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The attached Joint Staff Advisory Note (JSAN) of the Poverty Reduction Strategy Papers for 2003/2004 and 2004/2005 for Kenya, prepared jointly by the staffs of the World Bank and the IMF, was distributed with the member country's Poverty Reduction Strategy Papers to the Executive Boards of the two institutions. The objective of the JSAN is to provide focused, frank, and constructive feedback to the country on progress in implementing its Poverty Reduction Strategy (PRS).

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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REPUBLIC OF KENYA

Joint Staff Advisory Note on the Annual Progress Reports of the Investment Programme for the Economic Recovery Strategy for Wealth and Employment Creation

Prepared by the Staffs of the International Development Association (IDA)
and the International Monetary Fund (IMF)

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I. Overview And Process Of Preparing The Annual Progress Reports

1. **Kenya's Investment Programme for the Economic Recovery Strategy for Wealth and Employment Creation (IP-ERS) 2003–2007—its poverty reduction strategy paper (PRSP)—was launched in March 2004**. A Joint Staff Assessment of the IP-ERS was discussed by the Executive Boards of the World Bank and the IMF on May 6 and May 10, 2004. The Government's first IP-ERS Annual Progress Report (APR) for the period 2003/04 (July/June) was submitted to the Bank/IMF staff in July 2005. A second APR, covering 2004/05, was submitted to the staffs in September 2006. This JSAN therefore covers both APRs.

2. **Staffs welcome the participatory processes for the preparation of the APRs, which helped promote ownership and improved the reports**. Both reports were discussed in several forums. In March 2005, during a government sponsored workshop, government officials, heads of parastatals, and representatives of civil society, universities and research institutes, the private sector, and development partners participated in a lively and constructive exchange on the 2003/04 APR. The progress report was discussed in the Consultative Group meeting held in April 2005 and the government subsequently presented the progress report to a subcommittee of parliament and to the cabinet. The government reflected comments from all these stakeholders in the final report. The preparation of the second report also involved government departmental heads at the district and headquarter levels. This has considerably strengthened government ownership across ministries and district administrations. Both reports have been posted on the monitoring and evaluation department's website within the Ministry of Planning.

3. **The progress reports address the key recommendations of the Joint Staff Assessment of the IP-ERS**. First, they describe the measures being taken to strengthen the analysis of poverty such as data collection for the Kenya integrated household budget survey,

the fourth participatory poverty assessment, and poverty and social impact analyses. The results of this work support a comprehensive poverty assessment expected to be completed during 2007. Second, the APRs cover implementation of public financial management reforms. Third, the reports detail recent improvements in the budget preparation and execution processes including an expanded preparation timetable that has since 2004/05 led to better prioritization of public actions. Fourth, the reports identify actions to build capacity in key areas, along with the envisaged support from the donor community. Fifth, the reports present the government's efforts to strengthen the systems for monitoring economic growth and poverty outcomes through collection of administrative and survey data, strengthening of the national statistical system, and development of methods to measure growth and poverty.

II. Monitoring And Evaluation

4. **While the reports demonstrate the growing capacity in Kenya for monitoring and evaluation, delays in issuing these reports limit their role in setting the policy agenda**. For example, the reports come too late to feed into the next budget and do not discuss how the government will address major challenges that have emerged during the past years. These include (i) the findings of the assessment of New Partnership for Africa's Development and other reports that show that the majority of Kenyans continue to view corruption as a major problem; (ii) the impact of higher global oil prices on the economy; and (iii) persistent delays in donor budget support. The staffs believe a discussion of how to deal with these challenges would be useful in the next progress report. The revisions in the targets of the IP-ERS indicators also need to be clarified in more detail, including those relating to the harmonization of common external tariffs within the East Africa Community (EAC) Customs Union.

5. **The staffs note that the second APR improves upon the first by drawing more on existing domestic policy documents**. These include the documents relating to sectoral strategic plans, budget processes, and other public financial management policy documents. The second APR also includes a fuller assessment of achievements, constraints, and challenges in implementation of the IP-ERS. It also presents improved information on key macroeconomic and fiscal developments (including real GDP growth, core poverty spending, a strategy on domestic borrowing, inflows of grants, and costs of restructuring parastatals), which is consistent with that presented in other government domestic policy documents, such as the medium-term budget strategy paper 2005/06–2007/08. Future reports should draw more upon government's medium-term budget strategy paper to assess the link between expenditure allocation plans and IP-ERS priorities.

