



External finance for rural development

Country case study: Kenya

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Key messages

- Rural development and agriculture are high priorities for Kenya, given its large rural population, high levels of rural poverty and undernourishment, and the importance of the sector for jobs and growth.
- The government's ambitious plans for these sectors require more funding, but budget projections do not signal any increase in public resources, while some are set to decline.
- Official development finance (ODF) accounts for just under half of all government spending for rural development and agriculture. Most ODF is concessional, with a higher share of grants for agriculture and rural development than the average for all sectors. There has been limited non-concessional finance for the sector to date.
- Government demand for external assistance to the sector is expected to increase over the next five to 10 years, with a continuing preference for concessional finance, followed by non-concessional. Demand for non-concessional finance may dampen as a result of the re-classification of Kenya's risk of debt distress from moderate to high due to the economic impact of the Covid-19 crisis.

Introduction

Background

Rural development worldwide relies heavily on private funding. Yet the public sector has a key role to play in providing both investment and policy support to tackle persistent market failures. These include the under-provision of public goods (such as infrastructure, and research and development), negative externalities (such as the need to adapt to and mitigate the effects of climate change), informational asymmetries (e.g. the development of rural financial services) and the lack of protection for vulnerable people through, for example, social protection.

Far more finance is needed to achieve food security and promote sustainable agriculture in line with Sustainable Development Goal (SDG) 2. The United Nations (n.d.) estimates that an additional \$267 billion per year is needed to achieve every SDG 2 target: almost twice as much as total official development assistance (ODA) each year from all donors combined. Official development finance (ODF)¹ to agriculture and rural development rose slightly from \$10.2 billion in 2015 to \$10.9 billion in 2018. This is only a fraction of the total ODF disbursements of \$254 billion in 2018. Public expenditure on agriculture development also remains low: since 2001, governments have spent, on average, less than 2% of their central budgets on agriculture (FAO, 2019).

Objectives, definitions and methodology of this country case study

This country case study summarises key findings from a country analysis of financing for rural development in Kenya. It is one of 20 analyses that is synthesised for comparison in Prizzon et al. (2020).

The case study has two main objectives:

- to map demand from the Government of Kenya over the next five to 10 years for external development assistance to support public investment in inclusive and sustainable rural development
- to analyse the financial and non-financial terms and conditions of such demand, its main preferences and the type of instruments that the government wishes to access or scale-up to support public investment in rural development.

Definitions

What we mean by public investment in inclusive and sustainable rural development (see Prizzon et al., 2020, for more details): Our research has focused on six areas that contribute to such investment: access to agricultural technologies (research and development) and production services; agricultural value chain development (e.g. crops, livestock, fisheries); climate-resilient agricultural practices; rural basic infrastructure (e.g. water and irrigation systems, local roads, local energy generation and storage facilities); rural financial services; and rural investment environment (e.g. policy, legal and regulatory frameworks).

What we mean by external assistance for inclusive and sustainable rural development: We look beyond ODA to include government-to-government funds from bilateral and multilateral donors that do not meet concessionality criteria² (usually defined as other official flows, or OOFs). We call this official development finance (ODF). As a proxy for financing rural development, we examine data on external assistance to the agriculture sector and rural development (cross-cutting) based on an Organisation for Economic Co-operation and Development (OECD) definition. This is not a perfect measure, but given

1 The sum of ODA and OOFs: the latter flow from bilateral and multilateral donors that do not meet the concessionality criterion for ODA eligibility.

2 The definition of concessionality is based on the share of the grant element. With the 2014 OECD reform, the grant element varies according to the income per capita of the ODA eligible country to be counted as ODA: at least 45% for low-income countries (LICs), 15% for lower-middle-income countries (LMICs) and 10% for upper-middle-income countries (UMICs). The International Monetary Fund (IMF) discount rate (5%) is also adjusted by income per capita group: 1% for UMICs, 2% for LMICs and 4% for LICs, including least-developed countries (LDCs).

the lack of a sectoral definition or attribution to rural development as such, it is the closest we can get to a consistent, cross-country mapping of external assistance from development partners. As a second-best option, we rely largely on quantitative and qualitative data on agricultural development. While the agriculture sector is a major component of rural development, data on agriculture alone cannot capture important non-farm activities.

Research questions

This country case study reflects our four main research areas:

- the government's priorities for public investment in inclusive and sustainable rural development
- financing for public investment in inclusive and sustainable rural development
- borrowing (external development assistance) for this public investment
- the government's preferences in relation to external development assistance for public investment, including its demand for specific types of instruments.

As this project took place during the early stages of the Covid-19 pandemic, we also reflect the short- and medium-term implications of the crisis for government priorities and preferences for public investment, as well as the amount and type of external assistance demanded.

Methodology

We used a qualitative case study approach, with the analysis of individual countries informed by a political economy framework, as developed by Greenhill et al. (2013) for aid negotiations (see Prizzon et al., 2020).

Our approach comprised a critical review of relevant policy literature³ and data analysis,⁴ which also helped us to identify country stakeholders. This was followed by interviews with key informants, informed by an electronic

questionnaire submitted before each interview. For Kenya, we held eight interviews between May and June 2020, and received nine questionnaires (see Annex 1 for a list of those interviewees who agreed to their names being shared).

