government's development agenda.** These include: Program to Strengthen Governance for Enabling Service Delivery and Public Investment in Kenya (GESDeK, P161387); Kenya Electricity Modernization Project (P120014); Kenya Infrastructure Finance and Public-Private Partnerships (IFPPP) Project (P121019); Marine Fisheries and Socio-Economic Development Project (P163980); Water and Sanitation Development Project (P156634); Kenya Water Security and Climate Resilience Project (P117635); Kenya Financing Locally-Led Climate Action Program-for-Results (P173065); Transforming Health Systems for Universal Care Project (P152394); Kenya COVID-19 Health Emergency Response Project (P173820. The operation complements contributions by other development partners to support Kenya's recovery from the pandemic and achieve its development goals, including the current International Monetary Fund (IMF) program.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

10. **Economic growth was robust prior to the COVID-19 crisis.** Kenya's real GDP was growing at an annual average rate of about 5 percent in the decade prior to the pandemic. Along with strong private consumption growth (also averaging about 5 percent), this was supported in the 2015-19 period by increased public spending, reflecting an ambitious development agenda including plugging the large infrastructure gap and implementing the devolution mandate under the new constitution. Government consumption and investment accounted for almost a quarter of GDP growth during 2015-2019. The strong pre-pandemic growth performance was pro-poor, reducing the share of the population living below the US$1.90 a day (2011 purchasing power parity) poverty line from 45.2 percent in 2009 to an estimated 34.4 percent in 2019.

11. **The pandemic has been a major shock to the economy, but policies have been responsive and helped to mitigate the economic impact.** Real GDP contracted by 0.3 percent in 2020, down sharply from 5.0 percent in 2019 (Table 1), due to a severe slump in the second quarter (-4.7 percent year-on-year

[1] This paragraph draws on the *Kenya Climate Risk Country Profile (2020)*.

[y/y]) when the worst of the pandemic's economic effects was felt. Policymakers acted swiftly to help cushion the impact on firms and households. Actions included easing monetary policy, financial regulatory measures to prevent a credit crunch, and fiscal measures including more social protection and health spending, and tax cuts. This helped to mitigate the negative economic shock and supported a partial economic recovery in the second half of 2020. The most affected sector was services, as containment measures severely disrupted education (most institutions were shut between March and December 2020), hotels and restaurants (international air travel was banned through August 2020), transport, and trade. The main silver lining for the economy was agriculture, which recorded robust output growth (4.8 percent in 2020), helped by good rains; construction activity was also buoyant (up by 11.8 percent in 2020) supported by continued infrastructure and housing investment.[2]

12. **The economy staged a significant rebound in 2021, albeit with considerable variation in conditions across sectors.** Supported by a particularly large rebound in the services sector, and expansion in industrial output, real GDP increased by 7.8 percent y/y in the first three quarters of 2021. High frequency data are consistent with continued expansion, and GDP is estimated to have increased by 5.9 percent in 2021 as a whole. The Purchasing Managers' Index[3] shows continued sequential improvement in business activity through the end of 2021, and industrial output continues to grow strongly. Agriculture output, however, has fallen (by 0.8 percent y/y during Q1-Q3 2021), as below-average rains reduced crop and livestock production in 2021 following exceptionally strong output in 2020. Beneath the overall buoyancy of the services sector lies a mixed picture across sub-sectors, ranging from a rebound to well above pre-crisis output in some subsectors (e.g., education) to only a partial recovery in others (e.g., tourism). A Central Bank of Kenya (CBK) survey of hotels conducted in mid-November 2021 showed that all the sampled hotels were open, with employment in the sector increasing to about 78 percent from the low of 37 percent in May 2020, and average bed occupancy rising to over 50 percent from its low of 10 percent in May 2020 (though it still remains below pre-COVID levels). International visitor arrivals to Kenya were on a recovery path during most of 2021 and stood at about 77,000 in November 2021. However, this is still about 40 percent lower than before the pandemic, and Omicron variant of COVID-19 has subsequently caused additional travel disruption.

13. **Both exports and imports rose sharply in 2021, and the current account deficit has widened as imports outpaced exports.** Kenya runs structural current account deficits, amounting to 5.3 percent of GDP in 2019 (i.e., pre-pandemic). The current account deficit narrowed to 4.5 percent of GDP in 2020, as the pandemic suppressed domestic activity, global energy prices fell, and imports contracted even more than exports. Subsequently, international trade has picked up again. Both imports and exports have increased, with total imports growing more, resulting in a renewed widening in the current account deficit (estimated at 5.7 percent of GDP for the 12 months through September 2021). Increased imports were driven by higher global energy prices (fuel-related imports account for about one fifth of imports by value) and increased demand for industrial supplies driven by the domestic economic recovery. Rebounding global demand in 2021 supported exports of horticultural products and manufactures. Services exports, however, have remained subdued, due to the ongoing weakness in global tourism. Remittances, which

[2] Housing investment has been helped by the government's Affordable Housing Program as part of the "Big Four" agenda. The government has established the National Housing Development Fund (NHDF) and the Kenya Mortgage Refinance Corporation (KMRC), undertaken regulatory reforms, and instituted provided incentives to increase private sector participation in the sector.
[3] Compiled by IHS Markit, the Stanbic Kenya PMI is a diffusion index capturing monthly changes in business conditions as reported by purchasing managers at about 400 companies.

have in recent years grown to become a major source of foreign currency (equivalent to close to one third of export earnings), have remained robust on the back of higher inflows from North America, likely benefiting from the unprecedented pandemic response measures in the United States (US) supporting workers' incomes.

14. **The current account deficit was financed mainly by a mix of private and public sector borrowing.** Consistent with the global weakness in foreign direct investment (FDI) during the pandemic, FDI to Kenya fell sharply in 2020 through the most recent data (September 2021). Net portfolio investment stabilized after falling sharply in 2020, to register a small net inflow equivalent to 0.2 percent of GDP on a 12-month cumulative basis in September 2021. The temporary, official bilateral debt service suspension under the G20 Debt Service Suspension Initiative (DSSI) helped to reduce external financing needs. There was also an increase in official financing, including inflows from the IMF Extended Credit Facility (ECF)/Extended Fund Facility (EFF) arrangements which began in April 2021, and World Bank DPF from the previous operation (P175251) in this series in June 2021. In addition, Kenya received SDR 520.2 million (equivalent to US$740 million or about 0.7 percent of GDP) in the IMF's August 2021 general Special Drawing Rights (SDR) allocation. Half of this (US$370 million) is expected to be retained as reserves, while the other half has been allocated to fiscal financing in FY2021/22. Foreign exchange reserves stood at US$8,715 million on January 20, 2022, sufficient to cover about 5.3 months of imports.

15. **Since the onset of the COVID-19 crisis, the Kenyan shilling (KES) has depreciated against the US dollar, helping to absorb the shock by partly reversing previous real effective exchange rate appreciation.** The KES depreciated by 9.5 percent against the US dollar in 2020, with much of this change occurring in the early part of the COVID-19 crisis against the backdrop of broad-based US dollar appreciation against most countries' currencies. The exchange rate depreciated slightly further in nominal terms in 2021, falling by about 2.1 percent against the US dollar. In real trade-weighted terms, however, these developments only partly reverse the significant trend-appreciation of the real effective exchange rate in previous years, helping to absorb the pandemic shock and preserve the official reserve buffer.

16. **Headline inflation rose in 2021, driven by supply side factors, but core inflation has remained largely steady.** After a period of extraordinary disinflation due to the crisis compressing domestic demand and global fuel and other input prices during much of 2020, inflation began increasing in the fourth quarter of 2020, as food and international oil prices began to rise again. Prices increased further in 2021 due to the implementation of domestic tax measures enacted in the Finance Act 2021, and higher global energy prices following disruptions in coal and natural gas production, and a consequent increase in agricultural input costs. Domestically, dry weather conditions have contributed to temporary supply disruptions in a few food items, like tomatoes and onions, adding to food price increases. Headline inflation increased to a four-year high of 6.9 percent y/y in September 2021 before easing to 5.7 percent y/y in December averaging 6.1 percent y/y in 2021 compared to an average of 5.2 percent y/y in 2020. Core inflation, which removes volatile food and energy prices to provide a measure of underlying inflation pressures, however, remains at a moderate level (1.9 percent y/y in December 2021).

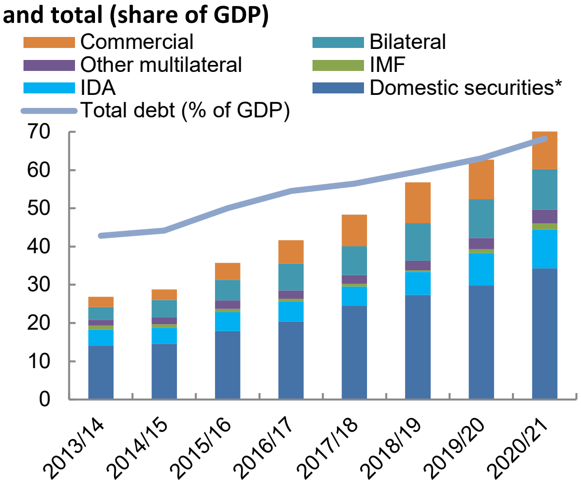
17. **Monetary policy has remained accommodative, supporting still-tepid private credit growth and the recovery.** The repeal of interest rate caps in November 2019 restored the scope for monetary policy to help manage aggregate demand, which was timely ahead of the onset of the COVID-19 crisis. The CBK reacted swiftly to the crisis and loosened monetary conditions, reducing its key policy rate in March 2020

by 100 basis points (bp), and the required cash reserve ratio by 100bp to 4.25 percent to bolster bank liquidity. This was followed by an additional 25bp off-cycle rate cut in April 2020, which reduced the benchmark rate to a historical low of 7.0 percent, where it remains. Private sector credit has been growing and was up by 7.8 percent y/y in October 2021, supported by the CBK's accommodative monetary policy stance.[4] Nevertheless, in real terms, private credit growth remains subdued.

18. **The banking sector remains stable and resilient.** The capital adequacy and the liquidity ratios of the banking sector stood at 18.9 and 56.8 percent in June 2021, well above statutory requirements. With an ample capital position and strong deposit growth, the banking sector as a whole remains well-positioned at present to meet the economy's credit needs and support the recovery, including by helping to meet the government's financing requirements. Bank profitability improved in the year to June 2021, with the return on assets and return on equity increasing to 3.4 percent and 23.3 percent. Gross non-performing loans (NPLs) subsided to 13.6 percent in October 2021 after peaking at 14.6 percent in March 2021, consistent with improving economic conditions. Kenya's relatively advanced state of digitalization prior to the pandemic helped the financial sector adjust rapidly when containment measures made in-person banking transactions more difficult. As a result, a notable development during the pandemic has been a surge in cell-phone based banking: bank transactions on mobile phones have increased from 56 percent of all transactions before the pandemic to 85 percent currently.

19. **Kenya entered the pandemic with already stretched public finances.** Prior to the pandemic, large fiscal deficits had opened up (averaging 7.8 percent of GDP over 2015-19) on the back of increased public spending amid relatively sluggish revenue performance. The government debt burden, having been broadly stable since the mid-2000s, increased sharply from 42.9 percent of GDP in 2014 to 61.3 percent in 2019 (Figure 1). The increase in debt during this period was split about evenly between increased domestic and external borrowing. The latter includes Eurobonds (first issued in 2014 and now totaling US$7.1 billion), and an increase in official bilateral credit (mostly a US$4.6 billion increase in bilateral loans from China). Public investment in this period picked up, from an average of 5.8 percent of GDP over the previous five years (2010-2014) to 7.1 percent of GDP on average during 2015-19, as a significant share of the borrowing was channeled into major infrastructure projects. While improved infrastructure spending has enhanced service delivery (e.g., improved access to electricity, a better transportation network and digital connectivity), the additional borrowing has driven up the debt stock and interest costs, which rose from 2.7 percent of GDP in 2014 to 4.1 percent in 2019. This is increasingly squeezing non-interest spending, raising risks of crowding out

Figure 1: Government debt by creditor (US$, billions) and total (share of GDP)



Notes: Fiscal years (ending 30 June); *Estimated US$-equivalent value of local currency-denominated Treasury bills and bonds.
Sources: World Bank calculations based on National Treasury data.

[4] Credit availability has also been supported by the National Treasury's Credit Guarantee Scheme which began in December 2020 and has guaranteed 334 credit facilities through end-June 2021, covering 11 different economic sectors and amounting to KES 634.5 million.

private investment, and making the public finances and economy more vulnerable to shocks.

20. **Recognizing the need to shore up fiscal buffers, the National Treasury had begun implementing an ambitious fiscal consolidation plan before the onset of the pandemic.** The fiscal deficit was budgeted to be cut from 7.3 percent of GDP in FY2018/19 to 6.0 percent in FY2019/20 (Figure 2). In FY2019/20, prior to COVID-19, the authorities appeared on track to deliver this, implementing ambitious expenditure restraint measures which were sufficient to reduce the fiscal deficit for the first three-quarters (through March 2020) to 4.5 percent of GDP, down from 5.5 percent in the same period the year before. However, with the outbreak of COVID-19 in the final months of the fiscal year, tax revenue dropped well below target due to the economic slowdown as well as from discretionary fiscal measures (tax cuts and selective expenditure increases, such as on healthcare) to combat the pandemic. Consequently, the planned fiscal consolidation was put on pause, the fiscal deficit increased to 7.5 percent of GDP in FY2019/20 and to 8.2 percent of GDP in FY2020/21, and government debt rose to 68.2 percent of GDP (Table 2).

Figure 2: The pandemic forced a delay in fiscal consolidation (budget balance, percent of GDP)

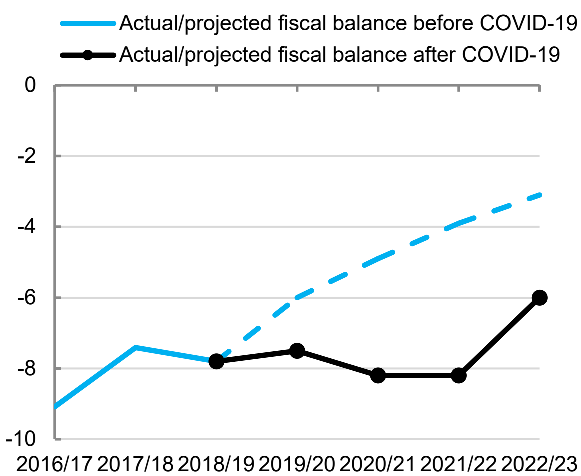
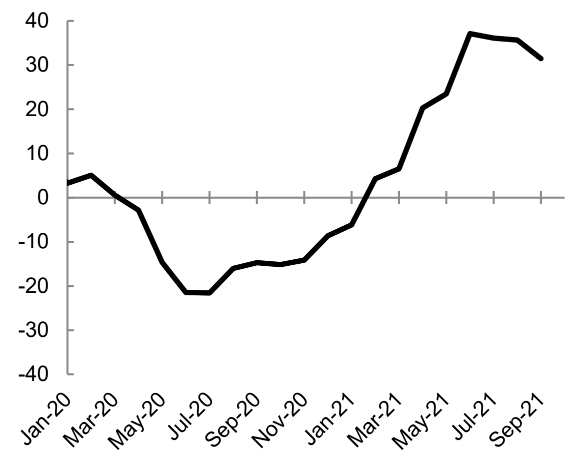


Figure 3: Revenues have staged a strong recovery (change in nominal tax revenues, percent y/y*)



Notes: 2016/17-2018/19: outturns; 2019/2020: pre-COVID target vs. outturn; 2020/21-2022/23: pre- vs. post-COVID projections.
*3-month moving average.
Source: World Bank calculations based on National Treasury data.

21. **Government revenues have staged a strong rebound and fiscal consolidation is resuming.** The growth of nominal revenues did not keep pace with that of nominal GDP in recent years. This was partly attributable to underlying structural changes in the economy (with agriculture increasing as a share of GDP while accounting for less than two percent of tax revenue), lower tax revenues from the financial sector (the financial and telecommunications sectors account for about 60 percent of corporate income tax) during 2016-2019 due to the interest rate caps which affected their profitability, and high tax expenditures due to increased tax exemptions and zero-rated goods. Revenues (including non-tax revenue, but excluding grants) declined further as a share of GDP due to the COVID-19 shock, from 17.5 percent of GDP in FY2018/19 to 15.8 percent in FY2020/21, with about 0.6 percentage points of this decline being due to discretionary tax rate cuts as part of the government's crisis response measures. However, signaling fiscal prudence and appropriately, given evidence of the economy strengthening, the authorities unwound most of this temporary tax relief in January 2021 (the main exception being

maintaining relief for taxpayers in the lowest personal income tax bracket). Tax revenues have continued to recover (Figure 3).

22. **Expenditures increased as the government responded to the crisis by allocating more funds to the health sector, protect vulnerable groups, and support the economy.** The government added KES 40 billion (0.4 percent of GDP) in COVID-19-related spending as part of a supplementary budget for FY2019/20, and a further KES 54 billion (0.5 percent of GDP) set of stimulus measures in the FY2020/21 budget. The first of these packages focused on boosting resources to the health sector, providing liquidity support to businesses through accelerated value-added tax (VAT) refunds and pending bills payments, and cash transfers to the urban poor. The second package focused on supporting hard-hit sectors and creating youth employment.

23. **The need to address fiscal risks from SOEs is in focus.** Kenya has a large public sector, including 337 state corporations and other public entities (such as autonomous public agencies, public funds and universities). Many of Kenya's SOEs have been severely impacted by the COVID-19 shock, which in the case of some entities exacerbated pre-existing financial performance challenges. Consequently, the financial performance of some public corporations needs to be improved to ensure that potentially large contingent liabilities do not crystallize and that fiscal consolidation efforts are not undermined by net transfers to SOEs. At the end of 2021, total guaranteed debt to SOEs was estimated at 2.5 percent of GDP.[5] Recognizing the importance of enhancing SOE performance and mitigating fiscal risks from the wider public sector, the government is pursuing a number of institutional and administrative reforms. Several mergers of SOEs are being undertaken in different sectors (agriculture, industry and finance), to reduce fiscal costs and to improve efficiency and service delivery. A Management Information System for the National Treasury is under development, to help strengthen its capacity to monitor and analyze SOEs' financial and operational performance. The government is also in the process of reviewing the terms and conditions of SOE Boards, as well as reviewing the classification of SOEs; a more granular classification, based on the economic nature of the SOEs, will contribute to more effective and differentiated oversight. Both the World Bank DPF series (including through actions on e-procurement, KPLC, and NHIF) and the current IMF program have a strong focus on SOEs.

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

24. **The economy is expected to continue its strong recovery trajectory in the near term.** GDP growth is projected to be 5.8 percent for 2022, and 5.5 percent on average in 2023–25. On the expenditure side, a strong recovery in private consumption, driven by wage and household income growth, improved consumer confidence and resilient remittances, is projected to buoy domestic demand. Economic activity will be supported by the ongoing vaccination drive, and progress on fiscal consolidation that will bolster confidence and resources for private sector investment. From a sectoral perspective, the recovery in industry and services is expected to continue, though some services sub-sectors will recover only gradually. The base case projections depend on the effective management of any re-intensification of the pandemic. Kenya plans to inoculate all adults (close to 30 million people) against COVID-19 by end-2022, and has intensified efforts towards that goal in recent months, helped by improved availability of vaccines. Nonetheless, Kenya, like most countries in the region, missed the World Health Organization (WHO) target

[5] National Treasury. (2021). 2022 Budget Policy Statement.

of inoculating 40 percent of the population by end-2021, and the vaccination program still has a long way to go towards achieving the national target, with about 20 percent of adults having been fully vaccinated by end-January 2022.

25. **The current account deficit is projected to widen, as strengthening domestic demand fuels imports, outpacing the increase in exports.** Kenya runs structural current account deficits which are consistent with its high investment needs as a growing middle income country, and the deficit of 4.5 percent of GDP in 2020 (compressed by the pandemic-induced import slump) is expected to widen somewhat to about 5.1 percent of GDP in the coming years. Imports are expected to increase, driven by recovering domestic demand, as well as due to a projected modest pickup in oil prices. Strong growth in merchandise exports is projected (mainly horticultural products including tea, coffee, and cut flowers), but services exports (tourism and transport) are expected to stage only a sluggish recovery as global tourism normalizes more slowly. International remittances are projected to remain solid, supported by the recovery in the global economy, and comprise an important source of foreign currency inflows (US$3.7 billion in the 12 months through November 2021, equivalent to over 3 percent of GDP).

26. **Notwithstanding the ongoing pandemic, the authorities have already started implementing an ambitious medium-term fiscal consolidation plan, supported by an IMF program** (see Section 2.3). This includes rationalizing tax exemptions through the Tax Amendment Act and allowing most of the temporary tax relief introduced at the start of the pandemic to lapse. The revenue projections used for the budget have been improved, significantly strengthening Budget realism. Coupled with the strong and sustained recovery in nominal revenues since the worst of the crisis in 2020, this has contributed to the primary deficit targets through the second IMF reviews (approved in December 2021) being exceeded. On the expenditure side, government recruitment, remuneration, and benefits have been frozen, and capital expenditures are being focused on completing only ongoing projects whilst halting any new projects without National Treasury approval. Further within the context of the medium term fiscal framework, county transfers are projected to remain constant in nominal terms (KES 370 billion) in FY2022/23, whilst the national government ceiling growth for recurrent expenditure is reduced. Measures supported by the proposed operation to strengthen public investment management (PIM) and government procurement support medium term fiscal consolidation by improving the quality and transparency of spending. A World Bank Public Expenditure Review published in 2020 estimates that these measures could yield fiscal savings of 2.6 percentage points of GDP.[6]

27. **In the coming years, fiscal consolidation is expected to be achieved from a balanced mix of revenue measures, expenditure restraint (whilst preserving space for social spending), and economic growth.** Stronger economic growth and ongoing tax reforms will drive nominal revenue growth. The return to pre-pandemic VAT and corporate income tax rates is expected to restore tax revenue to pre-pandemic levels, while recent tax policy changes including the removal of additional VAT and corporate income tax exemptions, and the introduction of a digital tax will, once fully implemented, yield an estimated additional 1 percent of GDP in annual revenues. Revenue (excluding grants) is budgeted to rise to 18.1 percent of GDP by FY2023/24, an ambitious but realistic target compared to the revenue mobilization achieved prior to the pandemic (17.5 percent of GDP in FY2018/19). A medium-term revenue strategy is being developed to transparently lay out the tax administration and policy elements to drive the increased revenue mobilization, and how this will be sequenced. Concerning expenditures, recurrent expenditure

[6] World Bank. (2020). *"Kenya Public Expenditure Review 2020: Options for Fiscal Consolidation after the COVID-19 Crisis".*

discipline and improved public investment spending efficiency (including through the implementation of PIM regulations and streamlining of the public investment portfolio supported by this operation) will gradually lower expenditure as a share of GDP; the expenditure share is budgeted to decline from 24.2 percent of GDP in the current fiscal year (FY2021/22) to 23.5 percent of GDP by FY2023/24. The planned shift in the fiscal stance is encapsulated by the change in the primary deficit, which is budgeted to adjust from 3.7 percent of GDP in the current fiscal year to a small surplus by FY2023/24.