6. **The staffs welcome the progress in strengthening the monitoring and evaluation system in Kenya since 2003/04**. The staffs urge the government to continue these efforts, including the preparation of a national monitoring and evaluation framework that relies less heavily on survey data and more on existing administrative data sources. The framework will also need to track resource allocations and expenditures, and to monitor results of surveys and censuses and relevant analytical and research activities. The government has begun strengthening the capacity of the Central Bureau of Statistics and the statistical offices of the

line ministries and other government entities responsible for collecting and analyzing data. Creating strong linkages between the activities of its monitoring and evaluation department and those of the Statistical Capacity Building Project is now critical. The staffs welcome the enactment of the new statistics act and the government commitment to establish an autonomous National Bureau of Statistics. However, more needs to be done to improve information flow between the government and citizens, including passage of the freedom of information act. A communications strategy aimed at providing regular information to the public on progress and challenges in the implementation of the IP-ERS would also be useful.

III. Progress and Priorities in Implementing the IP-ERS

A. Policies to Stimulate Growth

7. **The staffs welcome the recent stronger growth**. According to the revised national accounts estimates (based on 1993 Systems of National Accounts), economic growth has picked up from 3.0 percent in 2003 to 4.9 percent 2004 and to 5.8 percent in 2005, and is expected to exceed 6 percent in 2006. While this is still too low for Kenya to reduce poverty levels in line with the Millennium Development Goals (MDGs), more could be achieved by maintaining macroeconomic stability and addressing structural constraints to accelerating growth. The latter include the high costs of doing business that result from corruption, a weak judiciary, insecurity, the poor quality and efficiency of infrastructure services, and excessive regulatory activities. The staffs therefore urge the government to accelerate structural reforms that will provide substantial benefits for the Kenyan economy.

8. **A prudent fiscal policy will be key to maintaining macroeconomic stability, particularly in the run-up to next year's elections**. In this respect, staffs welcome the discussion in both reports on the fiscal strategy and performance, including on the objective to reduce domestic debt to maintain fiscal sustainability. Future reports could, however, include a broader discussion of the consistency of the government's medium-term budget strategies with maintaining debt sustainability.

9. **Stepping up public investment will be crucial for growth.** The 2003/04 progress report rightly notes that public investment of only 3.2 percent of GDP cannot sustain strong economic growth. In this regard, the staffs appreciate the attention given in the reports to reorienting public expenditure to create more fiscal space for public investment. The government has taken some initial steps in containing unproductive expenditure and also increased the budget allocation for infrastructure in the 2006/07 budget. However, spending rigidities remain, and continued efforts are needed to improve wage bill management and to implement the new pay policy. The staffs also note the absorptive capacity constraints in various infrastructure ministries and the resulting significant under-spending in the development budgets. Poor absorption of budget allocations reflects weaknesses in the management of donor funds, in procurement and accounting procedures, and in investment planning. The staffs urge the government to address these constraints while reducing expenditure rigidities and enhancing the efficiency of spending. The enactment of the 2005

procurement act should be followed by consistent implementation, with prompt operationalization of the Public Procurement and Oversight Authority.

10. **On the revenue side, customs reforms need to be revitalized now that the EAC customs union is in place and a new information technology system has been established**. While the APRs discuss the need for expanding the tax base, the discussion on tax policy could have been more balanced on tax incentives and exemptions by noting their potential to introduce further distortions, as seen in the 2006/07 budget. The next progress report could include a discussion on progress with harmonizing tax incentives within the EAC.

11. **The progress reports rightly identify improving Public Expenditure Management (PEM) as a key instrument for successfully achieving the IP-ERS targets and strengthening governance.** While some important steps have been taken to strengthen public financial management, most of the Public Expenditure Management-Assessment and Action Plan (PEM-APP) benchmarks (10 out of 16) are still to be met, and the benchmark on classifications that was achieved in the past requires sustained use of functional classifications in the reporting of both budgeted and actual outcome figures. Reforms lag in a number of key areas, particularly fiscal transparency, implementation of the integrated financial management information system (IFMIS), and management of contingent liabilities and the legal framework. Full implementation of the IFMIS will provide significant benefits to PEM. The second APR also lists key issues that need to be addressed, including conducting regular public expenditure tracking surveys and introducing a risk-based audit system to enhance fiduciary arrangements. As the government works towards meeting the remaining benchmarks, steps should be taken to consolidate public financial management reforms along with regular reviews of the existing plans to better prioritize, coordinate, and monitor reform measures. This is beginning to occur as donors improve coordination of assistance in the context of the government's strategy to revitalize public financial management that was launched in June 2006 and will be supported through a planned US$115 million multi-donor basket fund. To strengthen the link between policy and budgetary allocations, fiscal reporting and performance in budgeting should be enhanced.