Kenya: country context

Kenya has been classified as a lower-middle-income country since 2014. It has been given 'blend status', which enables the country to access concessional and non-concessional resources from international financial institutions, including the World Bank and the African Development Bank (ADB). It has access to both types of resources because, even though it remains eligible for concessional finance as a result of its levels of gross domestic product (GDP) per capita, it is also deemed to be eligible for some non-concessional finance by international financial institutions, given its credit worthiness. To date, the government of Kenya has focused predominantly on attracting concessional resources from these institutions.

The country has a dynamic economy and has benefited from solid economic growth. Kenya is now the largest economy in East Africa (Herbling, 2020). Economic growth averaged 5.6% between 2015 and 2019 (World Bank, 2020b). While the service sector has driven most growth since 2005, with a remarkable expansion in telecommunications and financial services, other sectors like agriculture and industry have been important contributors. The service sector made the largest contribution to the economy in 2019 (43.2%), followed by agriculture (34%) and manufacturing and industry (24%) (World Bank, 2020c).

On the demand side, household consumption, private investment and government public investment have all contributed to growth. Kenya has a young population: 68% of its population were below the age of 34 in 2017 (AFIDEP, 2018). The country has made major progress in its push for political stability, with the 2010

3 Government strategies, IMF Article IV, and World Bank diagnostic tools.

4 Spanning IMF, African Development Bank (ADB), OECD, Food and Agriculture Organization (FAO) and World Bank sources.

Constitution devolving significant resources to the county level (ADB, 2018).

Kenya has made moderate but steady progress on reducing levels of extreme poverty since 2006. In all, 36.8% of the population live in extreme poverty (based on 2015/16 latest data) (World Bank, 2020c) and while this is one of the lowest rates for East Africa, it is still twice as high as the average for lower-middle income countries (World Bank, 2018).

Nearly 75% of Kenya's population were living in rural areas in 2017 (World Bank, 2020c), where most people depend on smallholder farming for their livelihoods and where poverty rates remain higher than in urban areas (World Bank, 2018). Kenya's falling poverty rates between 2005 and 2016 were driven largely by a reduction in rural poverty, with only a marginal decline in urban poverty (World Bank, 2018).

While the agriculture sector contributes 34% of Kenya's GDP, as noted, it accounts for 57% of all jobs in the country. While this share of employment in the agriculture sector is close to the average for sub-Saharan Africa, it is high for a lower-middle income country (World Bank, 2020c). Poverty also varies across regions, with the highest rates in the North Eastern region and the lowest in the Central region the lowest.

Food insecurity is now a major concern in Kenya, with 29.4% of the population undernourished between 2016 and 2018 (FAO, 2019). While Kenya is by no means the worst in its region, its rate of undernutrition is almost three times higher than the average for lower-middle income countries, which stands at 10.9% (FAO, 2019).

In addition, climate change is having an impact. While this equatorial country has a climate that varies by region, its climate is already changing, with rising temperatures and more frequent extreme weather events (GOK, 2018b).

Rainfall patterns have changed, resulting in more droughts and more floods, depending on the region. This, in turn, is having a negative impact on livelihoods and crop production, while rising sea level temperatures have also reduced fishing stocks (ibid.). In 2020, a plague of locusts devastated crops in Kenya and East Africa, with

the World Bank projecting livestock and crop production losses of up to \$1.5 billion in Kenya alone (Kray and Shetty, 2020). The sheer scale of the locust plague has had an impact on the country and the entire region, and has been linked to climate change (UNEP, 2020).

Kenya is ranked on Notre Dame's Climate Vulnerability Index as 143 out of 181 countries in terms of its vulnerability to climate change (1 being least vulnerable, and 181 being most vulnerable) (ND-GAIN, 2020).

Government priorities for rural development

Rural development and agriculture are high priorities for the government of Kenya. The 'Kenya Vision 2030' (GOK, 2008), the government's 'Big Four Agenda' (GOK, 2017a) and its 'Medium-Term Development Plan 2018–2022' (GOK, 2017c) all identify the agricultural sector as critical to achieving national development. All of these documents note the importance of the sector for ensuring food security and nutrition (one of the big four priorities for the current government) and for boosting economic growth through further agro-industrialisation and manufacturing.

The government has ambitious plans to transform rural development and agriculture in the medium term. The government's 10-year 'Agriculture Sector Transformation and Growth Strategy 2019–2029' (ASTGS) (GOK, 2018a) sets out an agenda that aims for the radical transformation of the agricultural sector in Kenya. Its nine flagship programmes include, among others, programmes to increase the incomes of smallholders, pastoralists and fishers; increase output and the value-added of the sector by creating agro-processing hubs and improving irrigation; boost household food resilience by reforming subsidies and improving food reserves; strengthen knowledge and skills; enhance research, innovation and data, with a focus on digital; and ensure environmental sustainability and crisis management.