28. **Kenya participated in the G20 DSSI from January 2021.** This reduced gross external financing needs, lowered external liquidity risks, and freed fiscal space to sustain social and COVID-19 response spending. Savings amounted to approximately US$514 million (equivalent to about 0.5 percent of GDP). The savings helped to preserve space for priority social expenditures, which are subject to a floor in the government's IMF-supported medium-term fiscal framework. The proposed operation contributes to a continued focus in the coming years on strengthening funding modalities for, and improving the quality of, social spending, through its support to advancing universal health coverage.

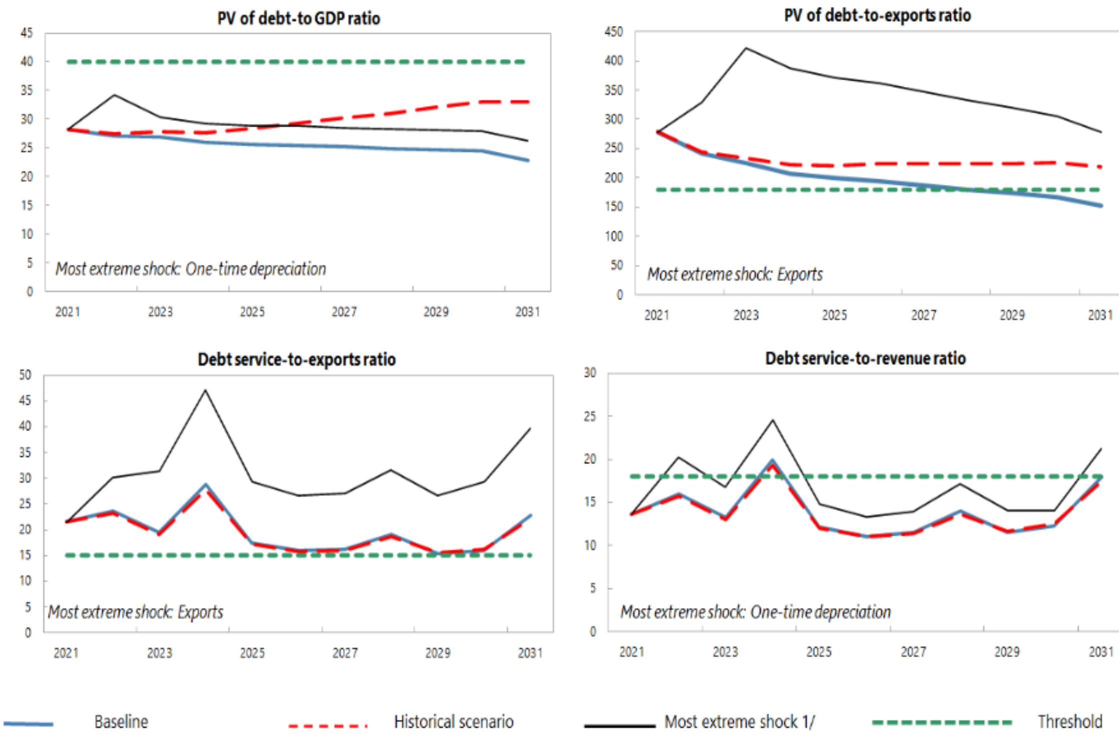
29. **Gross external financing needs are projected to be met mainly by a mix of private and public borrowing, with an additional and rising contribution from non-debt creating FDI.** Kenya's gross external financing needs from the current account deficit and debt amortization are projected to be US$8.3 billion in 2022, up from an estimated US$7.5 billion in 2021 (Table 3). Financing is expected to come from a mix of inward investment, and private and public external borrowing. Public borrowing will make maximum use of available concessional financing, including World Bank and IMF budget support. As the economic recovery continues in Kenya and globally, net portfolio investment and direct investment should also increase, contributing to a rising private sector contribution towards meeting total external financing requirements. External credit to the private sector, including "other investment" (such as loans to corporations), is expected to make a significant contribution to meeting gross external financing needs, especially in the outer years of projections, as economic activity and growth normalize fully. In a downside risk scenario where private financing inflows are lower than expected in the base case, this could be absorbed through less official reserve accumulation than what is targeted in the IMF-supported macroeconomic framework.

30. **The government's financing needs are expected to continue to be met by a mix of external and domestic sources.** The government's financing strategy is to make maximum use of concessional borrowing to meet budgeted financing needs, and significant net positive flows are expected from both the World Bank and the IMF. Residual net external financing needs after multilateral and concessional bilateral financing will be met from commercial sources. The government's primary source of net financing, however, is expected to remain the domestic bond market (71 percent of budgeted net financing for the current fiscal year). The government's significant reliance on domestic financing means that fiscal consolidation can be growth-enhancing, by freeing up space for more domestic credit to flow to the private sector, supporting a private sector-led recovery. The DPF series also supports measures to strengthen domestic debt market performance so as to deepen the domestic capital market (for both public and private sector borrowers) and minimize debt costs.

31. **Kenya's debt is sustainable under baseline assumptions; the risk of debt distress is high.** The latest IMF/WB Debt Sustainability Analysis (DSA) was published in December 2021. It finds that Kenya's debt is sustainable in the base case. The risk of debt distress remains high, an assessment which is unchanged

since May 2020, when risk was reassessed from moderate, reflecting the adverse economic and fiscal impacts of the pandemic. Kenya's high debt risk rating reflects breaches of indicative thresholds for liquidity and solvency – the external debt service to export ratio, external debt service to revenue ratio, and present value of external debt to export ratio – in the baseline and under the most extreme shock scenarios (Figure 4). The significant breaches of the DSA liquidity risk indicator thresholds are associated with the US$2 billion redemption in 2024 of the first Eurobond (issued in 2014). This should not pose a critical refinancing risk, however, as the authorities are planning for this lumpy repayment as part of their debt management strategy.

Figure 4: Public and publicly-guaranteed external debt under alternative Scenarios, 2021-2030



Notes: "PV" denotes present value. 1/Defined as the shock which causes the highest ratio in or before 2031.
Sources*:* Joint World Bank-IMF DSA, December 2021.

32. **Debt sustainability is underpinned by Kenya's good economic prospects backed by sound policies including, critically, the implementation of the fiscal consolidation embedded in the medium-term budget framework.** Projected robust economic growth should be supported by continued policy and institutional reforms, as well as progress on fiscal consolidation through strong expenditure control, and policy and administrative tax revenue improvements. The debt risk profile is expected to improve in the coming years as the debt stock and debt servicing costs peak and then begin to decline relative to output, revenues and foreign exchange receipts. The present value of public debt-to-GDP is projected to peak at close to its level currently (at 61.7 percent at end-2022) and thereafter decline steadily, falling below the 55 percent high risk threshold by 2026. Allaying liquidity risk concerns, indicators conservatively do not take into account remittance inflows, which have grown in recent years to the equivalent of over a quarter of the value of exports and have proved robust even to the global COVID-19 shock.

33. **The economic outlook remains subject to elevated uncertainty, and real GDP growth could slip under 4 percent in a downside scenario involving a slower pandemic recovery and weaker agriculture output**. The outlook for Kenya, as for most countries, hinges on the future course of the pandemic. Surges in COVID-19 related hospitalizations and deaths, including due to new and more transmissible variants, and a slower than anticipated pace of vaccination, could force the reinstatement of strict containment measures, setting back the economic recovery in manufacturing and the key services sector. In addition, a severe drought is affecting north-eastern, mainly pastoral, parts of the country.[7] Should the drought continue and spread to also affect Kenya's key crop-growing regions in 2022, this could impose large economic and fiscal costs at the national level. Finally, a slackening in global growth (notably due to a re-intensification of the pandemic) could adversely impact Kenya's exports, tourism, investment inflows, and diaspora remittances. Overall, real GDP growth in an adverse scenario (combining a weak year for agriculture and renewed pandemic-related disruption to industrial and services activity, although not to the extent of the extreme 2020 shock) would slow to 3.8 percent in 2022, hampering fiscal consolidation.

34. **Overall, Kenya's macroeconomic policy framework is adequate for the proposed DPF operation.** Kenya's economy has shown considerable resilience to the enormous pandemic shock, and its growth drivers are diversified, making it reasonable to expect good economic performance to resume post-crisis. The policy framework has weathered the pandemic so far; a coherent mix of supportive fiscal and monetary policies, and other response measures, were implemented quickly, and policy settings have subsequently remained responsive to the fluid situation. Macroeconomic stability has been maintained, including through exchange rate flexibility which has helped to absorb the shock and reduce pressure on foreign reserves, which have remained adequate. A credible commitment to medium-term fiscal consolidation is critical to support the recovery, reduce debt distress risks, and rebuild space for social and development spending. The government's budget for the current fiscal year is implementing this, benefiting from earlier (pre-crisis) policy reform measures, and supported by the current IMF arrangements. Kenya has also established a strong track record of carrying through economic reforms, as evidenced by its ambitious government devolution program, progress in combatting corruption, and achieving critical sectoral reforms, including those supported by previous DPF operations. The ongoing reform efforts, including those supported by the proposed operation, should further strengthen the macroeconomic and fiscal policy framework. Fiscal risks emanating from SOEs are also receiving needed attention, including through the proposed DPF operation.

[7] The severe drought in north-eastern Kenya is due to three consecutive below-average rainfall seasons, leaving an estimated 3-4 million people in need of humanitarian food assistance (see: https://fews.net/east-africa/kenya/alert/december-20-2021).

Table 1: Selected economic indicators

	2018	2019	2020	2021	2022	2023	2024	2025
	Act.	Act.	Act.	Est.	Proj.	Proj.	Proj.	Proj.
Real economy	**(Annual percentage change, unless otherwise indicated)**							
Real GDP	5.6	5.0	-0.3	5.9	5.8	5.5	5.5	5.5
Private consumption	4.7	4.9	-2.7	5.5	5.8	5.8	5.9	6.1
Government consumption	7.0	7.0	4.3	4.2	3.6	3.2	2.8	2.3
Gross fixed capital investment	-0.4	3.8	3.4	6.4	5.9	6.6	6.9	7.1
Exports, goods and services	6.8	-3.2	-8.2	8.0	5.0	6.5	7.1	7.6
Imports, goods and services	1.4	1.8	-8.5	5.0	4.0	7.0	7.5	8.3
GDP per capita (real US$)	3.2	2.6	-2.5	3.5	..	..	..	..
Prices and monetary accounts	**(Annual percentage change, unless otherwise indicated)**							
Consumer price index	4.7	5.2	5.3	6.1	5.0	5.0	5.0	5.0
Broad money (M3)	10.1	5.6	13.2	7.3	..	..	..	
Credit to private sector	2.4	7.1	8.4	7.7	..	..	..	
Policy rate (CBR*, percent)	9.0	8.5	7.0	7.0	..	..	..	
NPLs (percent of total loans)	10.0	10.0	12.2	11.9	..	..	..	
Fiscal accounts	**(Percent of GDP, unless otherwise indicated)**							
Total revenue and grants	17.5	17.1	16.3	16.5	17.3	18.1	18.4	18.4
Expenditure	24.5	24.6	24.2	24.7	24.4	23.3	22.5	21.9
Overall balance (inc. grants)	-7.2	-7.4	-7.9	-8.2	-7.1	-5.2	-4.2	-3.6
Public gross nominal debt	58.0	61.3	65.6	68.1	67.8	66.2	63.5	60.2
Balance of payments	**(Percent of GDP, unless otherwise indicated)**							
Current account balance	-5.4	-5.3	-4.5	-5.1	-5.1	-5.1	-5.0	-5.0
Exports (goods and services)	12.5	11.4	9.7	10.0	11.3	11.8	12.1	12.4
Imports (goods and services)	21.9	20.3	17.7	18.9	19.2	19.7	20.1	21.5
Foreign direct investment	1.6	0.9	0.5	0.2	0.6	0.8	0.9	1.0
Gross international reserves (US$, billions)	8.2	9.1	8.3	9.2	..	..	..	..
Months of import cover	5.3	5.5	5.1	5.6	..	..	..	..
Exchange rate (KES/US$, average)	101.3	102.0	106.5	109.6	..	..	..	..
Memo:	**(US$, billions)**							
GDP at current market prices	92.2	100.6	101.0	109.5	..	..	..	..

Notes: actual ("act."), estimated ("est."), projected ("proj."). *CBR: Central Bank Rate.
Sources: Kenya National Bureau of Statistics; CBK; National Treasury; IMF; World Bank.

Table 2: Key fiscal indicators (percent of GDP)

	2018/19	2019/20	2020/21	2021/22	2022/23	2023/24	2024/25
	Act.	Act.	Prel.	Est.	Proj.	Proj.	Proj.
Total revenue and grants	**17.7**	**16.5**	**16.1**	**16.8**	**17.7**	**18.4**	**18.4**
Revenue	17.5	16.4	15.8	16.3	17.4	18.1	18.1
Tax revenue	14.4	13.0	12.6	13.3	14.4	15.3	15.3
Other revenues	3.1	3.3	3.1	2.9	2.7	3.0	3.0
Grants	0.2	0.2	0.3	0.5	0.3	0.3	0.3
Expenditure and net lending	**25.0**	**24.2**	**24.3**	**24.2**	**23.5**	**23.5**	**23.1**
Recurrent	19.4	18.6	19.4	19.2	18.6	18.4	18.0
Transfer to counties	3.7	3.1	3.5	3.3	3.0	2.7	2.5
Interest payments	3.9	4.1	4.4	4.5	4.8	4.8	4.6
Domestic	2.8	3.0	3.4	3.4	3.8	3.7	3.7
Foreign interest due	1.1	1.1	0.9	1.1	1.0	1.0	1.0
Wages	4.3	4.2	4.4	4.2	4.0	4.0	3.9
Pensions and other CFS*	0.7	0.8	1.0	1.1	1.1	1.1	1.1
Defense and NSIS**	1.5	1.3	1.4	1.2	1.2	1.1	1.0
Other	5.3	5.0	4.7	5.2	4.6	4.7	4.6
Development	5.6	5.6	4.9	5.3	5.1	5.0	5.0
Deficit including grants (cash basis)	**-7.3**	**-7.5**	**-8.2**	**-8.2**	**-6.0**	**-4.4**	**-3.9**
Primary balance	-3.4	-3.4	-3.8	-3.7	-1.2	0.4	0.7
Financing (net)	**7.4**	**7.4**	**8.4**	**8.2**	**6.0**	**4.4**	**3.9**
Foreign financing	4.3	3.2	2.9	3.3	2.0	1.2	0.5
Domestic financing	3.1	4.2	5.5	4.9	4.1	3.1	3.3
Total Public Debt (gross)	**59.6**	**63.0**	**68.2**	**68.1**	**67.5**	**64.9**	**62.1**
External debt	31.0	33.1	35.5	33.9	32.6	30.5	27.9
Domestic Debt	28.6	29.9	32.7	34.2	34.9	34.4	34.2

Notes: *CFS: Consolidated Fund Services; **NSIS: National Security Intelligence Service.
Sources: National Treasury, Quarterly Budgetary Economic Review (first quarter, financial year 2021/2022); National Treasury, 2022 Budget Policy Statement; IMF.

Table 3: External financing requirements and sources (US$, millions)

	2020	2021	2022	2023	2024	2025
	Act.	**Est.**	**Proj.**	**Proj.**	**Proj.**	**Proj.**
1. Gross external financing requirements:	**6,191**	**7,474**	**8,301**	**8,521**	**10,520**	**9,517**
Current account deficit	4,754	5,766	6,097	6,511	6,840	7,320
Medium and long term debt repayments	1,437	1,709	2,204	2,010	3,680	2,197
2. Gross external financing sources:	**4,588**	**6,858**	**5,034**	**8,121**	**10,567**	**10,419**
Public sector	3,314	5,044	2,586	3,654	4,885	5,275
Grants	135	135	135	135	135	135
Borrowing	3,179	4,909	2,451	3,519	4,750	5,140
Private sector	1,274	1,814	2,448	4,467	5,682	5,144
Foreign direct investment, net	499	250	649	996	1,195	1,496
Other investments	775	1,564	1,799	3,471	4,487	3,648
3. Change in reserves (+ = increase)	**-819**	**2,504**	**-1,814**	**813**	**887**	**902**
4. Errors and omissions	38	520	0	0	0	0
5. Total financing requirement (1-2+3-4)	**745**	**2,601**	**1,453**	**1,212**	**839**	**0**
6. Additional external financing sources:	**745**	**2,601**	**1,454**	**1,212**	**839**	**0**
Official support including WB and IMF	745	2,088	1,453	1,212	839	0
Exceptional financing: DSSI	0	514	0	0	0	0
Financing gap (5-6)	**0**	**0**	**0**	**0**	**0**	**0**

Sources: IMF; World Bank.

2.3. IMF RELATIONS

35. **The IMF Board approved a 38-month, SDR 1.66 billion (approximately US$2.34 billion) program under the ECF and the EFF on April 2, 2021.** The first and second reviews were completed in June and December 2021, disbursing a cumulative US$972.6 million. The program supports fiscal consolidation and the economic recovery from the COVID-19 crisis. The World Bank and the IMF are closely coordinating the efforts to support the recovery and the government's inclusive growth reform agenda. Specific areas of collaboration include measures to achieve fiscal consolidation and reduce fiscal and debt risks by enhancing domestic revenue mobilization and public financial management, strengthening the financial and operational performance of key SOEs, and improving governance and anti-corruption frameworks. The last IMF financing prior to the current arrangements was in May 2020, when Kenya received US$739 million under the Rapid Credit Facility to address the impact of COVID-19.

3. GOVERNMENT PROGRAM

36. **The government's long-term development blueprint is the "Kenya Vision 2030".** This aims to transform Kenya into a middle-income industrialized country offering a high quality of life to all its citizens. It is aligned with the United Nations Sustainable Development Goals and has been implemented through successive five-year Medium-Term Plans (MTPs). The current administration has prioritized four main pillars as part of the MTP 2018–22, referred to as the "Big Four" and comprising: strengthening food and nutritional security; construction of at least 500,000 affordable housing units; furthering universal health coverage; and raising the share of manufacturing to 15 percent of GDP.

37. **Implementation of the Big Four is ongoing, but recognizing the severity of the pandemic crisis and the need for a comprehensive response, the government also launched a post COVID-19 Economic Recovery Strategy (ERS).** The ERS is designed to mitigate the adverse socioeconomic effects of the pandemic and facilitate opening of the economy, accelerate economic recovery and attain higher and sustained economic growth. Some of the key elements in the ERS include strengthening healthcare systems; investing in information and communications technologies (ICT) and digital infrastructure; facilitating private sector activity; facilitating a green and resilient recovery and growth; increasing the resilience of the economy to global supply chain shocks; and strengthening governance and economic management. The ERS aims to provide a road map for transitioning to the fourth MTP and a new development framework beyond the Vision 2030.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

38. **The program development objective is contributing to Kenya's inclusive and resilient recovery from the COVID-19 crisis by strengthening (1) fiscal management, (2) operational efficiency in the electricity sector while placing Kenya on an efficient green energy path, (3) the governance framework for Kenya's natural and human capital (environment, land, water and healthcare).** The program responds to the urgency of the crisis to tackle longstanding bottlenecks and distortions, improve the efficiency and transparency of public spending, strengthen service delivery, and help lift the economy onto a higher, sustainable productivity and job-creating path.

39. **This DPF series directly supports the government's Big Four development goals and ERS.** Electricity sector reforms (pillar 2), and reforms to strengthen environmental governance and unlock bottlenecks hampering the more efficient and sustainable use of land and water (pillar 3) contribute to facilitating a green and resilient recovery and growth. Human capital reforms (pillar 3) strengthen Kenya's healthcare system. Finally, fiscal reforms (pillar 1), as well as reforms in the above-referenced pillars to strengthen the financial performance of public entities in energy, water, and health, all help to improve the quality of public spending, contributing to more sustainable public finances.

40. **The reform program benefits from strong government ownership and the World Bank Group's (WBG's) deep, extensive engagement in Kenya.** The policy matrix (Annex 1) has been developed through extensive dialogue and collaboration, and draws on analytical work and experience from the

implementation of the WBG's project portfolio in Kenya. To prepare this DPF series, the government has regularly convened a Technical Committee chaired by the Principal Secretary (PS) of the National Treasury, comprising government focal points from implementing Ministries, Departments and Agencies (MDAs) at the PS level, including the Office of the Auditor-General and Office of the President, and the World Bank. The government's strong ownership of the reform program flows on from the experience with the previous DPF operations for Kenya, which have demonstrated to policymakers the usefulness of this instrument in supporting the government to formulate and implement an ambitious multi-sectoral reform program. The implementation of government reforms is underpinned by an extensive technical assistance program involving the World Bank, International Finance Corporation (IFC), IMF, and other development partners.

41. **While governance is not a pillar of this operation, there are several reform actions that strengthen governance through systems and institutional mechanisms that contribute to the fight against corruption.** First, the new e-procurement system moves public procurement to a transparent digital platform, providing an electronic track record throughout the procurement cycle. This should help reduce the opportunities for corruption in government procurement by minimizing human interaction, enhancing transparency, accountability, and improving disclosure and access to procurement information. Second, the PIM measures supported by this series will improve transparency and accountability by ensuring that a rigorous appraisal process is followed to determine which projects are to be funded, and that previously-funded, under-performing projects are closely scrutinized and, where appropriate, closed. This will help eliminate or minimize the inclusion of projects due to considerations other than clear, objective criteria, and by strengthening project performance will improve service delivery. Third, improved land valuation will increase transparency in transactions and projects involving land, which have been prone to speculation and abuse by connected parties.

