Budget Brief

Kenya 2018

June 2018

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Economic overview

Global highlights

The global economy recorded a broad-based recovery in 2017 to register a GDP growth of 3.8% compared to 3.1% in 2016. It is expected that the growth rate will improve to 3.9% in 2018.

The improved performance is attributed to a rebound in private and public investments, growth in international trade, accommodative financial conditions, improved business and consumer confidence and the rise of oil and commodity prices.

Africa overview

African economies were resilient and gained momentum in 2017. Real output growth is estimated to have increased by 3.6% in 2017 and is expected to accelerate to 4.1% in 2018 backed by stable commodity prices and business reforms to address macroeconomic imbalances and boost investment.

The World Bank has raised concerns on the increasing debt levels across the continent, with the composition of debt changing as the countries shift from traditional concessional financing to market-based debt with the attendant exposure to market risks.

Regional highlights

East Africa remains the fastest-growing sub-region in Africa, with estimated growth of 5.6% in 2017, up from 4.9% in 2016. The growth is expected to remain buoyant, reaching 5.9% in 2018 and 6.1% in 2019.

Below are the 2017 macroeconomic indicators for the East Africa region:

Item	Kenya	Tanzania	Uganda	Rwanda
GDP current prices (USD' Million)	76,642	52,453	35,068	9,133
GDP growth rate (%)	4.9	7.1	4.4	6.2
Population (Million)	46.6	51.6	44	11.8
GDP per capita (USD)	1,645	1,017	797	774
Overall inflation rate (%)	8.0	5.4	3.8	7.1
Treasury bill interest rate (%)	8.01	4.04	9.49	7.07
Budget deficit % of GDP	-7.2	-2.1	-4.8	-4.6
Total public debt (USD million)	45,195	21,933	10,530	4,129
Trade deficit as % of GDP	-9.7	-9.3	-4.8	-9.9
Tax revenues (USD million)	14,501	5,571	3,773	1,487

Budget overview

The theme for the 2018/19 Budget Speech is "Creating jobs, transforming lives and sharing prosperity." This is in line with the Big 4 Agenda of growing the contribution of manufacturing to GDP from 9% to 15%, providing affordable housing, universal healthcare coverage and ensuring food and nutrition security for all by 2022.

The Cabinet Secretary (CS) National Treasury proposed a number of regulatory and tax incentives to support the Big 4 Agenda.

Manufacturing

The investments in manufacturing aim to grow the contribution of manufacturing to the GDP to create over 800,000 new jobs. The government plans for modern industrial parks in Naivasha, Athi River and Dongo Kundu, coupled with the launch of SGR phase II passenger and cargo services to achieve this goal.

Tax incentives include lower tax rates for Special Economic Zones and favourable investment allowances. Further, in his speech, the CS proposed to cut the cost of electricity during off peak hours and provided for a corporation tax deduction equivalent to 130% of total electricity costs.

The government also plans to work with other East Africa states to review the Common External Tariff rates to protect local industries.

Affordable housing

Incentives and regulatory updates on affordable housing are expected to result in the construction of 500,000 reasonably priced and equipped houses.

In April 2018, the government in partnership with the private sector incorporated the Kenya Mortgage Refinance Company to mobilise capital for affordable housing.

The CS proposes a lower corporation tax rate of 15% for developers constructing a minimum of 100 units per year.

The Employment Act will also be amended to require employers to contribute 0.5% of employee gross monthly pay capped to KES 5,000 to the National Housing Development Fund. Employees will make a matching contribution of 0.5%. The contributions will be used to finance the provision of affordable housing.

Universal health care

Community health programs such as Linda Mama will be scaled up through the provision of specialised medical equipment to county hospitals and increasing community health facilities.

The government will also pilot a universal health coverage program in Kisumu, Nyeri, Isiolo and Machakos counties in preparation for nationwide launch.