The government also identifies another nine programmes in its 'Agriculture Rural

and Urban Development (ARUD) Sector Plan 2020/21–2022/23’ (GOK, 2019a).⁵ Their objectives sometimes overlap with those of the ASTGS, with a focus on food security, greater agricultural productivity, more investment in the blue economy, improvements in market access and trade, the facilitation and regulation of agricultural research, and ensuring the equitable and sustainable management of land resources.

Our interviewees and survey respondents expect agricultural value-chain development⁶ to be the top priority for the government’s public investment in the next five to 10 years. This prioritisation reflects the government’s strong policy focus on the further commercialisation of the agricultural sector as part of its ‘Big Four Agenda’ to improve Kenya’s manufacturing capabilities, which includes flagship programmes to enhance agro-processing capabilities and services and training provision.

At present, the country’s agricultural value chains are under-developed (GOK, 2017b). Only 16% of Kenya’s raw agriculture is processed, lower than the percentages in neighbouring countries. Agricultural processing also accounts for just 3.2% of Kenya’s GDP (GOK, 2018a).

Our respondents had a wide range of views when it came to defining the second most important priority for government public investment in the future, with climate-resilient practices, basic rural infrastructure and rural finance, all cited as being important.

Climate change and rural infrastructure remain major challenges. Climate change, as noted earlier on, is harming crop production and lowering productivity; Kenya must also contend with poor infrastructure. Less than 1% of Kenya’s landmass, for example, is irrigated (GOK, 2018a). This presents another threat to food security and also lowers productivity (GOK, 2017b). In addition, pre- and post-harvest losses are high as a result of inadequate storage and poor handling, and there is poor access to markets.

In sharp contrast, access to rural finance is an area where Kenya has shown innovation through its promotion of digital finance. The country is viewed as a leader among its regional peers in this regard, and this is expected to remain a priority for the government.

Our respondents expected only limited prioritisation of public investment to support a rural investment environment (policy, legal and regulatory framework) or access to new technologies, even though the latter is identified as a priority within the government’s policy framework.

Most of our interviewees noted weak capacity as a major obstacle to effective public investment in the sector at the federal and county level, with project implementation often delayed or of poor quality. One interviewee highlighted the under-utilisation of project facilitation funding that has been made available to develop well-designed and bankable projects by the Ministry of Agriculture, Livestock, Fisheries and Irrigation (MoALF&I) in comparison to its use by other sectoral ministries.

The absorption rate of the development budget for the ARUD Sector Plan stood at just 66.8% in 2018/19. Government assessments confirm that government capacity is limited (GOK, 2015; GOK, 2017c). The government is working to address this issue with one of the ASTGS flagship programmes (programme 7) dedicated to boosting government skills (GOK, 2018a).

Some interviewees also noted poor governance and accountability as major challenges to effective public investment. This is not unique to the agricultural sector. Transparency International’s Corruption Perception Index, which assesses the scale of public corruption, reveals continued corruption in Kenya, with the country scoring below the average for sub-Saharan Africa (TI Kenya, 2020). In 2018, Kenya scored 27 points out of 100, a slight decline from its 28 points in 2017, well below both the global

5 This plan covers the work of the Ministry of Agriculture, Livestock, Fisheries and Irrigation, the Ministry of Lands and Physical Planning, the National Commission on Land and several autonomous and semi-autonomous government agencies.

6 The provision of services and inputs to help farmers to add value to their crops, livestock and fisheries.

average of 43 and the average for sub-Saharan Africa of 32.

Our interviewees noted that Kenya's agricultural policies have well-established programmes in place that target specific groups, particularly smallholder farmers, pastoralists, women and youth. Kenya's ASTGS, for example, includes flagship programmes to help smallholder and pastoralists in semi-arid and arid lands and women and youth). Other initiatives include insurance for pastoralists in arid areas. Women and youth are cross-cutting priorities for Kenya's Medium-Term Development Plan and are meant to be considered across all sectors and programmes.

While none of our interviewees expected Covid-19 to result in radical changes to the government's policy priorities for the sector, there was a mixed response on whether the crisis might enhance the government's focus on these priorities or not. Some interviewees felt that the economic impact of the crisis could delay implementation of ambitious flagship programmes as a result of financing constraints, while others suggested that the Covid-19 crisis might sharpen the government's focus on the sector, given growing concerns around food security and economic growth.

Kenya confirmed its first Covid-19 case on 14 March 2020 and took measures to contain the spread of the disease (IMF, 2020a). According to the IMF (*ibid.*), the pandemic has delivered a 'large economic shock' to Kenya that has had an impact on every sector. However, trade (including exports of flowers, which collapsed in the first half of 2020), tourism and remittances have all been very badly affected.

This has put more pressure on Kenya's balance of payments and its need for fiscal financing (IMF, 2020b) and has heightened concerns about food security as food prices have risen (GOK, 2017c). The IMF projects that national growth

will drop to 0.8% in 2020, down from 5.4% in 2019.

To ease this crisis, the government has borrowed just under \$2 billion in ODF (IMF, 2020b; World Bank, 2020b; ADB, 2020).⁷ Policies adopted by the government to date include support to the health sector, businesses, social protection, and youth employment schemes. In the agricultural sector, this support aims to maintain supply chains for both domestic and international markets. The government has called for enhanced production to boost growth and gain access to foreign exchange.