12. **The analysis of monetary policy needs to be strengthened in the APRs**. The 2003/04 progress report limits its analysis of the monetary outcomes to a narrow concept of underlying inflation (excluding food, energy, and transportation) and credit to the private sector and therefore fails to recognize the risks caused by the subsequent sharp increase in credit growth and inflation. While the 2004/05 report acknowledges the increase in headline inflation reflecting the rise in oil prices and higher food prices, it should also recognize the impact of the loose monetary policy stance in 2003/04 that resulted in highly negative real short-term interest rates. Future progress reports should provide a candid and up-to-date analysis of monetary policy performance and how to strengthen monetary operations.

13. **In view of the importance of external demand for recent growth, more attention could have been paid to external competitiveness**. An analysis of competitiveness in light of the appreciation of the Kenyan shilling in recent years would be important. The recent

increases in inflation also call for greater vigilance in safeguarding competitiveness. Future APRs could stress the need to enhance productivity through structural reforms and improving infrastructure.

14. **Structural reforms are vital to achieve stronger growth and reduce poverty, enabling Kenya to progress towards achieving the MDGs**. The staffs acknowledge many recent reforms in infrastructure utilities. The concessioning of railways, the commencement of the restructuring of Telkom Kenya and increased competition in the telecommunications sector, and the management contract for Kenya Power and Light Company will help improve the efficiency of key infrastructure parastatals and create conditions for attracting higher private investment in these areas. The announcement by the Minister of Finance in the 2006/07 budget speech of the government's intention to introduce private sector participation in the operations of the container terminal at Mombasa port is also welcome. However, as the APRs rightly acknowledge, in many other areas the reform effort has been limited to preparing studies, strategies, action plans, and parliamentary bills. In this context, the staffs welcome the enactment of the Privatization Act; implementation of this framework for privatization and private sector participation in parastatals would be facilitated by expeditious establishment of a privatization commission under the Act. The next progress report could examine how to accelerate parastatal reforms and review progress in developing expenditure management and audit systems to effectively monitor and supervise the public enterprises that are not privatized. The staffs welcome the government commitment to a new results-based management system, with performance contracts for heads of parastatals.

15. **The APRs should have stressed the need to accelerate financial sector reform**. Considerable reforms were planned for 2003/04 and 2004/05, but implementation has been lacking. The development and implementation of a financial sector strategy have been delayed, as have the introduction of a contributory pensions system and a comprehensive strategy for insurance service market development. The specific reforms that still need to be completed include restructuring and privatizing the National Bank of Kenya and other state-influenced banks, and strengthening the regulatory oversight of the banking sector. A diagnostic audit study of the National Social Security Fund needs to be undertaken to guide its financial restructuring. The APRs could have shed more light on how to advance these reforms expeditiously, with progress reported in the next APR.

16. **Much more needs to be done to improve business conditions and stimulate investment**. Public investment was 20 percent below the budget in 2004/05 and 2005/06 and private sector investment, although rising, also fell far short of expectations. Future reports could be enhanced by: (i) providing a clear diagnosis of the main weaknesses in the business environment and the factors adversely affecting both public and private investment; (ii) specifying the key measures to improve the business climate; and (iii) elaborating the plans and timetables for implementing a system of results-based management to create a leaner, more efficient, and motivated civil service. The next APR should include a focus on licensing reforms, reporting progress to date and challenges ahead.

17. **Greater emphasis needs to be placed on a program of trade reform to underpin Kenya's efforts to improve the local business environment, promote international competitiveness, and exploit the opportunities offered by globalization**. Kenya is implementing the three-tiered EAC common external tariff (0, 10, and 25 percent) and now needs to develop a trade strategy, in agreement with other EAC members, that further lowers trade barriers against the rest of the world so that domestic producers can derive the efficiency gains from global competition and consumers access to cheaper imports. In this vein, we encourage the authorities to work with their EAC partners to further reduce the maximum common external tariff, with no exceptions, by 2010. These actions should be supported by the removal of non-tariff barriers (notably road blocks and checkpoints) and complemented by continued efforts, in the context of the World Trade Organization, to gain greater market access for Kenyan exports. Appropriate measures need to be identified to address the adjustment costs that are likely to result from trade liberalization, including revenue losses. The staffs encourage the government to strengthen reporting in the next APR on progress in fostering regional integration in the Common Market for Eastern and Southern Africa (COMESA) and the EAC, including possible ways to rationalize regional trade arrangements in the context of the negotiations on the economic partnership agreements with the European Union (EU).