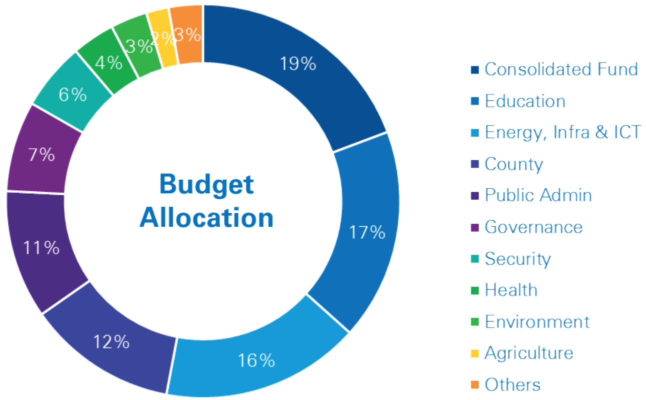
Other initiatives include the launch of a comprehensive NHIF medical scheme for secondary schools students.

Food and nutrition security

The government plans to partner with the private sector to promote large scale farming as one way of reducing the cost of food. The government will also provide incentives to attract investments in post-harvest handling and storage facilities to reduce wastage.

The CS also communicated the government's commitment to upscale the provision of insurance and affordable credit facilities to small scale farmers.

2018/2019 budget allocations



Upscale of major infrastructure

The government is keen on improving the country's infrastructure and has allocated **KES 273.8 Billion** to key infrastructure projects such as:

- Phase 2A of the SGR Project;
- Mombasa Port Development Project;
- Expansion of several airports and airstrips;
- Exploration of geothermal, wind and solar resources;
- Rural electrification; and
- The Eastern Electricity Highway Project connecting Ethiopia and Kenya.

Tourist destination – Tembea Kenya

The government has allocated **KES 2.045 Billion** towards the promotion of Kenya as a tourist destination. The funds will be used for advertising, lending to hoteliers and the restoration of Fort Jesus.

A click away

The Digital Literacy Programme, the construction of the Konza Complex and the Presidential Digital Talent Programme are among the ICT programs that have received a significant allocation **(KES 22.1Billion)** in this year's Budget.

The funding will support the digitalisation of government services such as Integrated Financial Management Information System (IFMIS) and Huduma centres which have improved information flow, transparency and tax collection.

Inua Jamii – Improved welfare for all

The government has extended cash transfers to vulnerable groups, less fortunate families, youth and persons with disabilities.

The Presidential Secondary School Bursary Scheme and the Kenya Hunger Safety Net Programme are among the funds that will benefit from the allocation of **KES 33 Billion.**

Tax collections from winnings and bettings will also be channelled towards the construction of a Sports Academy and the completion of the Ultra–Modern National Library.

Piece of the pie

County governments are set to receive 40% of audited national government revenues **(KES 314 Billion)** which is above the constitutional threshold of 15%. This is a boost to devolution and grassroots development.

There is commitment to have the Commission on Revenue Allocation develop a second policy on Marginalized areas to ensure they benefit from the Equalisation Fund.

Liquid gold

As Kenya joins the league of oil producing countries, the government has completed the Sovereign Wealth Fund Legislation to protect the country from the infamous "Dutch Disease".

The government has committed to allocate resources to facilitate the construction of the crude oil pipeline from Lokichar to Lamu and the completion of export facilities at Lamu on a project finance basis.

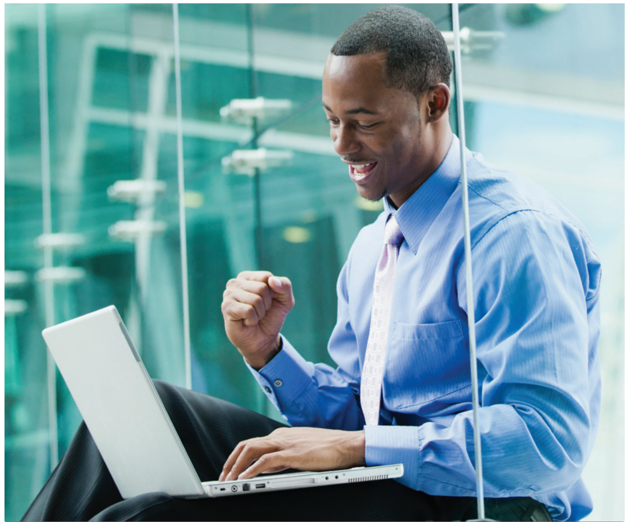
Relentless war on corruption

Reforms to the Public Procurement and Asset Disposal Act (PPADA) have been proposed to increase transparency in government procurement procedures.