Financing rural development

Public finance

Government expenditure in 2018/19 as a share of GDP stood at 27.3%, outstripping government revenues (17.2%). As a result, the fiscal deficit stood at 7.8% in 2018/19, higher than the government's deficit target of 6.8% for that year.

Kenya's fiscal deficit has increased over time as a result of ramped-up public spending (predominantly on infrastructure) before the general elections in 2017, as well as lower-than-anticipated revenues because of delays in tax reforms (IMF, 2018). Before the Covid-19 crisis, the IMF expected the fiscal deficit to fall, but it now projects that it will rise to 8.6% in 2019/20 on the back of fiscal stimulus measures taken by the government and a further fall in revenues (IMF, 2020a).

The government's ambitious spending plans to transform rural development and agriculture are not being matched by increased public budgets, resulting in significant shortfalls. They require a significant scale-up of resources from the public and private sector and from external donors. The cost of the government's ARUD Sector Plan 2020/21–2022/23⁸ requires twice the amount of funding needed for the previous

7 The government has drawn down on the full amount available to them from the IMF's Rapid Credit Facility (\$743.9 million) (IMF, 2020b), and has agreed a \$1 billion development policy financing loan with the World Bank (World Bank, 2020b), and a €188 million Covid-19 emergency loan from the African Development Bank (ADB, 2020).

8 Note that this includes non-rural spending, given its focus on urban agricultural development, and covers funding beyond the MoALF&I.

ARUD Sector Plan,⁹ while the ASTGS requires an additional KES 400–440 billion (approximately \$3.6–4.0 billion) between 2019 and 2024, of which KES 200–230 billion (approximately \$1.8–2.1 billion) is specifically for agriculture-focused spending.¹⁰

While the expectation is for considerable funding from the private sector and donors, government financing is also required to increase to meet these ambitious plans. The current ARUD Sector Plan expects donors to foot just under half of the bill (44%) as was the case for the previous ARUD plan, while the private sector is expected to foot 80% of the costs of the ASTGS's agriculture-focused financing, with the remaining 20% to be covered by government and donors.

At the same time, however, the government's medium-term budget signals a decline in resources in some areas and serious shortfalls in others. For example, the share of government expenditure allocated to the ARUD Sector Plan is projected to fall from 3% in 2019 to 2.5% in 2022/23, according to the government's medium-term budget plan (GOK, 2020b: 42, Table 3.2). The allocated budget for 2020–2022/23 for the ARUD Sector Plan is only KES 77,585 million (approximately \$707,000), just 57% of the required funding outlined in the ARUD Sector Plan, with shortfalls anticipated in financing from both the government and external partners (GOK, 2019a).

For the ASTGS, the plan will require 30–40% more funding to the MoALF&I than the amount allocated to the ministry for 2018/19–2021/22.¹¹ The National Agricultural Investment Plan (GOK, 2019e) recognises these budget constraints, and expects the MoALF&I to prioritise flagship

projects within its existing budget allocations to minimise additional spending.

External development assistance

The volume of total ODF to Kenya has risen marginally from \$2.9 billion in 2014 to \$3.1 billion in 2018 (constant prices) (Figure 1). It remains overwhelmingly concessional (91% on average) and over half – 57% on average – comes in the form of grants. The share of non-concessional finance has risen since 2014, but only marginally. In 2014, only 5% of ODF was non-concessional, and this peaked at 14% in 2016 before falling back to 7% in 2019. The main providers of ODF over this period were the United States (US), the World Bank's International Development Association (IDA), Japan and the United Kingdom.

These ODF figures do not, however, reflect Kenya's full access to concessional and non-concessional external finance as they do not include official finance from China. According to the Kenyan government's debt statistics, China was Kenya's largest creditor of external debt in 2019, accounting for 22.2% of the country's total external debt (GOK, 2019c). The terms and conditions of China's debt were not available, but the statistics indicate that most of Kenya's official creditor debt is non-concessional, with the majority of non-concessional debt held by bilateral sources, and very likely by China.