42. **The proposed operation has a strong, cross-cutting focus on supporting fiscal sustainability, including crucially through improving the performance and thus minimizing fiscal risks, of SOEs.** This goes beyond the first pillar on fiscal and debt reforms, with additional contributions from measures in each of the additional two pillars. The proposed operation helps to put in place the platform for property-based own-source revenues for county governments, thus contributing to the revenue mobilization agenda (pillar 3). The proposed operation also focuses on measures which make a less direct but crucial contribution to Kenya's fiscal adjustment and long-term sustainability: to support strong private sector led growth, without which making the needed fiscal adjustment would be very difficult (debt capital market performance in pillar 1, private infrastructure investment in pillar 2, land market transparency in pillar 3); and accelerating adaptation to climate change, which is emerging as a major source of fiscal risk to Kenya (pillar 3).

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

43. **The proposed second operation (DPF2) deepens and extends the reform actions achieved as prior actions for the first operation (DPF1).** In some cases, the indicative triggers for DPF2 that were envisaged in DPF1 have been revised, and one new prior action has been added. Table 4 describes these changes.

Table 4: Revisions to Indicative Triggers envisaged in DPF 1

Indicative Trigger (as stated in DPF1)	Prior Action (DPF2)	Comments
Pillar 1: Fiscal and debt reforms to make spending more transparent and efficient, and enhance domestic debt market performance		
Indicative Trigger 1: To implement E-GP, the Recipient's National Treasury approves the E-GP policy framework, which includes the E-GP (i) Strategy (ii) Implementation Roadmap (iii) E-Procurement Business Model and (iv) E-GP Business Processes and Specifications.	**Prior Action 1:** To strengthen the transparency of public procurement and reduce opportunities for corruption, the National Treasury has approved the E-GP policy framework, which includes the E-GP: (i) Strategy (ii) Implementation Roadmap (iii) Business Model and (iv) Business Processes and Specifications.	Editorial revision to clarify the reform goal upfront; no change in substance.
Indicative Trigger 2: To strengthen the public investment portfolio, the Recipient's National Treasury applies the Public Investment Monitoring and Evaluation Criteria to the inventory of active projects and publishes a Cabinet decision for rationalizing the inventory.	**Prior Action 2:** The Cabinet has taken a decision for rationalizing the public investment project portfolio, using criteria that include: (i) the completion progress of the project, (ii) the adequacy of financing needed to complete the project beyond the current budget cycle, (iii) the priority status of the project considering development priorities, and (iv) the availability of sufficient data on the project to measure implementation progress and impact.	Revised to specify the relevant criteria for the Cabinet decision and to align the Trigger with the corresponding SDFP Policy and Performance Action.
Indicative Trigger 3: The Recipient's central bank (CBK) implements the Treasury Bonds Benchmark program, to strengthen the domestic bond yield curve and increase secondary market liquidity.	**Prior Action 3:** To strengthen the domestic bond yield curve and increase secondary market liquidity through a transparent and active structured issuance strategy that ensures regular, predictable benchmark-bond issuances linked with active liability management, the Central Bank of Kenya has adopted and published the Guidelines for, and is implementing, the Treasury Bonds Benchmark program.	Revised for clarity and specificity.

Pillar 2: Electricity sector and PPP reforms to strengthen the cornerstone utility (KPLC), place Kenya on an efficient, green energy path, and boost private infrastructure investment		
Indicative Trigger 4: To further strengthen electricity sector cost-recovery, with provisions to protect the poor, the Recipient's Energy and Petroleum Regulatory Authority (EPRA) issues a tariff order after completing a full review process covering: i) higher system loss provisions; ii) operating and maintenance costs of the last mile electrification program; and iii) improved targeting of lifeline tariffs by lowering the threshold from 100kWh to 30kWh.	**Prior Action 4:** To improve the operational and financial performance of KPLC: (i) a competitive selection process for the Managing Director of KPLC has been introduced for the currently vacant position, (ii) a revenue protection program (RPP) covering high value consumers is being implemented.	Revised due to developments in the energy sector following the release of the Presidential Task Force recommendations. See description of pillar 2 for details.
Indicative Trigger 5: The Recipient issues a decision on the signed PPAs that have not reached financial closure or commenced construction with a view to competitive procurement of renewable energy and reduce the cost of supply.	**Prior Action 5**: The Ministry of Energy has approved a five-year power generation and transmission development plan (2021-2026) to guide the competitive procurement of clean energy, at least-cost and aligned with demand.	Revised for clarity and specificity.
	Prior Action 6: The Borrower has enacted the Public Private Partnerships Act (2021), to enhance project selection and implementation processes, and clarify the roles and responsibilities of key participants in the PPP cycle, for efficient and timely delivery of PPP projects.	New prior action.
Pillar 3: Strengthen environmental and natural resource governance, combat climate change, and improve healthcare including pandemic response		
Indicative Trigger 6: In order to enhance environmental management and mainstream climate change governance, the Recipient has, through the Ministry of Environment and Forestry (MoEF), submitted to Parliament revisions to the Environmental Management and Coordination Act (EMCA).	**Prior Action 7:** In order to enhance environmental management and mainstream climate change governance, the Cabinet has approved the Environmental Management and Coordination Bill (2022).	No change in policy substance; revises evidence requirement to Cabinet approval of the Bill revising the EMCA (1999).
Indicative Trigger 7: To improve land price transparency and equip county governments to mobilize own-revenues based on property,	**Prior Action 8:** To equip county governments to mobilize own-source revenues based on property and to improve land price	Indicative Trigger 7(i) has been dropped. A comprehensive review of the required regulatory updates has been completed, and the Bank

the Recipient (i) submits to Parliament updated regulations of the relevant land valuation Acts to ensure alignment with the Land Value Amendment Act 2019, and (ii) revises the Rating Act and Rating for Valuation Act to align with devolution.	transparency, the Cabinet has approved the National Rating Bill.	will continue to support the preparation of the associated amendments for Parliament. The wording of trigger action 7(ii) has been revised to be specific about the required new legislation (the National Rating Bill).
Indicative Trigger 8: To enhance access to water and sanitation services, and improve the management and conservation of water resources, the Recipient, through MoWSI (i) adopts the governance framework for a medium-term National Water Sector Investment Program (NAWASIP), (ii) gazettes at least six basin areas under section 24 of the Water Act 2016; and (iii) implements new water abstraction charges and water conservation levies.	**Prior Action 9:** To enhance access to water and sanitation services, and improve the management and conservation of water resources: (i) the MoWSI has approved the medium-term framework for a National Water and Sanitation Investment Program (NAWASIP); (ii) the Water Resources Authority has designated six basin areas under section 24 of the Water Act 2016; and (iii) the MoWSI has stipulated new water use charges and water conservation levies.	Revised to clarify the relevant MDAs (Ministry of Water, Sanitation and Irrigation [MoWSI], Water Resources Authority [WRA]).
Indicative Trigger 9: To strengthen Kenya's capacity to combat communicable diseases by consolidating existing public health emergency preparedness and response functions under one authority, the Recipient establishes the Kenya Centre for Disease Control (KCDC).	**Prior Action 10:** To strengthen Kenya's infectious and non-infectious disease prevention and response capabilities, including by consolidating existing public health emergency preparedness and response functions under one authority, the Borrower has established the Kenya National Public Health Institute.	Revised to better reflect the policy content of the reform (which goes beyond the communicable disease and emergency preparedness aspects specified in the indicative trigger); the name of the new institution has been updated to the Kenya National Public Health Institute (as gazetted).
Indicative Trigger 10: The Recipient enacts a new University Law to introduce performance-based financing for universities consisting of core performance-based indicators and to improve the governance of universities and higher education regulatory bodies.		Indicative Trigger 10 has been dropped. The new University Act has progressed to its second reading in Parliament and the World Bank is exploring options to continue its support to the implementation of the government's higher education reforms.

Pillar 1: Fiscal and debt reforms to make spending more transparent and efficient, and enhance domestic debt market performance

Objective 1.1: Improving transparency in public procurement

44. **Rationale:** The public sector spends a large amount of resources on procuring goods and services; procurement by government alone is equivalent to about 5.0 percent of GDP.[8] Making this spending more transparent and efficient is central to the governance and fiscal reform agenda. Despite progress in recent years, including the Executive Order #2, 2018 which requires that all procuring entities (PEs), including SOEs, publish and publicize procurement contracts[9], governance challenges remain. The government is committed to improving transparency and reducing corruption in public procurement, but its ability to do so has been hindered by fragmented procurement policies and systems, insufficient information for effective oversight and enforcement of rules, and limited technical expertise. These challenges contribute to delays, cost overruns and weak accountability. Progress has recently been made to set out procurement policy and process improvements through the Public Procurement and Asset Disposal (PPAD) Act and the pursuant regulations (a prior action of the previous operation). The needed next step to entrench this progress and make the above-mentioned directive and regulations operational is to implement an end-to-end Electronic Government Procurement (E-GP) system, to automate all procurement processes, minimize human interaction, and enhance transparency, accountability, disclosure and public access to procurement information. Sound implementation of E-GP will facilitate the implementation of the PPAD Act, provide a consistent platform and a level playing field across the public sector for all procurement activities, and enable compliance of procuring entities with the PPAD Act and regulations to be monitored.

45. **Substance of the reform:** The proposed operation supports the adoption of a new policy framework to drive implementation of e-GP, furthering the sound implementation of the PPAD Regulations 2020, a prior action of the previous operation. The PPAD regulations establish the overall regulatory environment for greater transparency, whilst the E-GP policy guides the adoption of the implementing platform for improved transparency in public procurement. The policy includes the E-GP (i) Strategy (ii) Implementation Roadmap (iii) E-Procurement Business Model and (iv) Business Processes and Specifications. The adoption of this policy enables the government to establish an end-to-end E-GP system, which will be rolled out across all public sector PEs, including SOEs. Bids for the development of the E-GP software have been evaluated, and the contract for implementation is expected to be awarded, in adherence with the new policy. Once designed and piloted successfully, the use of the E-GP will be mandatory for all procuring entities, as stipulated by the PPAD Act and set out in the government's E-GP implementation strategy and roadmap. As such, the move to E-GP is crucial in implementing and reinforcing the irreversibility of the procurement enhancements in the PPAD Act and Regulations.

Prior Action 1: To strengthen the transparency of public procurement and reduce opportunities for corruption, the National Treasury has approved the E-GP policy framework, which includes the E-GP: (i) Strategy (ii) Implementation Roadmap (iii) Business Model and (iv) Business Processes and Specifications.

[8] Based on average procurement expenditure over the three fiscal years through FY2020/21. Excludes procurement from the wider public sector (i.e., SAGAs), as well as military- and national intelligence-related procurement.
[9] See the public procurement portal at: *https://www.tenders.go.ke/*. The government has committed to add beneficial ownership information to new tenders on the portal (structural benchmark of the IMF program, due by March 2022).

46. **Expected Results:** The results indicator is the number of government MDAs procuring all of their goods and services on the E-GP platform (at least five by 2023, comprising high-spending MDAs where E-GP implementation is being piloted as part of the rollout across the whole of the public sector).[10] The ultimate objective is to make public procurement transparent, reducing opportunities for corruption and, by expanding access to information and opportunities for companies to compete to supply the public sector, making public spending more efficient and thereby supporting fiscal consolidation efforts. The inclusion of not only government entities but also SOEs in the E-GP system adds to the reform's anticipated development impact. Over time, E-GP will also provide opportunities for further digital innovations to streamline public procurement. Complementing the legal and policy reforms supported by this DPF, the effective implementation of E-GP, and its integration with related business processes including accounting and auditing functions, is also being supported by the World Bank through the Program for Results (PforR), GESDeK.

Objective 1.2: Strengthening the quality of public investment spending

47. **Rationale:** Strengthening PIM is critical for Kenya's fiscal sustainability and a resilient recovery. Public investment spending, much of which is debt-financed, stands at about 5.8 percent of GDP, and the government has a large public investment portfolio comprising close to 4,000 projects. Weaknesses in the identification, design, appraisal, selection, implementation, and monitoring and evaluation (M&E) of public investment projects have resulted in a large and fragmented development budget, including many non-performing projects. This has undercut the quality of public investment spending and contributed to the narrowing of fiscal space. A new approach to PIM is needed to redirect spending on, and prioritize the progress of, those projects with the highest social returns.

48. **Substance of the reform:** The proposed operation supports PIM improvements which build on the reforms included in the first DPF operation, and which also constitute SDFP PPAs for fiscal sustainability. As a prior action of the previous operation, the National Treasury (i) approved new PIM regulations, covering all phases of the public investment project cycle, including provisions relating to the identification, economic appraisal, selection, implementation, and monitoring and evaluation of all proposed, active and completed projects; and (ii) completed an inventory of all the public investment projects in the education, health and infrastructure sectors that are currently active in the capital budget, including financial and non-financial information regarding the status of each project. The prior action for the proposed operation follows on from this by ensuring that the new regulations and recommendations of the stock-taking exercise are implemented, through a Cabinet decision, based on clear criteria, to remove underperforming projects from the government's investment portfolio. Together, the PIM measures supported by the DPF series constitute a comprehensive shift towards a new, more coherent and efficient approach to how government develops and manages its large investment portfolio, by assessing rigorously the performance of the current stock of projects, and subjecting the flow of potential new and ongoing projects to sound selection and M&E criteria.

Prior Action 2: The Cabinet has taken a decision for rationalizing the public investment project

[10] The MDAs expected to undertake the pilot are the Ethics and Anti-Corruption Commission, Kenya National Highway Authority, National Treasury, Office of the Auditor General, State Department for ICT, Innovation and Youth, and State Department for Public Service.

portfolio, using criteria that include: (i) the completion progress of the project, (ii) the adequacy of financing needed to complete the project beyond the current budget cycle, (iii) the priority status of the project considering development priorities, and (iv) the availability of sufficient data on the project to measure implementation progress and impact.

49. **Expected Results:** Strengthened PIM is expected to increase the development effectiveness and efficiency of government investment spending, contributing to inclusive economic growth and reducing fiscal costs. The intermediate target is that at least 30 ongoing projects comply with the PIM Regulations, and that at the time of results evaluation all new projects included in the next Budget (FY2023/24) comply. The achievement of these results is supported through the SDFP Policy and Performance Actions. It is also supported by the ongoing GESDeK PforR, through which the PIM guidelines, which underpin the PIM regulations, and the public investment project inventory, which constitutes the basis for the Cabinet decision, have been completed. Implementation of the Cabinet decision on underperforming projects will continue to be supported by the World Bank by these instruments, including through the introduction of manuals for appraisal and M&E of public investment projects, as well as a PIM Information System under the GESDeK PforR, which will enable the National Treasury to monitor the compliance of proposed and existing projects with the PIM regulations. The contribution of the PIM reforms to fiscal consolidation is expected to be significant; the PER (2020) estimated that the cost of funding stalled projects would be at least 11 percent of GDP, or about twice the annual development budget, and that if one third of dormant projects (with less than a 25 percent implementation rate) were terminated, this would reduce costs by 1.5 percent of GDP relative to a scenario where the projects were executed.

Objective 1.3: Strengthening the performance of the domestic debt market

50. **Rationale:** The government's domestic debt portfolio is large: close to half of Kenya's government debt is domestic (48 percent at the end of FY2021), equivalent to 33 percent of GDP, and comprising mainly securities (treasury bills and bonds). However, the yield curve is currently highly fragmented (with many relatively small bonds of different tenors outstanding), and liquidity in the secondary market where previously-issued securities are traded amongst market participants is currently very thin. This increases the cost of financing for the government (due to higher liquidity premiums), impedes price discovery, makes local currency debt less appealing to foreign investors, and ultimately raises the cost and availability of long-term capital to both the public and private sectors.

51. **Substance of the reform:** The proposed operation supports the implementation of a Treasury Bonds Benchmark Program, to improve secondary market liquidity and facilitate a sound debt management strategy. This will consolidate bond issuances in fewer maturities across a longer-term maturity spectrum, to reduce fragmentation and support the evolution of a benchmark yield curve. Two strategies are planned to enhance the benchmark bond program and restructure the debt maturity profile. First, the CBK will prioritize the building of benchmark bonds, by embarking on a program including the development of a bond reopening calendar, identifying candidate bonds and reopening timings (and justification for the choice), and concentrating issuance amounts in specific pre-identified benchmark tenors to ensure that the benchmark sizes are achieved consistently. Second, the CBK will complement the benchmark building program with liability management operations, including a refinancing program through strategies such as bond switches, buybacks, and exchanges to reduce refinancing risk and increase concentration in the benchmark issues. This program in the secondary market complements the

prior action for the previous operation, whereby transparency in the primary (issuance) market was improved by the CBK's publication of auction rules and guidelines for issuing government securities.

Prior Action 3: To strengthen the domestic bond yield curve and increase secondary market liquidity through a transparent and active structured issuance strategy that ensures regular, predictable benchmark-bond issuances linked with active liability management, the Central Bank of Kenya has adopted and published the Guidelines for, and is implementing, the Treasury Bonds Benchmark program.

52. **Expected Results:** The reforms strengthen government debt management by improving the functioning of the domestic debt securities market, through increased transparency in the primary market, and a more liquid secondary market based on a less fragmented yield curve with more liquidity concentrated strategically in benchmark bonds. This will in turn lead to better price discovery, ensuring that the government is able to implement its debt management strategy by borrowing domestically at the lowest possible cost, and facilitating longer-term domestic borrowing and reduced refinancing risks. The measures also support overall capital market development and deepening, particularly as a higher quality yield curve will provide better price discovery and improved reference pricing as to the long-term risk-free rate and cost of capital in Kenya. The results indicator measures the increased liquidity concentration and reduced fragmentation in the curve to be achieved by the measures under the program to increase minimum benchmark size. The aim is for all marketable bonds with a remaining maturity of up to five years to have a minimum issuance size of at least KES 50 billion and for bonds with a remaining maturity of more than five years to have a minimum issuance size of at least KES 75 billion. The debt market functioning results are also being supported by complementary World Bank workstreams to support debt management and capital market development. These include the IFC-World Bank Joint Capital Markets Program (J-CAP), and a separate World Bank-financed operation (Financial Sector Support Project, P151816) supporting the CBK to implement the Central Securities Depository (CSD) System, a critical piece of infrastructure for the trading of government bonds.[11]

Pillar 2: Electricity sector and PPP reforms to strengthen the cornerstone utility (KPLC), place Kenya on an efficient, green energy path, and boost private infrastructure investment

Objective 2.1: Improvement in the efficiency of operations, phasing out costly excess supply, and new electricity generation based on clean technologies aligned with realistic demand forecasts.

53. **Sector context:** Kenya was one of first countries in sub-Saharan Africa (SSA) to institute market-oriented energy sector reforms, resulting in sector utilities operating at arms' length and a decades-long supply deficit being transformed into a surplus through leveraging private sector participation. The country's ambitious last-mile electrification program has succeeded in approximately doubling the access rate in the past decade to 75 percent today (from both grid and off-grid options); the grid connection base has also more than doubled, from a little over three million connections in 2015 to more than 7.5 million connections. The two key utilities, KPLC (the cornerstone distribution utility) and KenGen (the generation

[11] The CSD functions as the central depositary for government securities and provides automation of timely posting and settlement of these securities and their payments, development of the capital market, and other liquidity management facilitates settlement. The CSD also supports the operational risk management for the CBK to carry out monetary policy through open market operations with government securities.

company) are publicly listed companies, with 49 percent and 30 percent private shareholdings. More than 30 percent of power generation is from private sector independent power producers (IPPs), and more than 90 percent of power comes from renewable energy (geothermal, hydro, wind and solar).

54. **Despite these notable achievements, Kenya's energy sector faces a number of challenges.** These have manifested in the declining operational and financial performance of KPLC, threatening the financial sustainability of the sector, with the economic downturn caused by the pandemic exacerbating financial pressures. High system losses (caused by both commercial and technical factors) have resulted in incomplete cost-recovery from tariffs (estimated at about 94 percent at the end of 2021), weakening KPLC's financial position. This has been exacerbated by inadequate budget transfers to fund the last mile electrification program, coupled with slow growth in electricity consumption despite the ambitious connection campaign. Liquidity constraints for KPLC have forced it to resort to high-cost, short-term debt to finance long-term assets, and payables arrears have increased (whilst arrears on the receivables side are also substantial). A large number of power projects under various stages of development are further increasing the risk of excess capacity, and the scale of the associated fixed take-or-pay obligations threatens the financial sustainability of the sector. The last-mile electrification program has now slowed down considerably and the earlier goal of achieving universal access to electricity by 2022 has been deferred to 2026.

55. **The previous operation in this DPF series supported critical reform measures to respond to these challenges.** These began to address anomalies in cost-recovery tariff principles, drive down energy costs by addressing the over-capacity in the pipeline, and resulted in the adoption of a transparent and competitive process for future capacity additions, putting Kenya on a path towards 100 percent clean and affordable energy through a least cost power development plan based on a realistic demand growth assumption and aligned with the country's Nationally Determined Contribution (NDC) goals.

56. **To address the challenges facing the sector, a high-level (Presidential) Task Force was appointed in April 2021,** with the mandate to recommend options to address the significant high-cost over-capacity in the pipeline. The Task Force submitted a report in September 2021 with an array of recommendations to reduce costs of sector operations and improve efficiencies in KPLC. The report recommended a 33 percent tariff reduction by end-December 2021. The government reduced the retail tariffs by 15 percent effective December 2021, with a further 15 percent tariff reduction proposed to be effective from March 2022. Box 1 provides more information on tariffs and associated reforms to lower underlying costs and ensure sector sustainability.

Box 1: Kenya's retail electricity tariffs

The government is implementing the recommendations of the Presidential Taskforce on the Review of Power Purchase Agreements (PPAs) to reduce the relatively high price of power in Kenya and lower KPLC's costs. This has included a 15 percent retail tariff reduction, effective December 2021. The reform agenda is expected, over the medium term, to match the lower tariffs with a lower cost structure and place the sector on a sustainable financial footing. To address the immediate funding shortfall created by the tariff reduction, a fiscal transfer is being provided to KPLC on an exceptional, one-off basis. Any additional tariff reductions and further fiscal support would need to be based on progress on the medium-term reform program to sustainably lower costs.

The annual cost of the 15 percent reduction is estimated by the government to be KES 26.3 billion (~US$232 million). For FY2021/22, this is planned to be partially financed through operational and maintenance budget reductions for, and cost efficiencies within, public entities in the sector (KPLC, KenGen, Ketraco and GDC) amounting to KES 12.2 billion (~US$107 million). This leaves a potential shortfall of KES 14.1 billion (~US$124 million), which is being covered by a fiscal transfer: for the current fiscal year (FY2021/22), the National Treasury has provisioned an amount of KES 7.05 billion, and an equivalent amount will also be provided as a transfer in the first half of FY2022/23. This constitutes one-off fiscal support to KPLC. Further reforms in the company. as recommended by the Presidential Task Force, are expected to generate additional savings. In addition, to fulfil existing obligations and further support KPLC's financial position, the government has set aside KES 3 billion (~US$26 million) towards part payment of public sector pending bills (arrears) to KPLC. The government's announced intention of reducing tariffs by a further 15 percent effective March 2022 is premised on cost savings including from the renegotiation of PPAs.