B. Poverty Reduction and Equity

18. **The staffs support reforms of agriculture and water policies, which are starting to produce results**. The proposed reforms of agricultural institutions and parastatals, the revitalized market information systems of the agricultural ministry, and the reinstatement of the disease-free zones should contribute to further gains. The success in helping smallholder horticultural producers to comply with new EU food quality and safety regulations is an especially important achievement. Reforms of coffee marketing should improve farmers' share of receipts from sales of coffee. Several poverty and social impact analyses are under way—including one concerning the impact of maize policy on producers and consumers—the results of which are expected to assist the government in implementing reforms. Reforms in the water sector have led to the creation of a new framework for sustainable service delivery and to commercialized operations in several urban areas, which are major achievements. The challenge for the government is to maintain the momentum in implementing these reforms.

19. **More needs to be done to reduce drought- and flood-related risks**. The second APR presents a good account of the government's efforts to address drought- and flood-related emergencies, including through creation of drainage systems in flood prone areas. Future APRs should highlight other measures to reduce the risks of flooding, such as water catchment restoration. The government's early warning system proved effective in averting a potential humanitarian crisis from a severe drought in 2005–06. The establishment of the emergency contingency fund in the budget should enable the government to meet its future emergency funding needs while maintaining macroeconomic stability. The staffs welcome the government's draft strategy for long-term development of arid and semiarid lands. Future APRs could highlight its main elements and plans for its implementation.

20. **The staffs welcome the successful implementation of the Free Primary Education program**. This was aided by the government's strong leadership and development of a comprehensive strategy which helped development partners align their support. Remaining challenges include improving quality, expanding opportunities for secondary school education, and overcoming regional and gender disparities in access to education. The staffs welcome the completion of the five-year strategic plan for 2003–07, prepared by the Ministry of Education, which will guide and regulate programs and provide the framework for harmonizing development partner support and help Kenya achieve the education MDG.

21. **A national health strategic plan has been completed**. This plan is expected to form the basis for more effective donor support in a sector-wide approach. Such support from the Bank and other development partners seeks to help strengthen the country systems in the health sector after Government and Bank reviews confirmed concerns about corruption risks. The Bank's contribution to a health SWAp will proceed when strengthening steps have been completed in the Ministry of Health. In the meantime, the Bank will support and scale-up successful health initiatives in entities other than the Ministry of Health that deliver health care to the poorest of Kenyans (e.g., microfranchising schemes). Strong and focused government leadership will be critical in encouraging development partners to align their support behind the strategy. Without resolving these issues, achievement of the health sector MDGs by 2015 would be difficult. The staffs suggest that the next progress report discuss in greater detail the actions being taken to improve health indicators in Kenya, which have been declining for some years.

22. **The staffs are encouraged by the quality and the results-focus of the Kenya National AIDS Strategic Plan for 2005–2010 and urged greater attention to the management of governance issues**. Beyond the ongoing actions to reduce corruption risks in HIV/AIDS programs administered by the National AIDS Control Council (NACC), the challenge now is to ensure that the plan is implemented, with improved coordination, strengthened attention to management and governance issues, enhanced support for the mitigation of the disease (including for orphans), accelerated treatment program for the infected, and continued strong emphasis on preventing the spread of the disease. Addressing the management problems that impede service delivery, for example, at the NACC, is critical to regain the confidence of Kenyans and of development partners. A monitoring and evaluation framework has been developed and should be used regularly to assess performance.

23. **High inequalities in Kenya—between rich and poor people, between women and men, and between regions—are an obstacle to poverty reduction**. In particular, women and men have highly unequal access to basic social services (water, sanitation, education, and health), and assets such as land. The high levels of inequality mean that growth must be rapid and pro-poor to significantly reduce poverty. The government needs to put in place measures aimed at improving access to public services and at removing barriers that prevent access to credit, land, and other productive resources.

C. Governance

24. **The staffs welcome the emphasis given in the reports to governance**. They concur that weak governance, as manifested in endemic corruption and poor accountability in public resource management, is a key reason for the poor economic performance of the past two decades. They also agree that reforming the judiciary, strengthening the rule of law and security, and implementing reforms in public administration are critical to improving transparency and accountability. The staffs acknowledge the government's efforts to implement policies and to put in place institutions to tackle corruption, and recognize that winning the war against corruption will take many years. They welcome the ongoing implementation of the Governance, Justice, Law and Order Sector Reform Program, which is assisting with policy reforms and institutional strengthening that are required to fight corruption and promote good governance across all levels of government.