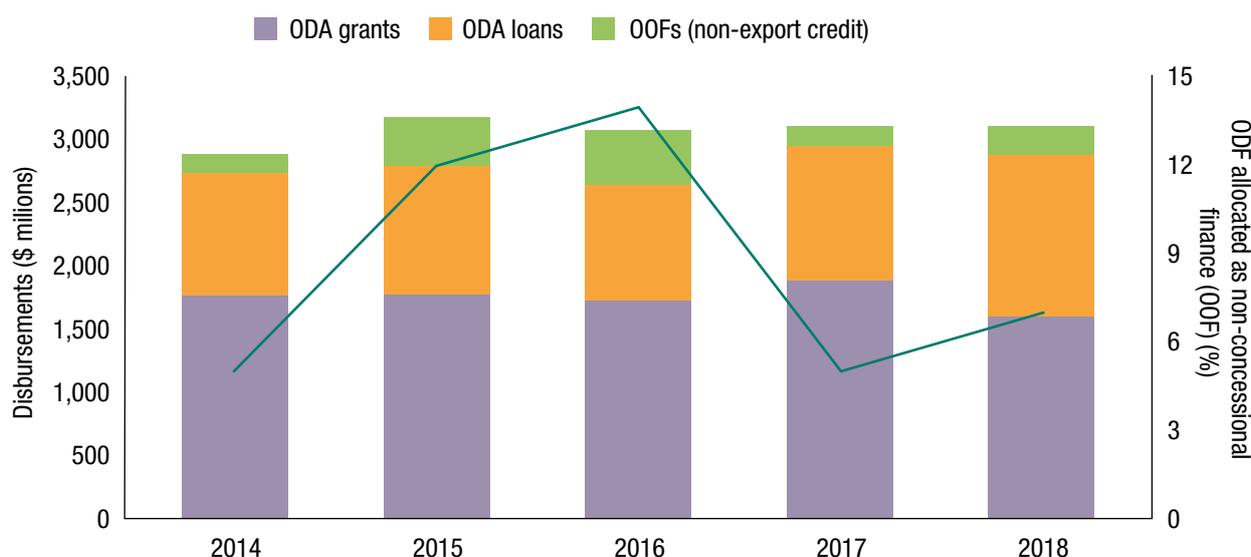
It appears that the government of Kenya has yet to take on considerable volumes of non-concessional debt from multilateral financial institutions, using up its concessional finance from these institutions under its blended terms instead. At the same time, however, it has been willing to take on non-concessional

9 The required development budget for the ARUD sector's 2020/21 to 2022/23 plan is KES 174,782 million. The Government of Kenya's total allocated budget for Agriculture Rural and Urban Development Sector (ARUD) between 2016/17 to 2018/19 was KES 79,200 million (GOK, 2019a). Just under half (45%) was provided via loans and grants from development partners.

10 The remaining funding is to support an enabling environment and involves infrastructure development that is required in roads and energy and is anticipated to be covered by other government Ministry's beyond MAIF&I, private sector and donors.

11 This calculation is based on expected disbursements of MoALF&I development budget between 2018/19 and 2020/21 and is found in GOK, 2019a: 87, based on the 2019 ARUD Sector Plan.

Figure 1 Official development finance disbursements to Kenya across all sectors



Note: constant 2018 prices. ODA, official development assistance; ODF, official development finance; OOF, other official flow. Source: OECD (2020)

debt from China – predominantly for large infrastructure projects.

Kenya is not an aid-dependent country. ODA – concessional finance – accounted for 2.8% of Kenya’s gross national income (GNI) in 2018, down from 4.3% in 2014 and far below the 10% threshold that is considered a measure of aid dependency by the OECD (OECD, 2003). Concessional finance is also falling if measured as a share of government expenditure: In 2017, it represented 12% of government expenditures, down from 18.9% in 2014 (World Bank, 2020c). This trend, however, reflects Kenya’s solid economic growth and its increasing government expenditure, rather than falling volumes of ODA.

While the country itself may not be aid-dependent, financing for agriculture and rural development remains heavily reliant on ODA. ODF makes a significant contribution to agricultural development, with external partners financing just under half (45%) of the government development budget for the ARUD Sector Plan between 2016/17 and 2018/19 (GOK, 2019a).

In 2018, the government received 6.3% of its ODF for rural development and agriculture, or \$194 million (see Figure 2) – the majority of which was for the agricultural sector. This is above the global average, which stands at 5%, and reflects the importance of these sectors to

national development. The share of ODF to rural development, for example, has increased from 5.8% in 2014 to 6.3% in 2018.