Reflecting the government's commitment to ensure the financial sustainability of the sector, and following the expiry of the term of the Presidential Taskforce, a new steering committee has been established to oversee, co-ordinate, and monitor the implementation of the taskforce recommendations. With poor governance having been identified as a key contributor to inefficiencies, the government has made key leadership changes in the sector. Leadership changes have been effected at the Ministry of Energy (including a new Minister and Principal Secretary) as well as at KPLC. The KPLC Board has been reconstituted and human resource measures are being undertaken to strengthen management, improve adherence to regulations and policies, and address previous instances of malfeasance. A new Managing Director is being recruited through a competitive process (Prior action 4(i)). Further, at the sector governance level, the measures include improvements in governance arrangements through new guidelines to eliminate overlaps in, and clarify, sector entities' mandates, including through a review of the existing Energy Policy (2018) and issuance of a new White Paper.

The new leadership teams are implementing an array of reforms, supported by this operation (prior actions 4 and 5). Efficiency measures at KPLC include procurement reforms and an organizational review. In addition, the appointment of forensic auditors, vetting of staff, and automation of critical citizen-centric services such as billing, metering, and payments are ongoing. The reduction in KPLC's commercial losses is being driven through the implementation of a Revenue Protection Program (RPP) covering high value consumers, including Advanced Metering Infrastructure (AMI), control centers and audit of the technical integrity of current smart metering installations of large customers and their integration into the AMI data management system, as well as establishment of a well-resourced optimal organizational structure for management of the RPP. Data and systems are also being upgraded, notably KPLC's Facility data base

(FDB) through door-to-door inspection of all customer meters, mapping all customers to distribution transformers, incorporating the data into a Geographic Information System (GIS), and metering of distribution transformers.

The government is also keeping its focus on maintaining the major gains achieved in recent years in last-mile connectivity and access to power, especially in rural areas and for the poorest and most vulnerable households. The additional provisioning for KPLC by the National Treasury, for example, partly clears outstanding KPLC dues for the "last mile" program. Whilst helping to alleviate KPLC's liquidity constraints, this also reinforces the policy principle of funding KPLC's activities which support the government's sector development objectives.

57. **The indicative trigger of a detailed tariff review as envisaged at the time of the last operation has been revised in light of these developments.** The indicative trigger had anticipated that the gap between KPLC costs and revenues would be closed from the revenue side through a comprehensive tariff review. Instead, at this time, the focus of sector reform efforts has shifted towards reducing costs. As the full scale of the economic damage of the pandemic has unfolded and challenges have continued (including with the recent fifth wave of confirmed cases which peaked at the end of December) there is a need for policy to continue supporting households and firms. This makes it difficult to embark on a full tariff review at present that would have required an upward adjustment to achieve a full cost-reflective tariff (Indicative Trigger 4, see Table 4 above). This is particularly the case since the average end-user tariff is relatively high in Kenya, at USc24/kWh (including all taxes and levies, although prior to the recently-announced changes) compared to neighboring countries; average industrial tariffs currently stand at USc 18 / kWh, compared to USc 12/kWh in Uganda, USc 7/kWh in Tanzania, and USc 4/kWh in Ethiopia. Thus, the authorities are placing the emphasis for improving cost-recovery in the near-term on non-tariff measures, by accelerating efforts to tackle inefficiencies and drive down costs, and the indicative trigger envisaged in DPF1 has been revised accordingly.

58. **Rationale for and substance of the reforms:** The proposed operation focuses on critical elements of the turnaround strategy in the areas of strengthening KPLC's financial position, management improvements, and operational efficiency. First, to strengthen management of KPLC, the government has adopted a competitive and objective recruitment process for the chief executive of KPLC, with the help of a third-party professional human resources firm, and the process of recruitment for the currently vacant position has been initiated. Second, operational efficiency will be improved by adopting a revenue protection program entailing extending the coverage of remote metering and advanced metering infrastructure (AMI) for high value consumers, as well as auditing of technical integrity of current smart metering installations of large customers and their integration into the AMI system, and establishment of a well-resourced optimal organizational structure for management of the RPP (with a view to completion by March 2022). Early results from the implementation of the AMI has shown promising results with sales revenues increasing by 18 percent in the targeted installations. The DPO measures will help to mainstream the remote metering and AMI implementation to cover all the large customers of KPLC that would allow for revenue protection of more than 80 percent of KPLC sales.

Prior Action 4: To improve the operational and financial performance of KPLC: (i) a competitive selection process for the Managing Director of KPLC has been introduced with the process initiated for the currently vacant position, (ii) a revenue protection program (RPP) covering high value consumers is being implemented.

59. **Sector sustainability also requires removing excess, costly supply from the pipeline.** Kenya's least-cost power development planning process seeks to ensure that power generation expansion follows green and least-cost technology options, aligned to demand growth. However, the demand growth assumed under the 2018 Least Cost Power Development Plan (LCPDP) to match the government's aspirational goal of achieving a 5,000 MW generation program has proved to be overly ambitious. The previous operation in the DPF series therefore supported the adoption of an up to date LCPDP; this includes a realistic long-term demand forecast and specific focus on promoting clean energy so as to ensure a 100 percent green grid, up from the current 93 percent.[12] The previous operation also supported the replacement of the Feed in Tariff Policy with a new Renewable Energy Auction Policy, to ensure competitive, least-cost procurement of clean energy. The next step in the pipeline management process – to achieve least-cost, green energy investment consistent with Kenya's needs – is to adopt realistic near-term demand forecasts to inform the development of generation projects in the short term (three-five years). These forecasts are complementary to the updated, longer-term LCPDP, as they lay out the near-term path for generation capacity additions. This is intertwined with strengthening KPLC by implementing the turnaround actions of the above-described prior action 4, since KPLC's financial viability is integral to the financial viability of the energy sector and to creating incentives for investment in renewable energy-based power generation in the future.

Prior Action 5: The Ministry of Energy has approved a five-year power generation and transmission development plan (2021-2026) to guide the competitive procurement of clean energy, at least-cost and aligned with demand.

60. **The critical policy and institutional reforms supported by the DPF series form part of an overall package of support to the energy sector by the WBG.** There is ongoing World Bank support to the last-mile electrification program, as well as off-grid renewable energy-based solutions for underserved counties, to support increasing access to electricity towards the universal access goal. While the system loss of KPLC is at par with the average of SSA utilities (excluding South Africa), it is on an increasing trend, partly because of the recent rapid expansion of the low-voltage network to cater to an ambitious electrification program without commensurate investments in the medium and high voltage networks. The ongoing World Bank support is funding remote metering for large customers, AMI, and customer mapping to help address the revenue leakages and improve the system losses of KPLC. Further investments will be needed to strengthen the network for reducing technical losses, to complement other steps to improve efficiency (including those supported in this DPF operation, which is focused on supporting the needed policy and institutional improvements). Adequate public funding for last mile connectivity will need to be ensured to achieve the goal of universal access by 2026. Lastly, complementing the DPF measures, KPLC will need liquidity support in the short to medium term, coupled

[12] Kenya is ranked 7th globally for geothermal capacity development (2020). Going forward, the availability of indigenous geothermal resources coupled with the existing hydro-based generation, interconnection to tap into regional hydropower resources, and the potential for intermittent renewables (solar and wind), make it possible for Kenya to plan to meet its electricity needs fully from renewable energy sources, eliminating liquid fuel power generation (currently about 7-8 percent of the supply mix).

with tariff adjustments to generate sufficient revenues for KPLC to meet its cost efficiency improvement. Funding support is being considered under a proposed new energy operation (Kenya Expansion of Sustainable Access to Electricity Program [KESAEP], P176698).

61. **Expected results:** Efficiency is improved, the trend of increasing overcapacity is halted, and any new generation is based on clean technologies and installed at market-determined and transparent prices. The results indicators capture improved cost-recovery in the tariff, and the streamlined capacity of the pipeline to ensure supply-demand balance. The reforms mean that several large, and potentially expensive, projects which have been in the planning stages or not yet signed by the regulator (Energy and Petroleum Regulatory Authority, EPRA) will no longer come onstream. In addition, new renewable energy capacity will be competitively priced through an auction framework (DPF1 prior action). The cost savings can be estimated by comparing the projected generation costs per KPLC's previous generation schedule with revised projections based on only the needed new capacity brought in at competitive pricing and aligned with realistic near- and long-term demand forecasts. Savings are estimated to be about US$1.1 billion (at current exchange rates) over the next ten years, or US$110 million per year on average. The current power purchase costs of KPLC are about US$850 million, accounting for almost two-thirds of the utility's total revenues from sales. The expected strengthening of KPLC's performance substantially reduces fiscal risks to the government, given the large size and strategic nature of this SOE.

62. **Climate change mitigation:** These reforms are central building blocks for Kenya's contribution to mitigating climate change. The streamlining of the energy investment pipeline allows for only the needed power plants to be constructed, avoiding excess capacity construction. The LCPDP and its near-term implementation as supported by the proposed operation paves the way for a 100 percent green grid by 2030, keeping Kenya on a green energy path and resulting in the eventual decommissioning of the existing heavy fuel oil-powered emergency generation.

Objective 2.2: Improve the legal and institutional setup for PPPs, to enable PPPs to fulfil their potential to crowd in private infrastructure investment.

63. **Context of PPPs in Kenya:** The above objective in this pillar of DPF series focuses on strengthening the cornerstone energy sector, including by providing a sound enabling environment for private investment in renewables to meet growing electricity demand. The second and final objective is to strengthen the role of PPPs across the wider economy, to share risks between the public and private sectors, leverage private sector capital and expertise to efficiently operate and maintain infrastructure, and support private sector-led growth by opening up investment and revenue-generating opportunities for businesses. Beyond the electricity sector, the prioritized pipeline of projects currently includes transactions spanning transport, housing and student accommodation, health, solid waste, special economic zones, water and agriculture. However, the existing legislation (the Public Private Partnership Act, 2013) and institutional setup for PPPs, in place since 2013, have been slow to deliver on the full potential of PPPs. Accelerating the delivery of PPPs has strong potential to help meet Kenya's infrastructure investment needs, reduce fiscal pressure, and open new private sector opportunities.

64. **Rationale:** To accelerate PPPs, the multiple review and approval processes under the current Law need to be streamlined, to address the very slow development timeline faced by projects. Kenya's flagship

PPP project, the US$1.5 billion Nairobi-Nakuru-Mau Summit (NNM) PPP Toll Road, illustrates the challenges: seven years after being conceptualized, it only reached commercial close on September 30, 2020. An additional shortfall of the current Law is that it does not effectively provide for a devolved decision-making process that would allow Kenya's county governments to decide on local-level projects below a certain threshold (a "PPP lite" model). This dampens interest in smaller-scale PPPs which, collectively, could increase private investment in local infrastructure and public service provision.

65. **Substance of the reform:** The proposed operation supports amending the PPP Act, to enhance approvals and processes, clarify the roles and responsibilities of key participants in the PPP cycle for efficient and timely delivery of PPP projects, and to allow county governments to decide on local level projects below a certain threshold (i.e., enabling a "PPP lite" model). Overall, the amendments streamline the existing process for approving projects and adapt the PPP framework to Kenya's devolved system of governance. The National Treasury is also strengthening assessing, monitoring, reporting and management of the contingent liabilities generated by PPPs, which is being supported through both World Bank-supported Investment Project Financing (IPF), supplemented by trust fund resources provided by the PPIAF, and the IMF program (which includes structural benchmarks on fiscal risks reporting including PPPs). A Fiscal Commitment and Contingent Liabilities (FCCL) Management Framework has been developed and approved. The results indicator is the number of PPP projects that have achieved at least one additional milestone (RFQ [request for qualifications], request for proposals [RFP], negotiations or contract signing) since the adoption of the new legislation, with a target of at least ten by the end of 2023.

Prior Action 6: The Borrower has enacted the Public Private Partnerships Act (2021), to enhance project selection and implementation processes, and clarify the roles and responsibilities of key participants in the PPP cycle, for efficient and timely delivery of PPP projects.

66. **Expected Results:** These reforms will improve the legal framework for PPPs, to accelerate the pipeline of projects and crowd in more private infrastructure investment. The results indicator is the number of PPP project milestones passed. Achievement of the results is also supported by ongoing IPFs, in particular, the Kenya Infrastructure Finance/PPP Project (P121019). Contributing to the progress towards achieving the results, the PPP Unit in National Treasury has been upgraded by Cabinet Directive to the level of a Directorate, and a presidential appointment of a Director General for PPPs was made on December 1, 2020. The new setup is expected to strengthen capacity, making the PPP Unit equal to the complexity of decision-making in this area, and to give it the needed authority to facilitate reaching decisions in multi-stakeholder contexts.

Pillar 3: Strengthen environmental and natural resource governance, combat climate change, and improve healthcare including pandemic response

Objective 3.1: Strengthening environmental and climate governance

67. **Rationale: Kenya's economy depends heavily on environmental goods and services.** Natural capital accounts for 35 percent of total wealth, and about 42 percent of GDP and almost 70 percent of total employment are generated by natural resource-related sectors. Policy reforms and institutional strengthening to embed sustainable environmental management to preserve and increase natural capital are therefore critical to drive a green recovery from COVID-19, and ensure that Kenya's growth path is

sustainable. Devolution (beginning in 2013) involved the transfer of some responsibilities related to environmental, natural resources and climate change management to the 47 county governments. The capacity of the counties to manage environmental and natural resources has been developing, but inter-government coordination between counties and national government has been weak, preventing effective information-sharing and impeding the collaboration required to support effective environmental and natural resource management.

68. **A critical aspect of the environmental policy reform agenda is to mainstream climate change mitigation and adaptation considerations at both the county and national government levels. Climate change is expected to have a considerable negative impact on livelihoods and economic growth in Kenya.** Floods and droughts, which are increasing in frequency and severity, are already estimated to create long-term fiscal liabilities equivalent to 2-2.8 percent of GDP each year (estimated flood costs amount to 5.5 percent of GDP every seven years, while drought costs amount to 8 percent of GDP every five years). Moreover, the economic impacts of climate change will continue to intensify in the coming decades, reducing crop and livestock production, as well as that of coastal fisheries, thus lowering aggregate growth and productivity and threatening food security. Globally, Kenya is the 38th most vulnerable country and the 39th least ready country to cope with climate change.[13]

69. **Substance of the reform:** The previous operation (P175251) of this DPF series supported Kenya to submit an updated NDC in December 2020. The objective of Kenya's updated NDC is to reduce emissions from its business-as-usual scenarios by 32 percent by 2030 through policies and measures to mitigate and adapt to climate change. In the context of the devolution, Kenya's overall environmental management approach needs to follow a more coherent and holistic approach that embeds climate change considerations and mainstreams climate governance into national and subnational levels to successfully implement its NDC. To achieve a such harmonized, holistic and coherent approach, the proposed DPF supports key reforms in the cornerstone legislation for environmental management, the Environmental Management and Coordination Act (EMCA). Stakeholder consultations have identified key reform focus areas including a) entrenching a coordinating framework between the national and county governments on environmental management; b) providing for stronger national government representation in the County Environment Committees; c) streamlining climate change governance, including the above-mentioned actions relating to implement Kenya's updated NDC by anchoring it in the EMCA; d) providing for Integrated Environmental Impact Assessments; e) strengthening the EMCA institutions, e.g. granting autonomy to National Environment Trust Fund (NETFUND); and f) creating new committees to improve environmental governance, e.g., the Committee on Environmentally Significant Areas (ESAs).

Prior Action 7: In order to enhance environmental management and mainstream climate change governance, the Cabinet has approved the Environmental Management and Coordination Bill (2022).

70. **Expected Results:** These reforms will put Kenya on a path to achieve its mitigation and adaptation goals and meet its NDC commitment. It is expected that Kenya will take effective actions on climate change as per its NDC that will reduce greenhouse gas emissions by 32 percent (equivalent to 143MTCO2) by 2030. The achievement of these goals is being supported by complementary interventions, such as

[13] Based on Notre Dame Global Adaptation Initiative (ND-GAIN) assessment (2019), see: https://gain.nd.edu/our-work/country-index/

efforts to reduce pressure on forests from households' use of wood for cooking-energy (e.g., Kenya's Off-Grid Solar Access Project [KOSAP] promotes clean cooking technological solutions through results-based financing; microfinance schemes under the "Bottle for life" program are helping switch families to LPG). In addition, the reforms will establish climate change governance into EMCA, paving the way to mainstreaming climate change consideration into the design and planning of investments in different sectors to prioritize incorporating technologies and approaches that mitigate emissions. The results indicator is the increase in the number of counties which have County Climate Change Action Plans, developed through participatory methodologies and endorsed by the County Governors (from eight to 25). These policy reforms complement support which the World Bank is providing to the government through the Financing Locally-Led Climate Action Program (P173065, FLLoCA), a PforR operation supporting stronger climate change risk management capacity.

Objective 3.2: Making Kenya's land market more transparent and equipping counties to mobilize own-source revenues based on property taxes

71. **Rationale**: Kenya currently lacks standardized land value information. This is a critical shortcoming in the transparency of the market for land. It also results in speculative activity in public infrastructure projects, increasing their costs. The development of a valuation index which is reviewed regularly will inform the valid market price when the government acquires land for development projects. It will also mitigate the risk that local communities are exploited, as it allows communities to know the value of their properties, a strongly pro-poor measure. The Land Valuation Amendment Act 2019 provides for the development of a land value index for all the 47 counties. However, the lack of updated, relevant regulations despite the passing of the Act is impeding the rollout of the land value index across counties. The relevant regulations are those provided for by the Land Act, Land Registration Act, the Prevention, Protection and Assistance to Internally Displaced Persons and Affected Communities Acts. As a result, to date, land value indices have been completed in only six of 47 counties, none of which have yet received Parliamentary approval. Further, the Rating Act and Rating Valuation Act, which provides the legal basis for counties to determine ratings for land valuation, is outdated. Together, these gaps also contribute to significant forgone own-source revenues that local governments could generate from property taxation.

72. **Substance of the reform:** The reform supports the development of a national land value index. It updates the Rating Act and the Rating for Valuation Act to align the legal framework with devolution and to provide counties with the legislative framework to review and update their valuation rolls.

Prior Action 8: To equip county governments to mobilize own-source revenues based on property and to improve land price transparency, the Recipient's Cabinet has approved the National Rating Bill.

73. **Expected results:** The reform will increase transparency in the land market and reduce development project costs which are currently often inflated by distorted land costs. The results indicator is the production of county value maps (targeting at least 15 by 2023). These indicate the land values along submarkets, an intermediate step towards ensuring that the national land value index is completed. Developing value maps ensures consistency of land values across transactions in one submarket, reducing the opportunity for speculative activity and thus controlling the public costs of land in development projects. By updating the legislation on ratings, counties will have a framework against which to update their valuation rolls, thus creating another credible source of information regarding the value of land.

Counties will be able to use this information to raise more own-source revenues by levying property taxes and land rates, strengthening county government finances and contributing to the revenue mobilization agenda, which is urgent given Kenya's stretched public finances.

Objective 3.3: More sustainable water resource management

74. **Rationale**: Kenya is a water-scarce country, with low and declining freshwater resources.[14] Rainfall is unevenly distributed, both spatially and temporally, and over 80 percent of land is arid or semi-arid. Critical watersheds are degrading fast due to poor land-use practices, deforestation, and encroachment on riparian lands. Erosion hotspots cover about half of the land area in Kenya's river basins, resulting in high sediment loads in rivers and reservoirs, and deteriorating water quality. Large-scale investments in water and irrigation are needed. The country's water storage capacity is low, at only about 103m^3 per capita (well below the average for Africa).[15] Major cities such as Nairobi and Mombasa already face large gaps between water supply and demand,[16] leading to chronic water shortages. Only about 2.5 percent of Kenya's cultivated farm area is irrigated. Access to potable water supply and sanitation (WSS) services also lags the SSA average. About 20 million Kenyans (over 30 percent of the population) lack access to basic water services, 35 million people lack access to basic sanitation, and four million have no sanitation access at all and practice open defecation. These gaps weigh on public health and human capital; for example, unsafe drinking water and inadequate sanitation account for 75 percent of the disease burden.

75. **Managing water as a scarce and critically important natural resource, and expanding irrigation and potable WSS services, have been impeded by gaps in the policy and regulatory framework.** Existing water resource management rules do not provide for the integrated planning, management, and allocation of water resources at the basin level; they also do not address the expanded institutional mandate of the Water Resources Authority (WRA) to regulate water resources. Water abstraction charges have not provided adequate economic incentives for water conservation, nor generated enough financial resources to enable WRA to execute its regulatory functions and watershed conservation activities.[17]

76. **Substance of the reform:** The previous operation in this DPF series supported Cabinet approval of the new National Water Policy and new regulations to enable implementation of the water legislation, including regulations on water and sanitation services, water resources management, water harvesting and storage, and irrigation. The proposed second operation of the series deepens these reforms by supporting the implementation of specific aspects of the new policy and regulations, with a focus on strengthening WRA's capacity to carry out its regulatory function, gazettement of six basin areas[18] to enable integrated management and allocation of water sources at basin level, and the adoption of a governance framework for the National Water Sector Investment Program (NAWASIP) as a medium-term

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[14] The total renewable water resource currently available in Kenya is 450 m^3/capita/year, which is well below the globally recognized scarcity threshold of 1,000m^3/capita/year (Falkenmark M. et al, 1989). A recent study by the 2030 Water Resources Group analyzed current water demand and future national development plans and concluded that in 2030 Kenya will likely face a 30 percent gap between water demand and available water resources (see https://www.2030wrg.org/kenya/).

[15] For instance, South Africa has seven times more storage capacity than Kenya.

[16] Current water supply for Mombasa and Nairobi only covers 25 percent and 75 percent of water demand, respectively.

[17] WRA has been running a 50-60 percent budget deficit in the past five years and faces severe financial constraints. Current water abstraction revenues only cover about 20 percent of WRA's operating costs.