25. **The reports indicate that the government has been implementing actions to improve governance and strengthen transparency and accountability across the public sector, but significant additional steps are needed to address important weaknesses in the governance architecture and secure better governance outcomes**. The staffs welcome the enactment of the public officer ethics act (2003), requiring civil servants to file annual declarations of income, assets and liabilities; the anti-corruption and economic crimes act (2003), which established the Kenya Anti-Corruption Commission; the government financial management act (2004), the public audit office Act (2004), and the public procurement and disposal act (2005), which are aimed at improving governance and public service delivery. Other actions anticipated in the progress reports include the steps underway requiring public disclosure of wealth and asset declarations and their regular verification; completing the ongoing audit of government procurements, publishing its findings, and further investigating and prosecuting those found to have abused procedures; and rapidly implementing public financial management reforms.

26. **The staffs also welcome the inclusion of the government's anti-corruption action plan for 2005/06 in the progress report**. Staffs note that the government has ended land grabbing and *harambees* (coerced fund-raising), which were a significant source of state corruption. The staffs also welcome specific anti-corruption measures in sectoral ministries, such as in education and water. They urge the government to prepare anti-corruption action plans—aimed at preventing corruption in the future—for all ministries. The Kenyan Anti-Corruption Commission can play an important role in this area by working with various ministries, departments, and agencies to develop such anti-corruption plans.

27. **Despite the steps taken to-date, governance remains weak**. The staffs take note of the recent finalization and submission to the government of the initial governance assessment report for Kenya by a team of World Bank experts, with IMF participation. This comprehensive review of governance in Kenya includes empirical evidence suggesting that a decline in corruption during 2003–04 subsequently halted, and that there may even have been a deterioration in operations of the judiciary and in procurement, although not to the pre-2003 levels. The progress reports should provide a more comprehensive assessment of

governance and anticorruption efforts. For example, they should not only cover actions taken but also the feedback from key stakeholders, such as the Kenyan public, on the effectiveness of such measures and the agenda that still lies ahead.

28. **Some prioritization is evident in the three-year action plan launched by the government in June 2006**. Building on this three year plan, the recently produced 2006/07 action plan, which also draws on the findings and recommendations of the governance assessment mission and is intended to be implemented through the end of 2007, represents a further step in the right direction. Moving forward, steps must also be taken to ensure transparency and the effective prosecution of corruption cases. The next progress report could give a greater emphasis on reporting progress, and outcomes of implementation. A transparency and timeliness will be essential to inform stakeholders of progress in implementing the governance action plan.

IV. Conclusions And Main Recommendations

29. **The progress reports demonstrate increasing government ownership and a strengthening of the process of monitoring and evaluation of IP-ERS and the accompanying development agenda**. Both reports present extensive information on priorities, progress and challenges, providing a basis for a frank and balanced assessment. For example, the reports' extensive reviews of steps taken to improve governance illustrate the authorities' appreciation of the multifaceted nature of this challenge, and the importance of taking concrete actions.

30. **Compared to the first progress report, the second report has substantial strengths**. Its focus on results and its comprehensive reporting on trends in key indicators establish its value as a performance assessment framework for government, civil society, and development partners to evaluate progress. The targets for performance indicators are better defined, and are more realistic than in the first report.

31. **The preparation process and the substance of future progress reports can be strengthened in several ways**. First, to be more useful in influencing budgetary allocations and helping to set the policy agenda, the reports need to be more timely. Second, the reports could be strengthened by presenting specific policy challenges and more information on the government's priorities for the coming year, particularly in the key areas for promoting growth and reducing poverty. Third, the reports could draw on as many sources of information as possible with respect to the key performance indicators in the IP-ERS, and candidly highlight areas where data are not reliable or not available. This will help the government and other stakeholders to identify more appropriate indicators and areas where strengthening of data collection efforts is most important. Fourth, the reports should highlight areas where progress towards targets can be accelerated, such as in under-five mortality and maternal mortality. Fifth, the reports could highlight the government's progress and challenges in implementing key structural reforms—including in the areas of investment climate and governance—that are essential to sustain and accelerate the current growth momentum. Data from the planned governance survey will help set baselines for measuring progress.