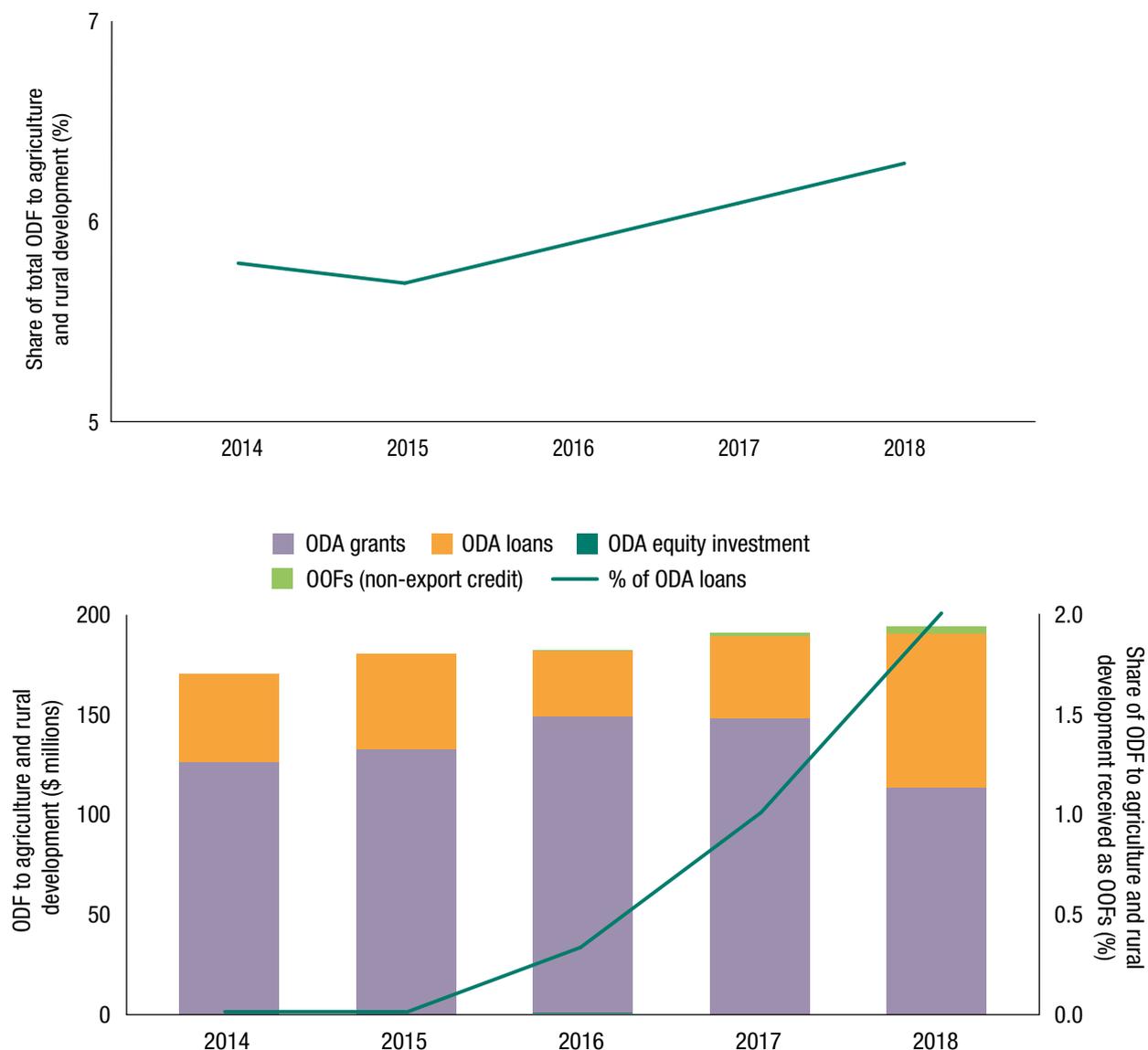
Most of the ODF received for Kenya’s agriculture and rural development between 2014 and 2018 came in the form of concessional finance, with 99%, on average, delivered as ODA. The vast majority of this ODA – 73%, on average – was provided as grants.

The share of grants is far higher than the average across all sectors over the same period, and reflects, in part, the grant aid modality of the major donors to the sector between 2014 and 2018, which were (in order of volume) the US, the European Union (EU) and the World Bank. Grants account for all of the finance from the US, and aim to support food security, the economic livelihoods of smallholder farmers in poor counties and improve the climate resilience of smallholder farmers in Kenya’s arid region. The US also funds agricultural research.

The EU has also provided all of its support in the form of grants, supporting efforts to build the capacity of smallholder farmers in poorer counties. The World Bank has provided concessional loans with a particular focus on climate resilience and water security.

In all, the share of ODF received as concessional loans rose from 26% in 2014 to

Figure 2 Share and composition of official development finance to agriculture and rural development



Note: ODA, official development assistance; ODF, official development finance; OOF, other official flow.
Source: OECD (2020)

42% in 2018. In contrast, non-concessional finance accounts for a very small amount of ODF to the sector, and was provided solely by the African Development Bank between 2014 and 2018 for the management of water irrigation and value-chain development projects.

Most of our interviewees and survey respondents noted that the government valued external finance not only because it provides access to resources at below-market rates, but also because it is accompanied by policy advice and project implementation expertise. One interviewee commented that the government

also valued the increased accountability that can accompany external finance, both in terms of fiduciary monitoring but also in terms of the push to deliver key results.

Government demand for external finance for rural development and agriculture is expected to grow in the next five to 10 years, according to most of our interviewees and survey respondents. This chimes with the government’s financing plan for the sector, with the ARUD Sector Plan 2020/21–2022/23 (GOK, 2019a) requiring a rise in the volume (though not the share) of donor financing, and ambitious investment plans to

support the ASTGS (GOK, 2019e) requiring increased donor funding.

The preference is for concessional finance where possible, followed by non-concessional, which also mirrors the government's draft debt policy (GOK, 2019c). The majority of interviewees and respondents did not anticipate an increased demand by the government for commercial loans for the sector in the medium term. However, hopes for increased non-concessional financing may be dampened by the economic impact of Covid-19 on Kenya and the recent reclassification of Kenya's debt distress levels from moderate to high by the IMF and World Bank (see the next section).