[18] The six basin areas gazetted are: Lake Victoria North Basin, Lake Victoria South Basin, Rift Valley Basin, Athi River Basin, Tana Basin and Ewaso Ng'iro North Basin.

intergovernmental program to accelerate access to WSS services. The adoption of the new regime of water abstraction charges and water conservation levies is essential to generate additional financial resources to meet the cost WRA incurs in discharging its regulatory functions and implementing watershed conservation activities. The new NAWASIP governance framework recognizes the shared constitutional obligation of both government levels to ensure the right to WSS for all Kenyans, addresses the current disjointed planning systems leading to a sub-optimal allocation of resources, and recognizes the constitutional obligation of both national and county governments to respect their respective functional and institutional integrity and cooperate in planning functions. The NAWASIP governance framework contains (i) the service coverage targets for the program; (ii) level of funding that both levels of government will commit to the program; (iii) guidelines for project selection and appraisal; (iv) reforms to improve the efficiency of capital expenditure under the program and operational efficiency of county-owned water service providers; and (v) a new intergovernmental conditional transfer mechanism to incentivize the implementation of the reform activities.

Prior Action 9: To enhance access to water and sanitation services, and improve the management and conservation of water resources: (i) the MoWSI has approved the medium-term framework for a National Water and Sanitation Investment Program (NAWASIP); (ii) the Water Resources Authority has designated six basin areas under section 24 of the Water Act 2016; and (iii) the MoWSI has stipulated new water use charges and water conservation levies.

77. **Expected results:** These reforms will improve the sector's policy and regulatory environment and create the conditions for the rapid expansion of WSS and irrigation services, while ensuring prudent management of Kenya’s scarce water resources. The direct outcomes of the reforms are expected to include: (i) increased access to WSS services (measured by the number of people gaining access to WSS services, with a target of at least 300,000); and (ii) strengthened capacity of WRA to discharge its regulatory mandate and protect watersheds (measured by the proportion of WRA’s annual operating costs financed through water abstraction revenues, targeted to move up from 30 percent to 70 percent). The reforms will also indirectly contribute to the government's efforts to expand irrigation services, improve food security, and increase farm incomes by facilitating farmer-led initiatives, promoting fast, low-cost irrigation interventions, and leveraging farmer co-financing.

78. **Gender equity:** Gender inequalities related to WSS remain significant in Kenya, and strongly gendered norms surrounding water and sanitation are commonplace. Globally, fetching water is primarily the responsibility of women and girls; in a 2017 WHO/United Nations Children’s Fund (UNICEF) Joint Monitoring Program analysis of 61 countries, women were mainly responsible for water collection in nearly three-quarters of households where the water source is off-premises. KNBS analysis of raw (currently non-public) data indicate that only 45 percent of female-headed households report having piped water (public tap/standpipe) as their main source of drinking water, compared to 55 percent for male-headed households. Over half (52 percent) of female-headed households rely on unprotected springs as their main source of drinking water, compared to 48 percent for male-headed households.

79. NAWASIP’s guiding principles include affirmative action, equity, inclusivity, and equality. Social and gender impact is one of the screening criteria for inclusion of WSS projects into NAWASIP under the governance framework. Lack of official, public national data is currently a significant gap, as neither level of government is collecting gender-disaggregated WSS data, which are important for setting priorities,

planning interventions and tracking success indicators towards closing Kenya's WSS gender gap. Accordingly, one of the expected results from the water sector reforms is for MoWSI to develop and operationalize a national data and information system that captures gender-disaggregated WSS data, as part of the implementation and monitoring of NAWASIP, including achieving its equity goals.

80. **Climate change adaptation:** The water reforms will deliver significant climate change adaptation benefits. First, the water abstraction fees and conservation levies will help unlock much-needed finance to enable WRA to scale-up watershed conservation activities using various technologies (e.g., soil and water conservation, vegetative riparian buffers, community forestry). These interventions will enhance the capacity of both communities and the ecosystems in the watershed to absorb and adapt to climate-induced impacts. For instance, increased vegetation cover and riverbank protection help mitigate the effects of flooding. Soil and water conservation techniques reduce soil loss and increase soil moisture content, thus minimizing the impact of droughts. Restoration interventions will also contribute to improving or preserving the carbon sequestration capacity of the watershed, consistent with the climate change and environmental management measures described under objective 3.1, above. Second, the reforms will strengthen WRA's adaptive capacity to discharge its mandate of regulating Kenya's water resources and protecting watersheds, including in the face of climate change, by expanding and diversifying WRA's revenue base and reducing reliance on the government budget.

Objective 3.4: Strengthening public health emergency preparedness and response

Kenya has made great strides in improving health outcomes, but the healthcare sector has been severely impacted by the pandemic. Ensuring that the gains of recent years in health outcomes are preserved and that more progress is made, despite the disruption and strain placed on the healthcare system by the pandemic, will be vital. The DPF series supports measures to enhance health sector governance, make more progress towards universal health coverage (prior action of the previous operation), and address institutional shortcomings revealed by COVID-19 (see below). The healthcare system reforms also contribute to strengthening Kenya's fiscal position, as they aim to improve the efficiency of public spending on healthcare. The reforms complement other World Bank support to the health sector, including to scale up health coverage.

81. **Rationale:** The pandemic has revealed shortcomings in Kenya's capacity to prepare for and respond to public health emergencies, consistent with the earlier findings of the Joint Government-WHO External Evaluation (JEE)[19] which found that the coordination of health security preparedness and response activities was inadequate, and recommended the establishment of a national public health institute to undertake this role.

82. **Substance of the reform:** The proposed operation supports the establishment of the Kenya National Public Health Institute (NPHI), with a mandate to coordinate public health functions and programs to prevent, detect, and respond to public health threats, including infectious and non-infectious diseases, and other health events. Activities of the NPHI will cut across national and county level, sectors, and stakeholders in order to implement a "One Health" approach to public health events. The NPHI is expected to consolidate the activities of several Ministry of Health units, such as disease surveillance, neglected

[19] World Health Organisation. Joint External Evaluation of IHR Core Capacities of the Republic of Kenya (2017).

tropical diseases and immunization; and to work closely with existing public health actors such as the Kenya Medical Research Institute, and research and training institutions.

Prior Action 10: To strengthen Kenya's infectious and non-infectious disease prevention and response capabilities, including by consolidating existing public health emergency preparedness and response functions under one authority, the Borrower has established the Kenya National Public Health Institute.

83. **Expected results:** The Kenya NPHI will strengthen disease prevention, detection and response activities; increase the effectiveness of responses through reliance on evidence; strengthen public health workforce capacity and skills; improve relations with stakeholders; and improve the coordination of multi-sectoral responses. The results indicator captures the expected increase in Kenya's capacity to respond to public health events and emergencies based on the results of the IHR States Parties Annual Reporting Tool (targeting an increase from 43 percent to 65 percent by this measure). The IHR State Party self-assessment Annual Reporting tool enables countries to meet their IHR obligations for annual reporting on country capacities in thirteen technical areas using standardized indicators. Each indicator is scored from 1 to 5 based on implementation status thus providing a year by year snapshot of changes in country core capacities to detect, assess, notify and respond to any potential public health event of international concern. The NPHI's activities will ultimately contribute to the government's objective (under the Big Four agenda) of universal health coverage, by improving access to prevention and health promotion services. This builds on contributions to the UHC reform agenda supported by the previous operation in this DPF series, through legal reforms to transform the National Hospital Insurance Fund into a more strategic purchaser of health services.

84. **To further support the results enabled by this reform, under the Kenya COVID-19 Health Emergency Response Project (P173820), resources have been allocated towards operationalizing the Kenya NPHI.** This includes work to (i) renovate or construct a building to house the NPHI; (ii) strengthen human resources capacity through training, learning exchange programs with a well-functioning equivalent institution, recruitment of personnel with specialized skills on contract basis to fill any skills gaps and provide mentorship to existing staff and facilitate knowledge transfer; (iii) develop a costed strategic plan; (iv) develop/update key platforms, including, but not limited to establishment of a public health research; integrated disease surveillance platform including passive and active forms of surveillance that aligns to Kenya's devolved context; one health focusing on detection and response to zoonotic diseases; and (v) develop and implement a dedicated ICT system which is linked to existing routine health information systems among others.

85. **Climate change aspects:** The new NPHI is expected to help Kenya combat the health impacts of climate change. The country faces high and growing risks from climate impacts on health including increases in vector- and water-borne diseases such as malaria and cholera; nutritional effects of food shortages including acute malnutrition and stunting; and morbidity and mortality resulting from extreme weather events such as floods and heat waves.[20] The enhanced health emergency preparedness and

[20] *See* IFRC Climate Centre, 2021, "Climate Change Impacts on Health: Kenya Assessment" *and* Rocque RJ, Beaudoin C, Ndjaboue R, et al, 2021, "Health effects of climate change: an overview of systematic reviews"

response capabilities embodied in the new NPHI is therefore expected to contribute to Kenya's ability to mitigate the impacts on health from climate change.

Table 5: DPF Prior Actions and Analytical Underpinnings

Prior Actions (PAs)	Analytical Underpinnings
Pillar 1	
PA1 PA2	The World Bank's Kenya Public Expenditure Review (2020) analyzed government procurement and PIM (amongst other areas), and recommended the adoption of e-procurement, and the streamlining of the large and fragmented public investment portfolio, including a significant share of stalled and under-performing projects.
PA3	The World Bank has engaged on enhancing the Kenya domestic government debt market through a series of complementary TA and operations since 2011: Efficient Securities Market Institutional Development (ESMID) Program, WBG Government Bond Markets Advisory Services Program (formerly GEMLOC - Global Emerging Markets in Local Currency Program) and IFPPP (P121019). The reforms are part of a broader technical analysis and series of recommendations made in a technical report "Developing the government Securities Market in Kenya: The Next Steps for the Public Debt Management Office" (2019) under the TA program for capital markets: Financial Sector Strengthening Facility Project for Infrastructure Finance (FIRST, P163792). The need for these actions were reinforced by a technical mission in Q4 2020 under J-CAP.
Pillar 2	
PA4 and PA5	A detailed strategy including options and a bidding framework for solar and wind energy was developed with support from World Bank-executed trust funds (P173040). This analytical work was used as input for the auction framework adopted by the government. Consultant support was mobilized under bank-executed trust funds to support the cross-sectoral least cost power development team in technical analysis for updating the LCPDP. Detailed financial analysis based on a comprehensive financial model for KPLC has been conducted which can inform the elements of the turnaround strategy.
PA6	IFPPP (P121019): This project has been supporting the government to undertake reforms and to bring PPPs to financial close. Project implementation has informed the institutional and legal reforms, in particular the need to (i) upgrade the PPP unit to enhance its ability to convene and to collaborate with other stakeholders within government, and (ii) streamline the approval processes for projects.
Pillar 3	
PA7	The Country Environmental Analysis for Kenya (CEA, 2019) described the significant environmental challenges emanating from natural capital degradation and the impacts of climate change. The CEA also highlighted the urgent need to sustainably manage Kenya's natural capital assets to sustain livelihoods and avert severe environmental, social and economic losses from degradation. Kenya's updated NDC which was submitted to UNFCCC in December 2020 also sets out an ambitious vision for climate action on both adaptation and mitigation. Additionally, the Financing Locally-led Climate Action Project (Report No. AUS0001289) in Kenya underscores the need to formulate clear policies, strengthen financial capacity as well as institutional and technical capacity within county governments and a well-articulated action plan to achieve enhanced climate and disaster risk management.
PA8	A 2017 report (Report No: ACS22683) produced by the World Bank on issues related to land acquisition challenges underscored the need for a way to curb speculation of land values that are triggered by development projects. This issue was further analyzed in the Kenya Economic Update October 2016: Beyond Resilience - Increasing Productivity of Public Investments. The report argues that there is an urgent need to address challenges related to land acquisition where speculation leads to escalation of costs and consequent significant delays.
PA9	The reforms are informed by analysis showing that Kenya's weak record on securing water, and

	expanding irrigation and potable WSS services, is partly due to gaps in the existing sector policy and regulatory framework, particularly the lack of an intergovernmental policy framework and program for expanding WSS services, and the delayed implementation of the water legislation. These constraints combine to undermine public investment in the sector.[21]
PA10	Prior to COVID-19, the World Bank supported the government to review the policies, legal and regulatory framework for pandemic preparedness and made recommendations on how these should be strengthened. Additionally, the World Bank supported the development of a governance mechanism for pandemic preparedness and response, which has informed the design of coordination mechanism for COVID-19. Under the Kenya COVID-19 Project (P173820), the World Bank is supporting constructing and operationalizing the Kenya NPHI.

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

86. **The DPF supports the objectives of the WBG Country Partnership Strategy (CPS) FY14-FY20 for Kenya.**[22] Both the DPF and the CPS are underpinned by Kenya's Vision 2030 agenda, as operationalized through the respective MTPs. The CPS has three domains of engagement: (i) 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 cross-cutting platform that underpins all three domains of engagement. This DPF helps to advance the objectives set out in the CPS. The fiscal, public financial management, and debt market reforms in pillar one provide impetus towards realizing the fiscal sustainability and good governance goals of the CPS. The second pillar orients the energy sector to be financially sustainable, efficient and green, which will support the competitiveness of the economy. Reforms in the third pillar enhance the equity, efficiency and sustainability with which Kenya's land and water resources are used – a prerequisite for sustainable, inclusive growth, as well as strengthening access to and the quality of healthcare services, supporting Kenya's human capital base to grow and drive inclusive economic growth.

87. **This DPF complements the WBG's support to Kenya through other instruments including IPF and PforR operations.** The Performance and Learning Review (PLR) of the Kenya CPS, the Kenya Country Private Sector Diagnostic (CPSD, 2019) and the Systematic Country Diagnostic (SCD, 2020) all point to the increasing importance of policy and institutional reforms to accelerate towards achieving the twin goals. The implementation progress and development impact of World Bank-supported operations are expected to be enhanced by complementary policy and institutional reforms, notably including in the electricity and health sectors.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

88. **Stakeholder consultations have informed the underlying national and sector plans and the**

[21] Sources: World Bank, 2020, "Impact of devolution on water and sanitation services in Kenya. World Bank, 2020, "Making devolution work for service delivery in Kenya."; Folscher, A., Liabwel, I., Malik, S., Moon, S., and Feuerstein, L., 2019, "Pipes, policy, and public money: integrity in water sector public financial management in Kenyan counties." Nairobi: Water Integrity Network (WIN) and Kenya Water and Sanitation Civil Society Network (KEWASNET); World Bank, 2021, "Strategic scenario analysis for expanding water and sanitation services in Kenya".
[22] CPS for the Republic of Kenya (Report 87024-KE) discussed by the Executive Directors on June 5, 2014; and Performance and Learning Review (PLR) of the CPS for the Republic of Kenya (Report 113547-KE) which extended the CPS to FY20.

associated policy changes supported by the proposed DPF. Public participation is a constitutional requirement for the government when making or implementing public policy decisions under Article 10(1) of the Constitution of Kenya. The preparation of the MTP III and ERS was informed by extensive consultations at national and county levels. The legislative changes supported by this operation have undergone stakeholder consultations. For example, the National Rating Bill went through extensive consultations beginning with a public call for comments which were further discussed in a consultative forum. Follow-up consultations were done with specific groups where comments required further discussion, such as with valuation professionals and county representatives. The comments received from the public and a record of the extent to which they have been incorporated in the final draft have been uploaded onto a public website for further public access.

89. **Collaboration with development partners has been facilitated by the Development Partners Group (DPG), the main donor co-ordination platform in Kenya.** The development partners are committed to supporting efforts by the government to mitigate the adverse socioeconomic effects of the pandemic and facilitate opening of the economy, accelerate economic recovery and attain higher and sustained economic growth, as contained in the ERS and consistent with the MTP III 2018–2022. The World Bank has regularly engaged with the Heads of Co-operation of the Development Partners Group on the design and implementation of the DPF series. Further, Heads of Missions (HOMs) have also been engaged on the DPF, both through DPG-HOMs meetings as well as bilaterally. This has been complemented by the government's own communications with development partners, including concerning the budget support operation.

90. **This operation complements contributions from development partners**, including other budget support. The World Bank, the African Development Bank (AfDB) and the IMF have consulted closely in developing and implementing their respective programs. The European Union (EU) has supported the public finance management (PFM) reform strategy, which is integral to these programs. Further, in general, development partners including Canada, Denmark, the European Commission, Finland, France, Germany, Japan, the Netherlands, Norway, Sweden, the United Kingdom, the United States, and the AfDB, in coordination with the WBG, are providing financial and non-lending support in several areas covered by the operation (public investment management, public financial management, health, education, land).

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

91. **The overall medium- to long-run poverty and social impacts of reforms supported by the proposed operation are expected to be positive.** Most prior actions target sector or macroeconomic performance and mainly affect the poor and vulnerable indirectly. The prior actions have the potential to improve non-monetary dimensions of wellbeing. In the medium to long-term, the poor and vulnerable could benefit from more efficient public investments and enhanced capacity of counties to raise own-source revenues from property taxes. The prior actions will also support stronger electricity and water sectors which in turn can benefit Kenyans, particularly if the inequality in access to these basic services is addressed. The poor and vulnerable will also benefit from better accessibility and affordability of healthcare and a stronger and better coordinated public health system. The Poverty and Social Impact Analysis (PSIA) for

reforms supported under the previous operation in this series analyzed the positive impacts of progress towards Universal Health Coverage (UHC). Poorer Kenyan households have higher relative out-of-pocket (OOP) health expenditures, and the incidence of catastrophic expenditures is more severe for the poorest households. Continued progress towards UHC can benefit the poorest by reducing such OOP health expenditures. For example, a 50 percent reduction in OOP expenses is equivalent to a reduction in poverty by an estimated 1.3 percentage points.[23]

92. **The prior action (PA9) on raising water sector abstraction charges could affect the urban poor if water providers pass on the higher charges to consumers, but water costs are below affordability thresholds and simulations show no material poverty impacts.**[24] Higher abstraction charges will increase the economic incentives for water conservation, as well as allow the WRA to cover a larger share of its operating costs. This reform is important for sector sustainability as Kenya is a water scarce country. Water abstraction charges were raised from KES 0.50/m^3 to KES 5/m^3. It is expected that the increase in water abstraction charges will be passed on to all end-consumers through increased tariffs across all water consumption blocks for those using piped water; prices of other sources of water consumption could increase as well.[25] There is thus potential for this measure to have negative poverty and equity implications, at least in the short to medium term, although simulations suggest that even large increases in the budget share of water expenditures would have very little impact on poverty (see below). Any near-term impacts also need to be weighed against expected longer-term benefits through the increased sustainability of Kenya's water resources, and non-monetary poverty impacts.

93. **Households most likely to be affected by the increase in abstraction costs are those whose main drinking sources face abstraction charges** - water service providers (piped water), water vendors, those drawing water from a borehole, or using bottled water. These households constitute 87 percent of urban households and 35 percent of rural households in 2019. In 2019 almost all the richest urban households used one of these water sources compared to 50 percent in the richest rural household. Furthermore, the use is over 30 percentage points larger among the poorest urban households compared to the richest rural households (Figure 5). Amongst urban residents, there is a marked difference in the source of drinking water: over 85 percent of the better off households use piped water or bottled water while only two-thirds of the less well-off use these sources, with a greater reliance on water vendors and borehole/tube wells. Census data show that between 2009 and 2019, the share of the population relying on water vendors has increased, particularly for urban households. In 2019, the share relying on water vendors varied greatly across counties with Mombasa (43.5 percent), Kajiado (23 percent), Marsabit (16

[23] The poverty impact of changes in healthcare expenditure is simulated by calculating the total amount a household spends on inpatient and outpatient charges, as well as over the counter purchases in the last 12 months (outpatient expenditure is scaled from 1 month to 12 months). For poor households and those who have access to NHIF, a proportion of the healthcare expenditure is then added back to a household's annual consumption, before poverty is recalculated. A Wald test is used to determine whether there is a statistically significant difference between the poverty headcount before and after.

[24] This discussion does not cover the increasing block structure of water tariffs for those using piped water. These are designed with the aim to keep charges low for low volume users who are thought to be the less well-off. Therefore, changes to the tariff design, which is the way the sector addresses equity considerations, are not expected to be changed. Since the tariff structure is assumed not to change, the differential rate at which water consumption gets charged will also not change. Studies suggest that increasing block tariffs is not progressive in practice since richer households might not actually consume water at the level of the most expensive block. (See Fuente, D., et al. 2016. "Water and sanitation service delivery, pricing, and the poor: An empirical estimate of subsidy incidence in Nairobi, Kenya".)

[25] It is expected that WSPs will request a tariff review to cater for the increased abstraction charges. The tariff adjustment will apply to all consumption blocks.

percent), Mandera (16 percent), and Nairobi (15 percent) showing amongst the highest share of households relying on water vendors for drinking water (2019 Census, Volume 4, table 2.15). However, in 2015/16 most households consumed less than 6m^3 a month from WSPs or water vendors.

94. **The average budget share of water expenditures is larger for rural residents compared to urban and higher for the poorer quintiles within both urban and rural areas (Figure 6).** The budget share for the poorest rural households that report expenditure on water is just under 5 percent (considered to be the affordability threshold) while the budget share for the poorest urban household is about 3 percent. In contrast, the budget share of water expenditures is just over 1 percent among the richest urban households. The reasons for this pattern will be further analyzed.[26]

Figure 5: Main drinking source (2015/16)

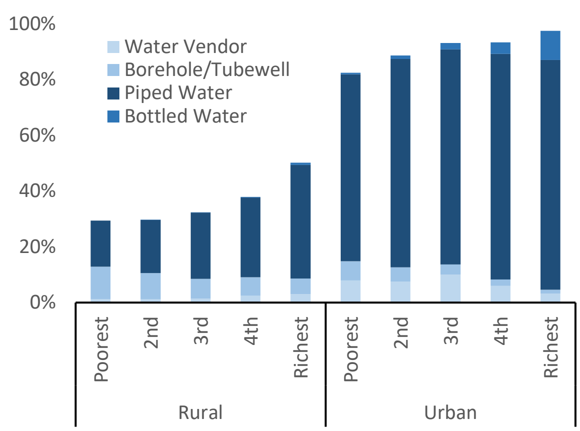
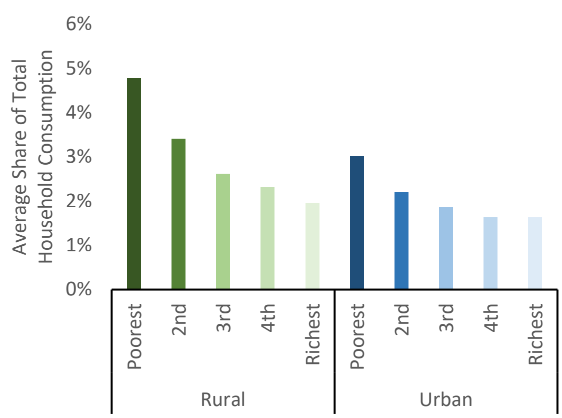


Figure 6: Budget share of water service provider, water vendor and bottled water spending (2015/16)



Sources (both figures): World Bank calculations based on KIHBS 2015/16 data.