Borrowing for rural development

Debt trends and composition

The most recent assessment of Kenya's debt sustainability by the IMF and the World Bank, conducted in mid-2020, concluded that debt levels were sustainable (IMF, 2020a). However, the profound impact of the global Covid-19 crisis on the economy, and particularly on trade, has aggravated existing vulnerabilities in Kenya's debt situation, leading the IMF and World Bank to raise Kenya's risk of debt distress from moderate to high.¹²

Kenya's general government debt had already increased from 49% of GDP in 2014 to 62% in 2019 (World Bank, 2020a)¹³ as a result of greater government borrowing for large public infrastructure investments (including the Standard Gauge Railway project). While this breaches the East African Monetary Union Protocol, which sets the limit for debt-to-GDP at 50%, it keeps the debt below the new debt ceiling set by Kenya itself in 2019, when the ceiling was changed from 50% of debt to GDP to an absolute figure of KES 9 trillion (POK, 2019).

The IMF expects Kenya's debt indicators to improve as exports pick up once the global crisis has passed. However, it suggests fiscal

consolidation and a more prudent approach to public debt management in the medium term to avert future risks (IMF, 2020a).

The majority of Kenya's external public debt – 75% – is split evenly between multilateral and bilateral official creditors (World Bank, 2020a). Kenya's external public debt makes up 51% of the country's total public debt, with the rest coming from domestic sources (CBK, 2020).

The share of official creditor debt from bilateral providers has risen significantly since 2014, which reflects a rise in lending from China. According to the government, China was the biggest lender of external debt to the country in 2019, accounting for 22% of the country's entire external debt (GOK, 2019c). In 2018, 64% of external debt from official creditors was non-concessional (World Bank, 2020a), with the majority coming from bilateral sources, and probably from China, given that Kenya has yet to take on considerable volumes of non-concessional debt from multilateral financial institutions.

The rest of Kenya's external debt in 2018 was private and came from bonds (17%) and commercial borrowing (7%). The volume of financing from these sources has increased substantially since 2014 (ibid.). Kenya issued its first sovereign bond in 2014, raising \$2.75 billion. The government also took out a syndicated loan of \$750 million in 2015 (IMF, 2018). The government has since issued two further rounds of bonds, one in 2018 for \$2 billion (IMF, 2018) and another in 2019 for \$2.1 billion (GOK, 2019d). These further rounds have been driven, in part, by a desire to raise funding to pay maturing debts (ADB, 2018).

Medium-term budget projections indicated a decreasing appetite for external borrowing as the government pushed for fiscal consolidation. The fiscal deficit was expected to decline to 3% in 2023/24, with government expenditure falling as a share of GDP and a fall in net borrowing for the development budget (GOK,

12 There have been breaches under the baseline scenario used by the IMF and World Bank in their Debt Sustainability Analysis regarding solvency and liquidity thresholds that relate to debt-to-export ratios.

13 This general debt does not capture all of Kenya's public sector debt, as it does not include extra-budgetary units or the debts of county governments.

Table 1 Government thresholds for debt sustainability

Public and publicly guaranteed (PPG) debt thresholds and ceilings	External debt thresholds
Present value (PV) of debt as a percentage of GDP: 70%	PV of debt-to-GDP ratio: 55
PPG debt service as a percentage of revenue: 30%	PV of debt-to-exports ratio: 240
Debt ceiling: KES 9 trillion	PPG debt-service-to-exports ratio: 21
–	PPG debt-service-to-revenue ratio: 23

Source: PBO (2020)

2020a).¹⁴ However, the medium-term budget was released before Covid-19 had reached Kenya, and before its impact began. Since then, the government has taken on a considerable amount of new loans, albeit concessional, from international financial institutions (IMF, World Bank and ADB) to provide a fiscal cushion for economic recovery and has officially paused its plans for fiscal consolidation.

Policies and preferences for borrowing and debt management

Kenya has laws and policies in place to manage public debt, including Article 201 of the Constitution, the Public Finance Management Act (GOK, 2012), a Medium-Term Debt Management Strategy (which is updated regularly), and an External Resource Policy (GOK, 2014). It also produced its first draft Debt Policy and Borrowing Framework in 2019 (GOK, 2019c) which provides guidelines for the management of debt.

Table 1 summarises the government’s thresholds for debt sustainability.

The government’s Medium-Term Debt Strategy also sets out an optimal financing strategy for 2020/21 to 2022/23 to reduce debt levels to enable fiscal consolidation at minimal cost and risk (GOK, 2020a). The strategy proposes the following:

- External debt (as a percentage of gross borrowing) should account for 28% of all gross borrowing, with domestic debt accounting for the remaining 72%.
- Of the 28% proposed external financing, half (14%) should be concessional, 1% should be semi-concessional, and the remaining 13% should be comprised of commercial borrowing.
- A portion of external debt should be in local currency (KES) to reduce the impact of exchange-rate risk and change the currency composition of Kenya’s debt portfolio.

The government has a strong preference for concessional finance. Its draft debt policy aims to maximise the use of such finance, with non-concessional finance only to be considered when concessional finance is not available, and only for projects that deliver enough financial or economic returns to repay the loan. The policy also states that commercial funds cannot be used for social projects and calls for an economic and social cost-benefit analysis to be undertaken for all borrowing to assess whether the benefits exceed the cost of capital. It stipulates that the project must show an impact before the end of the grace period of a loan and that short-term loans should be limited to projects that are commercially or strategically important (GOK, 2019c).

Despite this preference for concessional finance for rural development and agriculture, most of our interviewees and survey respondents noted that the government is expected to be willing to borrow on non-concessional terms for specific sub-sectors, such as rural basic infrastructure. Rural financial services and agricultural value-chain development could also be considered for non-concessional finance.

All of these areas fit with the government’s policy to ensure the use of non-concessional borrowing for projects that can generate financial returns. They also mirror the government’s non-concessional borrowing for the sector in the past, with the only use of non-concessional finance to the sector between

¹⁴ The share of development and net lending as GDP is forecast to fall from 5.5% in 2017/18 to 4.7% in 2023/24 according to the government’s Budget Policy Statement (GOK, 2020b).

2014 and 2018 being for infrastructure and value-chain development projects.

The only areas where our respondents expect the government to consider borrowing on highly concessional terms are climate-resilient agricultural practices and access to new technologies. They did not anticipate any appetite for borrowing (even on highly concessional terms) to support the rural investment environment (policy, legal and regulatory frameworks).

The government's expected preference when it comes to the terms and conditions of borrowing is for low interest rates (with close scrutiny of the cost of finance), a grant component and long maturity. This chimes with the draft debt policy, which calls for funding at the lowest cost (GOK, 2019c). Our respondents also identified the repayment schedule as important and noted a preference for more external debt in local currency, in line with Kenya's Medium-Term Debt Strategy, given the country's heavy exposure to debt in foreign currencies.

Preferences and instruments for rural development

Preferences for external assistance

The government prefers external assistance that is aligned to national policies, long-term, sustainable and predictable. Kenya has played a leading role in driving the international development effectiveness agenda forward, hosting the second-high level meeting of the Global Partnership for Effective Development Co-operation in 2016. It also has a strong set of policies and processes in place for its work with development partners, centred on the principles for international development effectiveness.

Kenya's 2014 External Resources Policy (GOK, 2014) identifies country ownership as the most important principle for its aid management. This was confirmed by most of our interviewees and survey respondents, who highlighted the importance of ensuring that funding is aligned to country plans. The policy also calls for ODA to make use of national systems and support local capacity, as well as being untied, predictable and results-oriented. The preference for long-term assistance reflects the long-term nature of

Kenya's development challenges and the desire to avoid the aid fragmentation and high transaction costs of multiple short-term aid contracts.

Demand for other types of instrument

Our survey respondents expect that the government would like more access to catastrophe risk drawdown option instruments, which could provide immediate liquidity in the aftermath of a natural disaster via a contingent credit line. It seems likely that this preference is driven by the impact of climate change on Kenya's agricultural sector, which is experiencing more droughts and pests, and the need for quick-releasing financing instruments.

The other main preference is for policy-based lending, with interviewees highlighting a strong desire by the government for more budget support. Finally, many of our interviewees noted a demand for instruments that support the leveraging of private finance to the sector. This fits with the government's ambitious agricultural development plans, which require significant private investment.

Conclusions

Our analysis of the experience and perspective of Kenya on financing public investment for inclusive and sustainable rural development, and particularly its demand for external assistance, is summarised as follows.

- Agriculture and rural development are high priorities for the government of Kenya, given the country's rural population, high levels of rural poverty and undernourishment, and the economic importance of the sector for jobs and growth.
- The government has highly ambitious plans for these sectors, which require substantial increases in funding from the government, the private sector and donors. However, medium-term budget projections do not signal any increase in public resources, with some resources set to decline. This will leave significant shortfalls that could be even worse as a result of the fiscal impact of the Covid-19 pandemic on Kenya.

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- ODF makes a significant contribution to agriculture and rural development, with donors providing just under half of all government spending for these sectors. The vast majority of ODF received is concessional and there has been a preference for grants: agriculture and rural development receive a higher share of grants than the average received for all sectors. Non-concessional finance has been extremely limited to date, with the government using such finance to fund major infrastructure projects outside these sectors.
 - Government demand for external assistance for agriculture and rural development is expected to increase over the next five to 10 years, with a clear preference for concessional finance, but also, to a lesser extent, some non-concessional finance. Any hopes of increased non-concessional financing may, however, be dampened by the economic impact of Covid-19 on Kenya and the recent re-classification of Kenya's risk of debt distress from moderate to high by the IMF and World Bank.
 - The government is anticipated to want greater access to catastrophic risk financing instruments, policy-based lending, and funding that leverages private sector financing for agriculture and rural development.

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Annex 1 List of interviewees

Name	Institution
Joseph Coompon	African Development Bank
Andrea Ferrero	European Commission
John Kabutha	The National Treasury
Moses Kanagi	The National Treasury
Esther Kasalu-Coffin	International Fund for Agricultural Development (IFAD)
Japheth Ntiba	State Department for Fisheries, Aquaculture and the Blue Economy
Nnenna Nwabufo	African Development Bank
Dunstone Ulwodi	The National Treasury

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