95. **Different price increases are used in this ex-ante analysis, as the final size of the increase in water tariffs is not known.** As households seek to maintain the same welfare levels (and water consumption) prior to a price increase, they must reduce other expenditures. This reduction in expenditures provides an estimate of the welfare loss households experience due to the price increase.[27] To calculate the welfare loss, the analysis considers the direct effect where the loss in welfare equals the increase in the cost of the water consumed by households at the new higher price.[28] The magnitude of the price increase

[26] The pattern could arise from a combination of factors. For those using piped water, consuming small quantities of water can be more expensive per unit. For example, in Nairobi, consuming 4 cubic meters of piped water per month would cost a flat rate of KSh 204 or Ksh 51 per cubic meter whereas consumption of 8 cubic meters will cost Ksh 53 per cubic meter (see https://www.nairobiwater.co.ke/water-tariffs/). Another factor could be a low income elasticity or responsiveness of water consumption to income. Another reason could be that the less well-off rely on more expensive, non-piped, sources of water.

[27] The impact of changes to abstraction charges on water expenditure is simulated on the KIHBS 2015/16 data scaled forward to 2021 to account for the impact of COVID-19. Budget shares of water expenditure (mineral water, water service providers, and water vendors) from 2015/16 household consumption are increased by 5 to 100 percent in 5 percentage point increments. The additional expenditure to maintain the same level of consumption is calculated as the difference between the amount spent using the unadjusted 2015/16 budget share and 2021 household consumption and the adjusted budget shares and 2021 household consumption. This additional expenditure is then deducted from the 2021 household consumption to calculate the consumption loss from the price increase.

[28] These direct effects can be considered as upper bound estimates of the welfare impact since households have the option to cut back on water consumption (and thereby conserve water use) or substitute to cheaper water sources.

(determined by the increase in abstraction charges) will affect the size of the welfare losses. The welfare losses are benchmarked in two ways: the first approach is to assess the share of total welfare losses borne by each income quintile; the second approach is to benchmark the welfare losses to each quintiles' own total spending or budget.

96. **While the overall impact on poverty is expected to be contained in all scenarios, urban residents will be the most impacted.** Despite accounting for a smaller share of the population, urban residents will bear the largest share of welfare losses associated with water price increases. Within urban areas a larger share of the welfare losses will be borne by richer households. The average consumption loss as a share of their own total budget is small in all scenarios analyzed. Nevertheless, the relative loss in welfare will be larger among urban households compared to rural households, and greater for the poorer households, with the largest average consumption loss equaling just under 2 percent of total household consumption among the poorest urban households (Figure 7). Given the relatively small consumption loss, particularly among those above the poverty line, the increase in water expenditure budget shares has little impact on poverty in rural and urban areas (Figure 8).

Figure 7: Average Consumption Loss as Share of Total Spending for an Increase in Water Expenditure Budget Share – Different Increase Scenarios

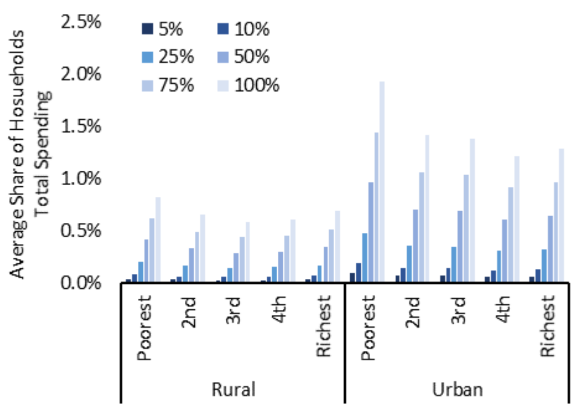
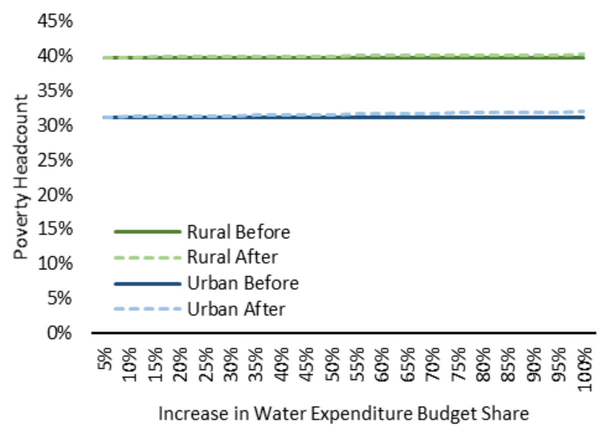


Figure 8: Poverty Impact



Note: The water expenditure budget share for each household is increased by 5 to 100 percent in 5 percentage point increments. The consumption loss is the amount needed to maintain the same level of consumption.
Sources (both figures): World Bank calculations based on KIHBS 2015/16 data.

97. **The recent Systematic Country Diagnostic for Kenya finds that access to safely managed water, sanitation, and hygiene (WASH) services is a major impediment to development of human capital.** Kenya's Ministry of Health estimates that 75 percent of the country's disease burden can be attributed to inadequate sanitation practices and unsafe drinking water. It is likely that poor access to WASH services is creating a drag on the Kenyan economy by reducing human capital through premature death, reduced working hours and productivity while ill, and the cost of medical treatment. Poor sanitation is also linked to childhood stunting, which can affect educational attainment and long-term productivity. The SCD thus recommends that Kenya should increase investment in safely managed WASH infrastructure and institutions to help develop human capital and combat COVID-19. The improvements in the sustainability and quality of water management supported by this operation are expected to increase access to water and sanitation services for an additional 300,000 Kenyans, contributing to an improvement in human capital and increasing welfare.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

98. **Kenya's national environmental legal and institutional framework is broadly aligned with good international practices.** The framework is defined by the 2013 National Environment Policy and the 1999 EMCA (amended in 2015) that established the National Environment Management Authority (NEMA). The Ministry of Environment and Forestry (MoEF) is responsible for establishing policy guidelines on environmental, forest, and protection and conservation of natural resources. NEMA coordinates the environmental management activities undertaken by other lead agencies and promotes the integration of environmental considerations into the development of policies, plans, programs and projects.

99. **Since 1999, NEMA has adopted the Environmental Impact Assessment (EIA) as a management tool to screen projects that may pose adverse impacts on the environment.** The second schedule of the EMCA requires that government, donors and private sector proponents conduct and submit an EIA report to NEMA for review prior to being issued a license. The EMCA provides for public participation as a mandatory component in the process of developing an EIA study report. Project proponents must provide persons who may be affected by the project with information regarding the project, its anticipated effects, and benefits. The EMCA requires that all policies, plans, and programs that are to be implemented by national, regional, county or other proponents, and which are determined by NEMA as likely to have significant effects on the environment, be subjected to a Strategic Environmental Assessment (SEA). Also, the EMCA provides for environmental audits; these include self-audits which are conducted on the initiative of the proponent of the project within 12 months of the commencement of the project or within 24 months of the completion of the project, or control audit that is conducted at the initiative of NEMA whenever it deems it necessary to ensure that a project is complying with the conditions of the license or to confirm self-audit findings. NEMA may also be petitioned to conduct an audit by members of the public. Both types of audits are required to be conducted by registered environmental auditors.

100. **The EIA recommendations and the license conditions are reasonably monitored and enforced by NEMA.** Several investment activities have been queried and stopped due to environmental concerns by NEMA. Interested parties can appeal to the National Environmental Tribunal (NET) to adjudicate NEMA decisions to issue or deny EIA licenses. NET on several occasions has set aside NEMA decisions to award or deny EIA licenses. Also, the public or concerned individuals can lodge petitions with the Environment and Land Court for determination. Therefore, all environmental and social risks and negative impacts for any future or existing project could be managed, and potential adverse impacts could be reduced to an acceptable level through the required ESIAs. This national environmental framework is currently strengthened by the World Bank's environmental and social operational policies on sector investment projects supported by the World Bank. However, a key challenge is weak or nascent environmental management systems and low compliance with the environmental provisions at the county level due to the devolution of certain environmental responsibilities to the counties.

101. **Policy actions related to the reforms to strengthen PIM are expected to result in positive environmental impacts overall.** The implementation of the PIM-related reforms is expected to enhance environmental risk management concerning the national infrastructure portfolio by ensuring that selected public investments meet project readiness criteria before implementation. This will include projects incorporating environmental considerations in the engineering designs, timely preparation of environmental and social impact assessments (ESIA), adequate environmental safeguards capacity during

implementation, and committing resources for monitoring of the environmental and social management plans (ESMPs).

102. **Policy actions related to the reforms to strengthen Climate and Environmental Governance are expected to result in more resilient projects and positive environmental impacts.** The EIA is a legal requirement under the current EMCA. Climate Change has not systematically been integrated to the EIA process. The revised EMCA as supported by the proposed operation will contribute to enhanced coordination and collaboration between county and national governments in the management of environmental issues. The reforms will incorporate Integrated Environmental Impact Assessment (IEIA), which will among other aspects promote the mainstreaming of climate change issues in the EIA process, and this will improve projects' resilience to climate change.

103. **Policy actions, institutional reforms and supporting regulations in the water, sanitation and irrigation sector supported by the DPF are expected to enhance management of water resources, water basin catchment conservation and food security.** The implementation of the regulations is expected to protect water quality and quantity, sustainably allocate water resources in water-stressed basins and ensure efficient management of water resources. These reforms will support the creation of water resource committees that will be charged with the management of water resources within their respective water basins. Also, the water resources committee (WRC) will advise the water resources authority (WRA) and county government, among others, on conservation, use and apportionment of water resources, review the basin water resources management strategy and the granting and cancelling of permits. The WRC will be appointed by the WRA and the Counties where the basin is located, and the appointment will reflect among other things gender, regional and ethnic diversity. The rapid expansion of irrigation and water storage could potentially lead to environmental impacts such as deforestation, land degradation, waterlogging, salinization of the soils, increased water-borne diseases, and biodiversity reduction. Before implementing the activities, the implementing agencies shall undertake project-specific EIA. This requirement provides a safeguard against potential negative environmental impacts. Moreover, as a direct result of the regulatory reforms, both WRA and the general public will have improved access to water resources information to inform environmental impact assessments. The new regulatory regime also strengthens WRA's capacity to control pollution and watershed degradation. The introduction of new water abstraction charges and water conservation levies will enhance the concept of payment for ecosystem services on the water resources conservation efforts and provide incentives for meaningful and measurable sustainable water resources management.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

104. **Kenya maintains good standards of budget transparency.** The general budget is made available on the National Treasury's website. 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 and the National Government Budget Implementation Report.

105. **The PFM system, together with government's commitment to improve PFM performance through various initiatives, provide reasonable assurance that the government 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 Integrated Financial Management Information System (IFMIS) in all line ministries and counties; well trained and qualified accountants and budget officers in the National Treasury and MDAs; and a functioning Internal Audit Department and independent Supreme Audit Institution, the Office of the Auditor General (OAG). Areas for improvement include delays in the rollout of some of the IFMIS modules; integration of IFMIS with some GoK information technology (IT) systems remains pending; review and enhancing of IT controls in IFMIS; automation of consolidation of MDAs' financial statements; and delays in submission of audit reports to Parliament. The government 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 Governance for Enabling Service Delivery and Public Investment in Kenya (P161387) and the Kenya Accountable Devolution Project (P149129) by use of targeted Disbursement Linked Indicators addressing the areas of weakness. As a result, there has been further strengthening in the areas of (i) improved prioritization and management of public investments; (ii) improved borrowing and cash management practices to enable reliable funding for service delivery and investment projects; (iii) consolidation of staff data for better human resource management; (iv) timeliness and quality of financial statements; and (v) quality of external and internal audit practices.

106. **The CBK continues to maintain effective operational controls.** The FY2018/19 and FY2019/20 OAG audit reports did not flag any weaknesses in the CBK's internal audit function and internal controls. The CBK received clean audit reports from the OAG for both years. The OAG completed the audit reports for FY2018/19 and FY2019/20 and the audit certificates were issued on July 30, 2020 and September 22, 2020 respectively. The FY2018/19 audit report was delayed to a lack of an Auditor General after the seat fell vacant in August 2019. The incumbent was eventually appointed in July 2020. An IMF Safeguards Assessment was conducted in 2019.

107. **Loan and 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 government 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 government, which the government then uses to make payments for its budget expenditures; or (iii) a combination of these approaches.

108. **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 payments.

109. **Once the funds enter the government's foreign exchange reserves and the budget, they will be comingled with the government'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 loan and 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 loan and credit proceeds, as defined in the Loan Agreement and the Financing Agreement. If any portions of the loan and credit are used to finance ineligible expenditures as so defined in the Financing Agreement and 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 loan and credit.

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

111. **Audit Arrangements:** 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 and IBRD funds are credited (both the US$ and local currency) and related transactions, audited on the basis of audit terms of reference 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

112. **The National Treasury and Planning will be the coordinating institution for monitoring and evaluation among all the participating MDAs for this DPF.** The institutional and policy reforms supported by the programmatic DPF series fall under the purview of 12 ministries and agencies. These are: Central Bank of Kenya, Energy and Petroleum Regulatory Authority, Kenya Power and Lighting Company, Ministry of Energy, Ministry of Environment, Ministry of Health, Ministry of Lands and Physical Planning, Ministry of Water and irrigation, National Lands Commission, National Treasury and Planning, National Hospital Insurance Fund, and the Public Procurement and Regulatory Agency. The National Treasury and Planning chairs the multi-sector coordinating committee established to oversee 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.

113. **The results framework presented in Annex 1 will be used as a monitoring tool by both the government 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 the results indicators are based on information which is routinely published by the government. 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 ministries and other stakeholders to ensure timely implementation and adequate monitoring

of indicators and outcomes of the program.

114. **Grievance Redress:** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB 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

115. **There is a substantial overall risk to the achievement of the intended development results, driven by substantial political and governance, macroeconomic, and stakeholder- and pandemic-related risks.** The program is being undertaken in the context of high uncertainty generated by the ongoing pandemic, adding complexity to the economic, political and institutional capacity backdrop for the implementation of the reforms.

116. **Political and governance risk is substantial.** Kenya's political environment has improved following the settlement after the presidential election of October 2017, yet vulnerabilities remain. There is renewed high-level commitment to tackle corruption, presenting an opportunity to learn from past efforts and make continued progress on effectively implementing devolution following the radical 2013 reforms. However, political and governance risks could complicate the reform path, particularly if fiscal consolidation efforts, as well as politically sensitive reforms, run into resistance or are reoriented to favor connected groups. To help mitigate these risks to the DPF results, the World Bank and other development partners support measures to improve governance by addressing the bottlenecks to improved economic management and service delivery. The DPF is complemented by operations such as the GESDeK PforR 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 (P167841), a multi-donor trust fund, supports counties in PFM and service delivery. The DPF and complementary operations will help maintain the positive trajectory in Kenya's fiduciary and other governance systems.

117. **Macroeconomic risk is substantial.** Kenya's medium-term economic prospects are good, benefiting from a relatively diversified economy with a potential real annual growth rate on the order of 5 percent. There is a risk, however, that the pandemic causes more severe long-term economic scarring than anticipated. This possibility contributes to the substantial fiscal risks Kenya faces. The fiscal deficit expanded to 8.2 percent of GDP in FY2020/2021, public debt increased to 68.2 percent of GDP, and while debt remains sustainable under baseline assumptions, the risk of debt distress is high. Crucially, the government remains focused on tracking back to fiscal consolidation and reducing debt-to-GDP to about

50 percent over the medium term. However, if fiscal slippage does occur and the public finances weaken further, this could undermine results. Specifically, in such a scenario, the reform efforts to strengthen the finances of key public entities (such as KPLC) could be negated. Mitigating this risk, many of the reforms supported by this operation contribute directly to reducing macroeconomic and fiscal risks, by supporting fiscal performance and consolidation efforts, and by reducing fiscal risks emanating from SOEs. These include the measures to strengthen public procurement, public investment management, and the domestic debt market, as well as sector reforms to strengthen the financial and operational performance of key entities (KPLC in energy, NHIF in healthcare, and improved financing in the water sector).

118. **Stakeholders risk is substantial.** The implementation of some of the reforms supported by the proposed operation could encounter opposition from some stakeholders. In particular, the increase in water abstraction charges, while needed and well below affordability thresholds, could be contested by some user groups. To mitigate these risks, key stakeholders should continue to be engaged and informed about the reforms, and the World Bank will support their sound implementation with existing, and potential additional, technical assistance and projects. Mitigation efforts may, however, be complicated by the political cycle, which does raise the residual risk in this area and merits rating stakeholder risk as substantial.

119. **“Other” risks are defined as COVID-19 pandemic-related risks, and rated substantial.** The government has established a track record of undertaking difficult reforms, has been highly responsive to address priorities arising from the COVID-19 crisis, and is maintaining the momentum to achieve its ambitious development goals. However, as the pandemic and its economic effects continue to play out, the public health and economic situation remains fluid, and uncertainty is still elevated. With only about 20 percent of the adult population having been fully vaccinated as of the end of January, there are clear risks of future resurgences. This could impede Kenya’s economic recovery, reform implementation, and the achievement of results. In mitigation of this risk, the proposed DPF contributes to strengthening Kenya’s policy and institutional platform to continue navigating through the pandemic and recover, as part of an overall WBG program geared towards helping the government respond rapidly and effectively.

Table 6: 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	Substantial
9. Other	Substantial
Overall	Substantial

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions and Triggers		Results		
Prior Actions under DPF 1	**Prior Actions for DPF 2**	**Indicator Name**	**Baseline (2020)[29]**	**Target (by 2023)**
Pillar 1: Fiscal and debt reforms to make spending more transparent and efficient, and enhance domestic debt market performance				
Prior Action 1: To establish the legal framework for government procurement to move to a transparent electronic platform (E-GP), the Recipient has issued the Public Procurement and Asset Disposal Regulations 2020.	**Prior Action 1:** To strengthen the transparency of public procurement and reduce opportunities for corruption, the National Treasury has approved the E-GP policy framework, which includes the E-GP: (i) Strategy (ii) Implementation Roadmap (iii) Business Model and (iv) Business Processes and Specifications.	1. More transparent procurement spending: Number of Government Ministries, Departments and Agencies procuring all of their goods and services on the E-GP platform.	0	5
Prior Action 2: To strengthen public investment management, the Recipient's Cabinet has approved the Public Finance Management (Public Investment Management) Regulations of 2021, covering all phases of the public investment project cycle, including the provisions relating to the identification, economic appraisal, selection, implementation, and monitoring and evaluation of all proposed, active and completed projects.	**Prior Action 2:** The Cabinet has taken a decision for rationalizing the public investment project portfolio, using criteria that include: (i) the completion progress of the project, (ii) the adequacy of financing needed to complete the project beyond the current budget cycle, (iii) the priority status of the project considering development priorities, and (iv) the availability of sufficient data on the project to measure implementation progress and impact.	2. A more efficient public investment portfolio: Number of projects complying with PIM Regulations.	0	30 ongoing projects; and all new projects included in the Budget

[29] Baseline as of 2020 unless otherwise specified.

Prior Actions and Triggers			Results	
Prior Actions under DPF 1	**Prior Actions for DPF 2**	**Indicator Name**	**Baseline (2020)[29]**	**Target (by 2023)**
Prior Action 3: The Recipient's central bank (CBK) has approved and issued the auction rules and guidelines for the issuance of Kenyan government securities, to add clarity and transparency in the primary domestic debt market.	**Prior Action 3:** To strengthen the domestic bond yield curve and increase secondary market liquidity through a transparent and active structured issuance strategy that ensures regular, predictable benchmark-bond issuances linked with active liability management, the Central Bank of Kenya has adopted and published the Guidelines for, and is implementing, the Treasury Bonds Benchmark program.	3. A more liquid debt capital market: Minimum benchmark bond size.	N/A	Bonds with remaining maturity up to 5 (10) years: KES 50 (75) billion
Pillar 2: Electricity sector and PPP reforms to strengthen the cornerstone utility (KPLC), place Kenya on an efficient, green energy path, and boost private infrastructure investment				
Prior Action 4: To move closer to electricity sector cost-recovery, i) the Recipient's Energy and Petroleum Regulatory Authority (EPRA) has allowed the following in the retail tariff: a) higher system loss provision for pass-through items (fuel cost, foreign exchange, inflation) for KPLC; and b) full pass-through of power purchase costs from new capacity PPAs; and ii) The Recipient's National Treasury has provisioned for KSh5 billion in the supplementary FY2020/21 budget for partial clearance of outstanding receivables against the last mile electrification program.	**Prior Action 4:** To improve the operational and financial performance of KPLC: (i) a competitive selection process for the Managing Director of KPLC has been introduced with the process initiated for the currently vacant position, (ii) a revenue protection program (RPP) covering high value consumers is being implemented.	4. More financially sustainable electricity distribution: Proportion of KPLC revenues to the revenue requirements computed by KPLC and agreed with EPRA.	87 percent	90 percent

Prior Actions and Triggers		Results		
Prior Actions under DPF 1	**Prior Actions for DPF 2**	**Indicator Name**	**Baseline (2020)** [29]	**Target (by 2023)**
Prior Action 5: To allow competitive procurement of renewable energy and to reduce the cost of supply, the Recipient's Ministry of Energy has approved and published a) a Feed in Tariffs (FiT) policy to include only small hydro, biomass and biogas technologies and restricted the generation pipeline to include only projects that have a signed PPA as of March 29, 2021; b) a Renewable Energy Auctions Policy for solar and wind.	**Prior Action 5:** The Ministry of Energy has approved a five-year power generation and transmission development plan (2021-2026) to guide the competitive procurement of clean energy, at least-cost and aligned with demand.	5. More efficient electricity supply: Pipeline electricity capacity terminated or deferred to better match supply and demand.	Not applicable	400 MW
Prior Action 6: To prevent a build-up of excess capacity and support the transition to a greener energy system, the Recipient's Ministry of Energy has updated the Least Cost Power Development Plan (LCPDP) 2021-2030.		6. Cleaner electricity supply: Percentage of electricity generated from fossil fuels.	11 percent (2019)	5 percent
	Prior Action 6: The Borrower has enacted the Public Private Partnerships Act (2021), to enhance project selection and implementation processes, and clarify the roles and responsibilities of key participants in the PPP cycle, for efficient and timely delivery of PPP projects.	7. Accelerated private investment in infrastructure: Number of PPP projects that have achieved at least one additional milestone (RFQ, RFP, negotiations or contract signing).	0	10

Prior Actions and Triggers			Results	
Prior Actions under DPF 1	**Prior Actions for DPF 2**	**Indicator Name**	**Baseline (2020)** [29]	**Target (by 2023)**
Pillar 3: Strengthen environmental and natural resource governance, combat climate change, and improve healthcare including pandemic response				
Prior Action 7: The Recipient has approved its updated NDC, with increased and accelerated mitigation commitments by 2030 (with 2025 milestones), and submitted it to the secretariat of the United Nations Framework Convention on Climate Change.	**Prior Action 7:** In order to enhance environmental management and mainstream climate change governance, the Cabinet has approved the Environmental Management and Coordination Bill (2022).	8. Mainstreaming of climate change: Number of Counties with County Climate Change Action Plans developed through participatory methodologies endorsed by county governments.	8 of 47	25 of 47
	Prior Action 8: To equip county governments to mobilize own-source revenues based on property and to improve land price transparency, the Cabinet has approved the National Rating Bill.	9. A more transparent land market: Number of County Value Maps prepared and submitted to Parliament.	0 of 47	15 of 47
Prior Action 8: To ensure prudent management and development of Kenya's scarce water resources, the Recipient has through its Cabinet approved (i) a new National Water Policy; and (ii) regulations for the implementation of the Water Act 2016 and the Irrigation Act 2019.	**Prior Action 9:** To enhance access to water and sanitation services, and improve the management and conservation of water resources: (i) the MoWSI has approved the medium-term framework for a National Water and Sanitation Investment Program (NAWASIP); (ii) the Water Resources Authority has designated six basin areas under section 24 of the Water Act 2016; and (iii) the MoWSI has stipulated new water use charges and water conservation levies.	10. Water and sanitation access gap narrowed: Number of people gaining access to improved water and sanitation services. 11. WSS gender equity knowledge gap filled: national data and information system capturing gender-disaggregated WSS data annually. 12. Enhanced water resource management: Proportion of the Water Resources Authority (WRA)'s annual operating costs financed through water abstraction revenues.	0 Not in place 20 percent	300,000 In place 70 percent

Prior Actions and Triggers		Results		
Prior Actions under DPF 1	**Prior Actions for DPF 2**	**Indicator Name**	**Baseline (2020)**[29]	**Target (by 2023)**
Prior Action 9: The Recipient has submitted to its Parliament the National Hospital Insurance Fund (Amendment) Bill, 2021 which seeks to align the National Hospital Insurance Fund's mandate with the goal of universal health coverage (UHC), and strengthen its governance and performance.	**Prior Action 10:** To strengthen Kenya's infectious and non-infectious disease prevention and response capabilities, including by consolidating existing public health emergency preparedness and response functions under one authority, the Borrower has established the Kenya National Public Health Institute (NPHI).	13. Expanded access to healthcare: Number of poor and vulnerable households covered through government-financed health insurance subsidies. 14. Enhanced health system capacity, including against pandemics: Capacity to respond to public health events and emergencies based on IHR States Parties Annual Reporting Tool.[30]	223,968 43 percent (2019)	1,000,000 65 percent

[30] See: *https://extranet.who.int/e-spar#capacity-score*

ANNEX 2: FUND RELATIONS ANNEX

IMF Executive Board Completes the 2021 Article IV Consultation and Second Reviews of the Extended Arrangement under the EFF and ECF Arrangements for Kenya[31]

December 17, 2021

The IMF Executive Board today completed the 2021 Article IV consultation and Second reviews of the EFF/ECF arrangements with Kenya, allowing for an aggregate immediate disbursement equivalent to about US$ 258.1 million for budget support.

- The Kenyan authorities have continued to show strong commitment to their reform agenda in a challenging environment and are acting to reduce debt vulnerabilities while maintaining support for the economic recovery.
- They have maintained careful control of government spending to limit the deficit and are taking steps to reform state-owned enterprises (SOEs) to limit pressure on the budget while protecting social programs.

Washington, DC: The Executive Board of the International Monetary Fund (IMF) completed today the 2021 Article IV Consultation and the Second reviews of the 38-month Extended Arrangement under the *Extended Fund Facility* (EFF) and 38-month arrangement under *Extended Credit Facility* (ECF) for Kenya. The Board's decision allows for an aggregate immediate disbursement of SDR 185 million (about US$ 258.1 million), bringing Kenya's total disbursements for budget support under the arrangements to about US$ 972.6 million.

enya's EFF/ECF arrangements for a total of SDR 1,655 billion (305 percent of quota) or about US$ 2.34 billion at the time of program approval on April 2, 2021 (see *Press Release 21/98*), are aimed at supporting Kenya's program to address debt vulnerabilities and their response to the COVID-19 pandemic and at enhancing governance.

Kenya showed remarkable resilience to the COVID shock in 2020 and is staging an economic recovery. Growth is now estimated to accelerate to 5.9 percent in 2021. Kenya's COVID-19 vaccination program has picked up speed in the second half of 2021, though uncertainty and pandemic-related pressures will persist until vaccinations become widely available. The political calendar is also a source of uncertainty.

Kenya's economic program aims to reduce debt vulnerabilities through multi-year fiscal consolidation efforts centered on raising tax revenues and tightly controlling spending, while safeguarding resources to protect vulnerable groups. The FY21/22 budget delivers on these objectives. A supplementary budget is being prepared, consistent with the flexibility built into the EFF/ECF arrangements, to expand the authorities' COVID-19 vaccination program, support the SOE reform plan and execute emergency spending related to the drought in the northern regions and security. Given Kenya's limited fiscal space, the authorities are proactively managing difficult trade-offs with the view to reduce debt vulnerabilities by

[31] https://www.imf.org/en/News/Articles/2021/12/17/pr21387-kenya-imf-exec-board-completes-2021-art-iv-consultation-2nd-rev-extended-arrangement-eff-ecf

rationalizing non-priority spending to offset half of the impact of SOE support on the deficit, in line with program commitments.

Kenya has also made notable advances on its structural reform and anti-corruption agendas. Fiscal governance and transparency will be bolstered by the authorities' action plan to address legal impediments that prevented the publication of beneficial ownership information related to public procurements and by planned audits of COVID-19 vaccine spending and of FY20/21 expenditure with a focus on COVID-19-related spending. As part of their strategy to address challenges in the SOE sector and put firms on a financially viable footing, the authorities are formulating robust restructuring strategies with safeguards to protect the Exchequer's financial interest. The authorities also plan to further enhance their monetary policy framework and to continue supporting financial stability.

At the conclusion of the Executive Board's discussion, Ms. Antoinette Sayeh, Deputy Managing Director and Acting Chair, made the following statement:

"The Kenyan authorities remain firmly committed to their economic program in a challenging environment. The program performance has been robust. All quantitative targets were met – the FY 2020/21 outturn overperformed – and all 2021 structural benchmarks are now completed except one.

"The authorities should continue executing their multi-year fiscal consolidation plan to reduce debt vulnerabilities. Some additional fiscal space is needed in FY21/22 for emergency spending to face the drought in the north and emerging security needs; the planned supplementary budget should also provide resources for expanding COVID-19 vaccinations and SOEs support, in line with program design. Strengthening domestic revenue mobilization, maintaining expenditure control while protecting priority social spending and improving spending efficiency will remain essential. Bold political commitment by all levels of government is needed to ensure the FY22/23 budget is aligned with the authorities' program.

"Proactive efforts to address fiscal risks from state-owned enterprises (SOEs) should continue. Financial support to SOEs will require difficult tradeoffs and adequate safeguards given Kenya's limited fiscal space and the need to maintain debt sustainability.

"Further strengthening fiscal transparency and governance requires more proactive efforts. The authorities should address legal impediments to begin publishing beneficial ownership information for awarded public tenders in early 2022 , proceed with planned audits of COVID-19 spending, and promptly act to follow up on previous audits.

"Well-calibrated Central Bank of Kenya policies have supported economic resilience and the banking sector. The stance of monetary policy should remain accommodative as long as inflation expectations remain well anchored.

"The program is subject to increasing global and domestic risks, including from the pandemic, tightening global financing conditions, and potential pressures from the upcoming political calendar. Kenya's medium-term prospects remain positive, and the authorities' continued commitment to their economic program is essential to maintain macroeconomic balance, while ensuring a more sustainable, greener, and inclusive growth."

ANNEX 3: LETTER OF DEVELOPMENT POLICY

REPUBLIC OF KENYA
THE NATIONAL TREASURY AND PLANNING

Telegraphic Address: 22921
Finance – Nairobi
FAX NO. 310833
Telephone: 2252299

THE NATIONAL TREASURY
P O BOX 30007-00100
NAIROBI
KENYA

When Replying Please Quote

Ref: NT/PDMO/RMD/09/02/01 'G' (13)

2nd February, 2022

David Malpass
President
World Bank Group
1818 H Street, N.W.
Washington D.C. 20433
UNITED STATES OF AMERICA

Dear President,

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 Credit from the International Development Association (IDA) and Loan from the International Bank for Reconstruction and Development (IBRD). This is the second in a programmatic series of two Development Policy Operations aimed at supporting policy and institutional reforms which are critical to the government's efforts to restructure in the wake of the COVID-19 crisis, and to achieve a resilient recovery. The Government of Kenya's medium term inclusive growth agenda and economic recovery strategy prioritizes reforms in four areas comprising Electricity; Human capital; Natural capital and the Fiscal sector.

2. This Development Policy Operation (DPO) helps to advance the Government of Kenya's (GoK) inclusive growth agenda and resilient recovery by supporting policy and institutional reforms that aim to: (i) strengthen the cornerstone energy distribution company - Kenya Power Lighting Company (KPLC) and place Kenya on an efficient green energy path; (ii) strengthen Kenya's health and education sectors; (iii) unlock investment and drive an inclusive, resilient, and green recovery; and (iv) support more transparent spending, unblock Public Private Partnerships (PPPs), enhance revenues, as well as strengthen public debt management. The reforms also orient Kenya's economic recovery path towards green growth (e.g., least-cost, clean energy investment) and climate change mitigation and adaptation (e.g., through the revision of Environmental Management and Coordination Act (EMCA) and strengthening Water Resources Authority (WRA) capacity to regulate the water sector).

1

Macroeconomic Performance and Developments

A. Recent Economic Developments

3. **Kenya showed remarkable resilience to the 2020 COVID-19 shock and is staging an economic recovery.** As a result of the pandemic, the economy contracted by 0.3 percent in 2020 following the adverse impact of COVID-19 pandemic and the resultant containment measures. The Government's priority was premised on the need to safeguard the lives of Kenyans while at the same time cushioning the economy from the effects of the COVID-19 pandemic. The health crisis required the introduction of temporary restrictive measures to curb the spread of the virus which resulted in negative impacts on some key sectors of the economy. Many businesses especially those related to tourism and educational activities closed down during the second quarter of 2020.

4. **The economy recovered strongly in the first three quarters of 2021, as economic activity picked up following the easing of COVID-19 restrictions, reopening of the economy as well as targeted stimulus interventions by the Government**. The economy grew by 9.9 percent in the third quarter and 11.9 percent in the second quarter from a growth of 2.0 percent in the first quarter. This growth was supported by continued recovery in manufacturing, transport and storage, education, accommodation and food services, and wholesale and retail trade. However, agricultural production was constrained during the period due to drought conditions in most parts of the country. Overall, the economy is estimated to expand by more than 7.3 percent in 2021 from a contraction of 0.3 percent in 2020.

5. **The economic recovery is expected to continue with real GDP growth projected at 5.8 percent in 2022 and above 6.0 percent over the medium term**. This growth outlook will be supported by the ongoing vaccination drive, prevailing stable macroeconomic environment, favourable weather conditions to support agricultural output and the recovery in industry and services sectors. Additionally, this outlook will be reinforced by the ongoing implementation of the strategic priorities of the Government under the "Big Four" Agenda and Economic Recovery Strategy. The successful implementation of the Economic Recovery Strategy, which is also aligned to the "Big Four" Agenda, will restore the economy to a strong growth path, creating jobs and economic opportunities across all regions of the country with a view to tackling social and income inequalities.

6. **The economy continues to register macroeconomic stability in the midst of the COVID-19 Pandemic as demonstrated by various indicators**. Inflation remains well anchored and within Government target range. The inflation rate was at 5.7 percent in December 2021 from 5.6 percent in December 2020 and is expected to remain within the target range in the near term. Interest rates have remained low and stable while lending to the private sector by banks has picked up with the credit expanding by 8.3 percent in the 12 months to December 2021. The Government rolled out a Credit Guarantee Scheme in December 2020, boosting lending to the Micro Small and Medium sized Enterprises (MSMEs).

7. **The external sector has generally been resilient buoyed by strong remittances and robust performance of agricultural products, especially tea and horticulture goods exports**. The

current account deficit is projected at 5.2 percent of GDP in 2021 and 2022, from an estimate of 4.8 percent of GDP in 2020. The foreign exchange market has largely remained stable with the official foreign exchange reserves currently at USD 9,632.2 million (5.8 months of import cover), providing adequate buffer against short term shocks in the foreign exchange market.

8. **On fiscal performance, revenues have been steadily recovering.** The Government is committed to a fiscal consolidation path in order to reduce the level of the fiscal deficit and stabilize growth of public debt. The economic slowdown and tax relief measures that were implemented in the first half of FY2020/21 led to a large decline in revenues. However, noting recovery in business activities, the Government unwound most of this temporary tax relief in January 2021 (except relief for taxpayers in the lowest personal income tax bracket). As a result, revenues have rebounded registering a strong growth of 24.2 percent in the first half of FY 2021/22 compared to a contraction of 12.9 percent recorded in similar period in the FY 2020/21. The strong performance is expected to continue in the FY 2021/22.

9. **Expenditure remains broadly steady in FY2021/22 in support of the economic recovery and management of the pandemic.** During FY2020/21, both recurrent and development expenditure decreased relative to nominal output, reflecting expenditure prioritization and cost cutting measures, including reduced transfers to parastatals, that were initiated before the pandemic to implement fiscal consolidation. However, the Government increased spending on health, social protection, and economic stimulus measures to help manage the pandemic. First half data for FY2021/22 show that expenditure declined to 10.3 percent of GDP compared to 10.7 percent of GDP in the first half of FY 2019/20, consistent with the Government's economic stimulus program and economic recovery strategy. In this regard, the target fiscal deficit for FY 2021/22 of 8.2 percent of GDP is expected to decline to 6.0 percent of GDP in FY 2022/23 and further to 3.2 percent of GDP by FY 2025/26. Fiscal consolidation will be achieved by raising revenue and reducing unproductive expenditures while protecting developmental spending.

10. **The outlook faces risks. Emergence of new Covid-19 variants, in Kenya or its trading partners, may trigger reinstatement of containment measures leading to renewed disruptions to trade and tourism**. Though global economic prospects have improved in recent months, largely supported by the deployment of vaccines and strong policy measures, the outlook remains uncertain, due to concerns over the new and more transmissible Omicron variants, higher than anticipated energy prices, rising inflation expectations and tighter external financing conditions. Additionally, weather related risks could adversely affect agricultural production.

B. Fiscal Policy and Framework

11. **Kenya's fiscal policy path aims at balancing the near-term need to support economic revitalization and tackle the challenges that emerged with the COVID-19 shock against the imperative of reducing debt vulnerabilities over the medium term.** The Government is accelerating the vaccination program and focusing on meeting the health and economic needs of the population. Response efforts have therefore been carefully prioritized to limit further buildups in sovereign debt. With the receding of the pandemic, the focus of fiscal policy has shifted to reducing the level of the deficit and putting debt on a downward path. This will help

lower financing risks and facilitate the expansion of credit to the private sector, supporting growth.

12. **Revenue performance will be underpinned by the on-going reforms in tax policy and revenue administration**. In addition, the economic recovery occasioned by implementation of priority programmes under the Economic Recovery Strategy, the "Big Four" Agenda and other priority programmes outlined in MTP III (2018-2023) are expected to boost revenue. The Government continues to minimize tax expenditures and increase predictability in the tax system that will boost revenue performance through the following specific interventions:

- **National Tax Policy:** Complementing the planned tax policy initiatives, the Government is in the process of developing a National Tax Policy that will enhance administrative efficiency of the tax system, provide consistency and certainty in tax legislation and management of tax expenditure.

- **Medium-Term Revenue Strategy (MTRS):** The Government is developing a Medium-Term Revenue Strategy (MTRS) with a four-year time horizon to undertake comprehensive reforms of tax policy and revenue administration for eliminating tax gap by FY 2029/30 to mobilize adequate resources for financing development needs. The MTRS, together with public expenditures rationalization will support fiscal consolidation.

- **Streamlining Exemptions.** The Government is in the process of making the tax system more efficient by streamlining exemptions. Total tax expenditures have been on a downward trend over the last four years. In 2020, total tax expenditures amounted to 2.96 percent of GDP, a decline from 5.15 percent of GDP in 2017. To ensure sustainability and value for money from the resources forgone through tax expenditure, the Government will continue to upscale efforts to rationalize and harmonize the tax expenditures with the aim of removing redundant tax expenditures and enhancing only those which promote investments.

13. **Expenditure Control:** The Government will continue to restrict growth in recurrent spending by cutting down on non-priority expenditures. Additionally, in order to ease the burden of pension payments in future, the Government will continue with implementation of the Superannuation Scheme for all civil servants below the age of 45 years rolled out in January 2021. The development budget is focused on completion of ongoing projects while the commencement of any new projects not approved by the National Treasury has been stopped.

14. **Financing:** External non-concessional financing will be confined to: (i) funding essential projects integral to our development program for which concessional financing is not available; and (ii) debt management purposes via operations that would result in both a reduction in the net present value of public debt and an improved debt service profile. Such external financing will complement our domestic financing and help prevent an unnecessary crowding-out of private sector credit.

15. **All the above measures are reflected in the 2022 Budget Policy Statement.** Aligned with the proposed program, the budget for FY 2022/23 targets total revenue projected at Ksh. 2,431.4 billion or 17.4 percent of GDP. This represents a 1.1 percent of GDP increase in tax revenues mainly supported by economic recovery. Total expenditure at Ksh. 3,324.4 billion or 23.7 percent of GDP in FY 2022/23 represented a 1.3 percent of GDP decline from the

previous year, as budgetary outlays for State Owned Enterprises (SOEs) and for COVID-related spending decline, reflecting continued tight expenditure control in other areas.

16. **For the subsequent years, we will continue revenue mobilization and tight expenditure control, with a view to reducing the budget deficit to 3.2 percent of GDP by FY 2025/26.** A key priority will be to raise the ratio of revenue to GDP to well above pre-COVID levels to create space for growth-enhancing investments and priority social spending. This will be achieved through tax policy measures, leverage on ICT to improve tax administration while progressively reducing recurrent expenditure as a ratio to GDP, by containing growth in the wage bill and in spending on goods and services, while keeping development spending steady.

C. Fiscal and Structural Reform Agenda

- **Fiscal reforms**

17. **Strengthening Public Procurement:** The Government is working diligently to strengthen the public procurement system (as reflected through the prior actions of the DPO series). The recent Public Expenditure Review (PER) by the World Bank identified significant potential for reducing transaction costs in government procurements and securing lower prices on account of further standardization and use of framework agreements in contracts. To this end, the Government is in the process of acquiring an e-procurement (e-GP) system that will be integrated to our Integrated Financial Management Information System (IFMIS) to automate application of the Procurement Act and Regulations. An agreed implementation strategy and roadmap for e-procurement was approved in September 2020. The competitive procurement of a system developer was temporarily delayed due to budget challenges, but an open international invitation to tender for the e-GP system software was advertised in August 2021 and the tender was closed in mid-September. A pilot of the new system will be initiated by July 2022 and the full rollout across Government Ministries, Departments, and Agencies (MDAs) planned by July 2023.

18. **Government Wage Bill:** Significant savings are expected from controlling the Government wage bill. To create much-needed fiscal space for priority social and development spending, the Government will continue with the proactive strategy to contain the ratio of the government wage bill to GDP. The target is to achieve a decline of 0.5 percentage points between FY2020/21 and FY2023/24. This will be accomplished through continued restraint in hiring and compensation. A key step in this direction was the decision to effectively implement a wage freeze for FY2021/22 and FY2022/23 by not adjusting basic salary structures, allowances, and benefits paid in the public sector for the first two years of the four-year period covered by the 3rd remuneration and benefits review cycle. In addition, the Government has maintained the policy of limiting new employment to priority areas and now requires all MDAs to obtain prior confirmation from National Treasury on the availability of funding before seeking approval for recruitment. Recruitment is subject to the availability of funding, consistent with the objective of a sustainable wage bill.

19. **Public Investment Management:** The Government remains focused on improving Public Investment Management (PIM) to deliver value for money in public capital expenditure. A framework for project appraisal and selection was developed as well as an automated project management information system. As part of this process, new PIM guidelines covering all

phases of the public investment cycle were issued through Treasury Circular No. 16 of 2019. Project proposals prepared by MDAs for review and approval by the National Treasury follow these guidelines. A key objective of our PIM framework is to ensure that the investment portfolio is efficiently managed and that all new projects are based on clearly defined criteria and pre-determined costing methodologies. Further, the National Treasury in collaboration with MDA's has recently carried out a stock-taking of Development project in nine Medium Term Expenditure Framework (MTEF) sectors and analyzed them using predetermined criteria. From the analysis it was found that a number of stalled projects needed to be rationalized to free up resources for post COVID-19 recovery, which was approved by the Cabinet under the current DPO.

20. **Public Financial Management (PFM):** The Government's development agenda is anchored on prudent management of available public resources. As such, the Government will continue to strengthen expenditure control and improve the efficiency and effectiveness of public spending through necessary public financial management reforms. Focus areas include strengthening budget processes, IFMIS functionality, commitment controls, and cash management. Having strengthened the IFMIS infrastructure, the Government is adding key functionalities to the system and enhancing controls. The Government has also introduced a new Cash Management Framework (previous DPO series) that involves regularly updated cash and debt plans approved by the Cash Management Committee.

21. **Public Debt Management:** As part of strengthening debt management, the Government is enhancing debt reporting, lengthening maturities, and avoiding bunching of repayments to mitigate refinancing risks. More generally, the Government is enhancing the structures and functions of the Public Debt Management Office (PDMO) to oversee debt management as envisioned in the PFM Law. To deepen the domestic debt securities market, the National Treasury is working with the Central Bank of Kenya (CBK) to implement several reforms. The Government has strengthened the auction management process by implementing the Treasury Mobile Direct platform for retail sale of government securities, and enabled auction of bids by banks through internet banking. Additionally, the Government is: (a) further strengthening market infrastructures and auction management processes for government securities by developing the Central Securities Depository System; (b) maintaining a smooth yield curve for domestic debt securities; (c) supporting the enhancement of market structure and conduct through treasurers and dealers of commercial banks; (d) lengthening the maturity profile of government debt securities; (e) enhancing transparency through publication of auction rules and guidelines (previous DPO in the current series); and (f) strengthening the bond benchmark building program under the current DPO. As a result of these efforts, the average time to maturity of outstanding treasury securities has increased from 7.7 years in June 2020 to 8.8 years in June 2021, with the ratio of T-bills to T-bonds moving from 30:70 to 20:80. Regarding external debt, the Government is proactively working to ensure increasing utilization of committed concessional financing while maintaining a presence in the international financial market. The Government has also established an Investor Relations and Donor Coordination Unit (IRU) to strengthen communication with external stakeholders. The IRU now has a page on the National Treasury website.

22. **G-20 Debt Service Suspension Initiative**: The Government's participation in the G-20 Debt Service Suspension Initiative (DSSI), including the relief provided for the second half of 2021,

has helped reduce financing pressures though yielding less than originally expected. During the first phase (January-June 2021) the Government obtained debt suspension of US$425 million (KSh 45.5 billion). During the second phase (July-December 2021), the Government of Kenya made a request to all its bilateral creditors for debt service suspension estimated at US$379 million. However, this amount is now projected to be lower at around US$89 million due to non-participation by some creditors.

23. **Public Private Partnerships (PPPs):** Given the limited fiscal space, the Government has revamped the PPP Unit in the National Treasury to support efficient and sustainable scaling up of the PPP program without undue fiscal risks. This has included the elevation of the unit to a Directorate and appointment of a Director-General for the PPP Directorate to provide strong leadership and strategic oversight. To ensure that only projects with the highest socio-economic returns are undertaken, the Government is in the process of creating and institutionalizing a joint PIM-PPP planning framework. This will help streamline the decision process of determining whether projects should be procured through the traditional public sector method or as PPPs. The Government is also strengthening coordination between PDMO, PIPM and the PPP Directorate for effective control of fiscal exposure, as envisioned in the PPP Act, 2021 (current DPO). The implementation of the revised institutional structure has progressed significantly. The new institutional structure was approved, and recruitment is underway. This will allow tapping private sector financing to support projects that will make important contributions to Kenya's key development objectives while effectively managing risks to the Exchequer through a strong project selection process.

24. **Pension Reform:** To put pensions on a sustainable footing, the Government has introduced a funded pension scheme for public sector workers, the Public Service Superannuation Scheme (PSSS). The Government is also increasing efficiency by re-engineering and digitizing the pension management system. This is being undertaken as part of the wider initiatives the National Treasury is pursuing, with the objective to transform the Public Service Pension ecosystem into a customer centered, modern and technologically-driven sector. The PSSS commenced on 1st January 2021 to replace the pay-as-you-go system over time. Participants in the PSSS include all new public sector employees who were below the age of 45 years as of 1st January 2021 those employed after that date. The PSSS allows, amongst other advantages, portability of pension benefits which facilities free movement of staff into and out of the public sector.

25. The Government has made inroads in assessing, monitoring, and addressing vulnerabilities in the SOE sector as per the set staged approach. As a result of in-depth financial evaluations conducted jointly with the IMF, the Government has identified a cumulative Ksh.383 billion liquidity gap over the next five years for 18 State Owned Enterprises (SOEs) involving the largest financial and fiscal risks (excluding Kenya Airways). This gap is expected to be primarily covered via SOE's cost saving measures. Kenya Airways (KQ) and Kenya Power and Lightning Company (KPLC) are the two companies with largest fiscal risks, and measures to improve the performance of the latter are under implementation including with the support of the current DPO.

26. The Government will continue to introduce further governance arrangements that enhance management and oversight of SOEs' financial pressures that were exacerbated by the COVID-19 pandemic and are still acute in many SOEs. The pressures have compounded pre-existing structural weaknesses in the sector, including overlapping mandates, poor financial

performance, and weak governance. To remedy this situation, a Strategy on SOE reforms has been completed that lays out concrete steps geared towards enhancing financial and operational efficiency and cost savings.

27. A Blueprint for Governance Reforms of State Corporations (SCs) was completed in July 2021. The Blueprint lists actions that will improve governance of SCs by reinforcing the separation of roles and responsibilities among institutions that exercise an oversight role. This includes an ownership role and a policy role for the National Treasury (NT) on behalf of the GoK to avoid the pitfalls of either passive ownership or excessive state intervention. The implementation of the Blueprint will strengthen GoK's ability to: (i) act as an informed and active owner; (ii) operate within a legal framework that is more favorable to commercial SCs' activities: and (iii) rely on good governance practices for the operations of SCs.

D. Achievements of previous operations

28. The previous DPO series supported policy and institutional reforms to advance the Government's "Big Four" Agenda which has achieved good results despite the COVID-19 crisis. Some of the results are as follows:

I. Under **the affordable housing pillar**, new regulations on mortgage refinancing have led to the establishment of Kenya's first mortgage refinance company, the Kenya Mortgage Refinance Company (KMRC). This has helped to crowd in at least $20m in private capital into the mortgage refinance market, with KMRC predominantly owned by 22 private shareholders (including the International Finance Corporation [IFC] and several financial co-operatives that cater specifically to middle and low-income borrowers). Further, regulatory reforms addressing challenges that inhibited the supply of housing units (Sectional Properties Act, Physical Planning Act, etc) together with various institutional and fiscal measures carried out by the government, have contributed to a pick-up in the construction of affordable housing units. Currently, there are over 36,691 affordable housing units at various stages of construction and another 384,162 in the planning stage. All these units are being provided through a combination of a public-private initiatives or entirely by the private sector. Conditional on the establishment of a planned Partial Credit Guarantee Scheme, banks will also be making KES 335bn (approx. $3.1bn) available for qualified home buyers. The Government has also implemented other measures/reforms to facilitate affordable housing program namely, provision of guidelines for land use, urban design and prices, VAT exemptions on importation and local purchase of goods for the construction, reduction of both corporate tax rate and import declaration fee and railway development levy, revised stamp duty Act to zero rate stamp duty for homeowners among others.

II. Under the **farmer incomes and food security pillar**, over 100,000 smallholder farmers so far have benefited from the new e-voucher program, enabling them to source certified agricultural inputs (fertilizer, seeds) at their nearest private agro-input dealer. This achieves more efficient targeting of support to farmers compared to the previous system whereby the government imported and distributed inputs, reducing distortions and rent-seeking opportunities in the agro-input market. In addition, the Warehouse Receipt Act and regulations have so far supported the issuance of 22 certificates of conformity to private operators, paving the way for them to participate in a new warehouse receipt system. Four warehouses are operational from October 2021. A newly registered Kenya Multi-Commodity

Exchange Company has also been set up with majority private shareholding (including farmer co-operatives).

III. Under **the fiscal pillar,** the operation has increased transparency and accountability in government procurement. From a situation where no details of tenders were published, currently over 50,000 tenders worth KES 408bn (approx. $1.2bn) have been published on a website (tenders.go.ke), with details of names of companies and their directors. Second, under this pillar, support to domestic revenue mobilization (e.g., VAT on petroleum products, streamlining of taxes) helped shore up revenues by an estimated 0.3% of GDP (before the onset of COVID-19). Third, debt transparency has and continues to improve, following the new Debt and Borrowing Policy, and support to the verification and publication of the external debt register; Kenya is among few countries to make public loan-level (included some SOEs) details of its external debts (current DPO). Domestic debt market functioning was supported by a new electronic system which allows for some 80% of retail and institutional investors to submit their bids in the primary debt market electronically. Further the Government has developed the Bond benchmark program to strengthen the secondary market liquidity and facilitate sound debt management (current DPO).

IV. Finally, under **the pillar to crowd in private investment**, the repeal of the interest rate cap in November 2019 helped to lift private sector credit, which had increased by Ksh.229 billion as of January 2021 (approx. US2.1bn), despite the COVID-19 induced economic slowdown. The previous DPO supported a new regulatory regime for investment and to Special Economic Zones (SEZs). Over 2017-2021, the number of gazetted enterprises in Kenya's SEZs increased by 6 to 137; with an attendant capital investment increase of Ksh 11.6bn and the number of workers employed increasing by 10 percent to 61,048. Further in August 2021 the Government launched Web portal to enhance communication, transparency and service provision.

- **Other Structural Reforms**

29. **Universal Health Coverage (UHC) remains a priority Big 4 agenda item. In this regard, the Government is instituting far-reaching reforms at NHIF to ensure the country has a national social health insurer that is able to responsively meet the needs of Kenyans by strategically purchasing services for their health and wellbeing.** Other areas of Government focus are: establishment of a mandatory UHC scheme to be managed by NHIF and regulated by the Ministry of Health and act as the national scheme for all persons resident in Kenya, notwithstanding one's social status; adoption of the completed Essential Health Benefits Package to enable Kenyans gain access to an essential set of health services at a much lower cost; and the provision of health insurance cover to initially one million households who are vulnerable and unable to meet even that low cost premium. The identification of these one million households by the Ministry of Health, Ministry of Labour and Social Protection, and the Counties across the entire Country has been done. The Government is also implementing reforms to strengthen public health emergency preparedness and response through establishment of a new National Public Health Institute (NPHI), the Kenya Centre for Disease Control (current DPO) with a mandate to coordinate public health functions and programs to prevent, detect, and respond to public health threats, including infectious and non-infectious diseases, and other health events.

30. **Universal electricity access:** The socio-economic status and the general well-being of society largely depends on access to stable, reliable and affordable energy supply. In this regard, the Government is implementing reforms geared towards reducing the cost of production and distribution in the short and medium term. These initiatives will support supply of electricity at lower cost to consumers. The Government is therefore committed to ensure an efficient and reliable production, transmission and distribution of affordable, clean and reliable energy. The last mile connectivity program crossed the 8.3 million household connections mark and the country is proceeding well towards the aspiration of 100% universal electricity access from the current 75 percent access. In order to achieve this, 524.5 km of additional transmission and 520 Km of distribution lines are set for construction, setting up of 6 transmissions and 11 distribution substations in the FY 2022/23 to improve system reliability and stability and reduce electricity losses. Further, to strengthen the financial performance of the distribution company (KPLC), the regulator has allowed the following in the retail tariff: i) higher system loss provision for pass-through items (fuel cost, foreign exchange, inflation) for KPLC and ii) full pass-through of power purchase costs from new capacity Power Purchase Agreements (PPAs) under the previous DPO in this series. In addition, the National Treasury plans for partial clearance of outstanding receivables against the last mile electrification program in FY 2021/22 and balance in 2022/23. Ongoing reforms through the movement to an auction system from the feed-in-tariff, structures for generation above 20MW will help to procure capacity at competitive prices and ensure alignment to the Least Cost Power Development Plan (LCPDP) under the previous DPO in this series. The Government is committed under the LCPDP to achieve universal electricity access by further expanding on the use of clean energy. The Government plans to achieve generation of 100% renewable energy that will increase as follows; geothermal from 28% in 2020 to 31.60% in 2040, solar from 2% to 9% by 2030, wind from 12% to 20% by 2030. Future generation will be based on up to date demand forecasts. To improve the governance for KPLC, the government is undertaking a competitive recruitment of a Managing Director (current DPO) and also implementing the Human Resource(HR) policy for recruitment of senior Staff as well as restructuring the procurement department to improve efficiency among others. To improve its financial position, KPLC is implementing the Revenue Protection Program(RPP) covering high value consumers including Advance Metering Infrastructure (AMI), control centres and audit of technical integrity of current smart metering installation of large customers (current DPO) through support of the World Bank Kenya Electricity Modernization Project (KEMP).

31. **The Post-Covid-19 ERS places emphasis on climate change adaptation and mitigation measures that will exploit green economic activities to put the economy on a green and climate resilient recovery build-back path.** Environmental conservation and sustainable access to water is essential for sustained agricultural transformation, higher productivity and growth as well as overall development. Water is also essential for Kenya's economic output and public health, but Kenya is a water-scarce country, with low and declining freshwater resources against rising demand. Rainfall is unevenly distributed, both spatially and temporally, and over 80% of land is arid or semi-arid. Critical watersheds are degrading fast due to poor land-use practices, deforestation, and encroachment on riparian lands. Erosion hotspots cover about half of the land area in Kenya's river basins, resulting in high sediment loads in rivers and reservoirs and deteriorating water quality. Recently approved National Water Policy and the issuance of new regulations (current DPO) will enable implementation of the water legislation, including regulations on water and sanitation services, water resources management, water harvesting and storage, and irrigation. The new policy provides for an intergovernmental framework and medium-term program for accelerating universal access to

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Water and Sanitation Services. Most importantly, these regulations include provisions for a new regime of water abstraction charges and water conservation levies to generate additional financial resources to meet the cost that the Water Resources Authority incurs in discharging its regulatory functions and protecting watersheds (current DPO).

32. **Land as a factor of production is critical to economic, social, political and cultural development.** Secure access to land, sustainable land use planning and equitable distribution of land remain immensely important for food security, employment creation and the socio-economic development of the country. Towards this end, the Government has continued to develop and implement policies and programs to guide land use, access to land title, security of tenure, and development of a transparent and secure land registration system. Given that community lands make up over two-thirds (about 68%) of Kenya's land area, dispersed within 24 of the 47 counties the Government is advancing on the sound implementation of the Community Lands Act and its regulations. The ultimate reform outcome is for a strengthened communal land tenure system, through the sound registration of community lands. Further, the Government will also continue to strengthen development of Land Value Maps to enhance transparency in public land acquisition by aligning the existing regulations to the Land Value Amendment Act, 2019, the Ministry has identified the gaps in the existing regulations that require to be revised under the current DPO that are aimed at strengthening the County Government own resource from properties. Also, the government has revised existing valuation and rating laws and developed a combined National Rating Bill (current DPO) aimed at enhancing county revenue collection. To enhance food security, the Government has developed a governance framework for leasing public land for commercial agriculture and issued standard operating procedures for leasing of public land.

33. **Climate change & Environment**: The Government is accelerating its climate change mitigation and adaptation efforts by updating Nationally Determined Contribution (current DPO) with increased and accelerated mitigation commitments by 2030 (with 2025 milestones) and submitting to United Nations Framework Convention on Climate Change. Further, to enhance environmental management and mainstream climate change governance, the Government through the Ministry of Environment and Forestry (MoEF), has submitted to Parliament the revised Environmental Management & Coordination Act (EMCA) (current DPO). That is aimed at strengthening the coordination of environmental policy mitigation issues between the County Governments and National Government.

34. **Strengthening Governance and the Fight against Corruption:** The Government remains committed in eliminating corruption which inhibits Kenya's economic growth and development through loss of funds. In this respect, the Government has stepped up its efforts in the fight against corruption through implementing a raft of measures that strengthen accountability at all stages of the public finance management cycle. To effectively and efficiently manage public resources, various reforms have been undertaken by the Government towards improving the Public Procurement and Assets Disposal system. Towards this end, the Executive Order No 2 of 2018 requiring State Agencies to make public the details of all Government tenders continue to be effected at all levels of Government, thus eliminating secrecy which facilitates corruption. Further the Government has developed an electronic system to ensure procurement processes are fully integrated with IFMIS (current DPO). Moreover, in recognition of the critical role played by institutions mandated to fight corruption, the Government has continued to facilitate these institutions such as the Office of the Director of Public Prosecutions, the Office of the Auditor General, the Ethics and Anti-Corruption

Commission, the Assets Recovery Agency, the Criminal Investigations Services and the Financial Reporting Centre. This is to enable them to work seamlessly together in developing and promoting standards and best practices in ethics and anti-corruption which will increase efficiency in the fight against corruption as well as recovery of the corruptly acquired assets. So far the institutions have achieved the following: investigated 170 corruption and economic crime cases and 83 ethical breaches, averted loss of Ksh.6.2 billion and recovered Ksh. 8.0 billion of corruptly acquired assets. To enhance access to justice, supported by the World Bank's Judicial Performance Improvement Project the Government has expanded physical infrastructure including establishment of mobile courts, automation of court processes and digitization of judicial systems, adoption of virtual courts, entrenchment of alternative dispute resolution initiatives such as mediation, arbitration and traditional justice systems, clearance of case backlog and improvement in case management in courts.

35. **On Social Protection**, the Government continues to undertake decisive steps to share and care for the vulnerable members of society by offering support through the Social Safety Nets Programmes (Inua Jamii), the Kenya Hunger Safety Net Programme and the National Council for Persons Living with Disabilities Fund. Since the onset of the COVID-19 pandemic in 2020, the Government has provided significant resources – to cushion the vulnerable members of the society through the injection of cash and provision of disposable income to people and businesses. Further, the Government will develop a financing plan for the Hunger Safety Net Programme aimed at increasing resources for the programme and also establish an institutional framework to coordinate social protection in the country. The Government has allocated Ksh.500 million to cushion households affected by the current drought in four counties namely; Turkana, Mandera, Wajir and Marsabit.

36. **On Education sector**, the Government under Covid-19 Economic Recovery Strategy (ERS) is undertaking enhanced development of requisite ICT and infrastructure to bridge digital gaps within the country for skill development, learning and development of content together with Development Partners such as World Bank and GPE among others. The Government is also Developing a policy on blended and online learning, and differentiated cost for university courses/ education, anchored in new legislation under the revised University Act. The Government is committed to strengthening University education which is the cornerstone for skills development and a pre-requisite for a strong industrial, manufacturing and health services among other sectors. This will be achieved among others by the Government commitment to support the enactment of the University Act currently in Parliament and immediate implementation of the Act.

37. **Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT).** the Southern Africa Anti-Money Laundering Group (ESAAMLG) is currently undertaking the Second Round of Mutual Evaluation of the Republic of Kenya. The Government of Kenya has successfully responded to the Technical Compliance (TC) questionnaire and the Effectiveness questionnaire and the ESAAMLG Assessors are conducting an online visit to Kenya from 31st January to 11th February, 2022. The evaluation covers a wide range of issues including examining the AML/CFT legal and supervisory framework for various sectors considered vulnerable to money laundering threats. Kenya was first evaluated on its AML/CFT regime in 2010, and the report revealed significant deficiencies, including the absence of legislation on terrorism financing and non-designation of lawyers as reporting entities. In this regard, the Government enacted the Proceeds of Crime and Anti-Money Laundering (Amendment) Act,

2021 in December 2021 to address Kenya's outstanding deficiencies by onboarding the AML/CFT duty on the advocates, notaries and other independent legal professionals. Whereas the High Court issued conservatory orders in the interim stopping the implementation of the relevant sections of the Amendment Act, the subject matter has now been addressed in the law.

E. Conclusion

38. The Government believes that the policies and institutional reforms summarized in this letter will go a long way towards achieving its inclusive growth and resilient recovery agenda as outlined in its Medium Term Plan and consistent with the Sustainable Development Goals as well as post COVID-19 Economic Recovery Strategy. The Government requests the World Bank's assistance to support the realization of this program.

Yours Sincerely,

HON. (AMB.) UKUR YATANI, EGH
CABINET SECRETARY/ THE NATIONAL TREASURY & PLANNING

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ANNEX 4: 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: Fiscal and debt reforms to make spending more transparent and efficient, and enhance domestic debt market performance		
Prior Action 1: To strengthen the transparency of public procurement and reduce opportunities for corruption, the National Treasury has approved the E-GP policy framework, which includes the E-GP: (i) Strategy (ii) Implementation Roadmap (iii) Business Model and (iv) Business Processes and Specifications.	No	No direct effects
Prior Action 2: The Cabinet has taken a decision for rationalizing the public investment project portfolio, using criteria that include: (i) the completion progress of the project, (ii) the adequacy of financing needed to complete the project beyond the current budget cycle, (iii) the priority status of the project considering development priorities, and (iv) the availability of sufficient data on the project to measure implementation progress and impact.	Yes: Positive	No direct effects
Prior Action 3: To strengthen the domestic bond yield curve and increase secondary market liquidity through a transparent and active structured issuance strategy that ensures regular, predictable benchmark-bond issuances linked with active liability management, the Central Bank of Kenya has adopted and published the Guidelines for, and is implementing, the Treasury Bonds Benchmark program.	No	No direct effects
Pillar 2: Electricity sector reforms to strengthen the cornerstone utility (KPLC, the transmission company) and place Kenya on an efficient, green energy path and boost private infrastructure investment		
Prior Action 4: To improve the operational and financial performance of KPLC: (i) a competitive selection process for the Managing Director of KPLC has been introduced with the process initiated for the currently vacant position, (ii) a revenue protection program (RPP) covering high value consumers is being implemented.	No	No direct effects
Prior Action 5: The Ministry of Energy has approved a five-year power generation and transmission development plan (2021-2026) to guide the competitive procurement of clean energy, at least-cost and aligned with demand.	No	No direct effects

Prior Action 6: The Borrower has enacted the Public Private Partnerships Act (2021), to enhance project selection and implementation processes, and clarify the roles and responsibilities of key participants in the PPP cycle, for efficient and timely delivery of PPP projects.	No	No direct effects
Pillar 3: Strengthen environmental and natural resource governance, combat climate change, and improve healthcare including pandemic response		
Prior Action 7: In order to enhance environmental management and mainstream climate change governance, the Cabinet has approved the Environmental Management and Coordination Bill (2022).	Yes: Positive	No direct effects
Prior Action 8: To equip county governments to mobilize own-source revenues based on property and to improve land price transparency, the Cabinet has approved the National Rating Bill.	Yes: Positive	No direct effects
Prior Action 9: To enhance access to water and sanitation services, and improve the management and conservation of water resources: (i) the MoWSI has approved the medium-term framework for a National Water and Sanitation Investment Program (NAWASIP); (ii) the Water Resources Authority has designated six basin areas under section 24 of the Water Act 2016; and (iii) the MoWSI has stipulated new water use charges and water conservation levies.	Yes: Positive	Yes (potential negative impacts of passthrough of higher water abstraction charges to consumers)
Prior Action 10: To strengthen Kenya's infectious and non-infectious disease prevention and response capabilities, including by consolidating existing public health emergency preparedness and response functions under one authority, the Borrower has established the Kenya National Public Health Institute (NPHI).	No	No direct effects