The PPADA Regulations, set to be tabled before Parliament are to improve public trust in light of recent misappropriation of public funds.

Ethics and Anti-Corruption Commission, Department of Public Prosecution, Asset Recovery Agency and Financial Reporting Centre will receive government finance to aid in fighting corruption.

Tax procedures



“The government granted an amnesty to taxpayers who had foreign assets and taxable income.”

Don’t ask, don’t tell

The government granted an amnesty to taxpayers who had foreign assets and taxable income, to declare the assets and repatriate the funds by 30 June 2018. Given the low uptake of the amnesty, the government has proposed to grant an extension for filing and declaration purposes to 30 June 2019, for income accruing for the period ended 31 December 2017. The amnesty previously covered up to the period ended 31 December 2016.

Perhaps in a case of what the eyes do not see, the heart does not grumble about, the government further proposes to exempt the repatriated funds from scrutiny in line with the provisions of the Proceeds of Crime and Anti-Money Laundering Act (PoCAMLA) provided that the funds are not proceeds from terrorism, poaching and drug trafficking.

The government’s approach to incentivise the uptake of the amnesty may result in higher foreign direct investments for the country. The six months period to June 2018 has seen a significant jump in diaspora remittances, no doubt underpinned by the amnesty. However, without scrutiny under the PoCAMLA, how would the regulator distinguish the proceeds from the prohibited sources and clean sources without the source of income being declared?

Caesar wants his dues

Tax by definition is a punitive charge. The only thing that hurts more than paying taxes, is not paying tax, as the resultant penalties are punitive.

However, the current penalties and interest on late payment of tax is not a significant deterrent. As a result, a majority of compliant taxpayers file returns on time but do not remit the related taxes to the Kenya Revenue Authority.

To motivate taxpayers to pay their dues on time, the government proposes to increase the interest rate on late payment of taxes from 1% to 2% per month. In addition there is a proposed 20% penalty on late payment of taxes. With the return of the punitive penalty and interest regime, it will be time taxpayers give unto Caesar what is Caesar’s.

Defining the rules of engagement

The government has proposed to limit the time for application of extension for filing returns. Further, the number of times a taxpayer can amend a filed return will now be limited.

This will effectively address the gaps in the law and remove the possibility of unlimited applications for extension of time to file returns or amend returns.

Income Tax

“The government has recognised the increasing importance of the port of Mombasa as a gateway to East and Central Africa and is now seeking to cash in.”

Corporation tax

Taxman goes after small business

Businesses with a turnover of less than KES 5M will be required to pay presumptive tax at 15% of the single business permit fee. This tax replaces the turnover tax currently levied at 3% of turnover. Turnover tax faced implementation challenges and did not achieve its objective of bringing the informal sector to the tax net.

While the introduction of presumptive tax appears to collect less tax as compared to turnover tax, the ease of its implementation and administration will enhance its reach and expand the tax base. It may also be used to enrol new taxpayers for ease of follow-up should the government decide to increase the tax rate in future.

Electricity allowance

Manufacturers will now enjoy an additional 30% deduction on their electricity bills effectively getting a 130% tax deduction. The move supplements the 50% reduction in the cost of off-peak power and supports the government’s Big 4 Agenda by reducing the cost of production to grow the local manufacturing sector.

Withholding tax

Leveraging on the ports

The government has recognised the increasing importance of the port of Mombasa as a gateway to East and Central Africa and is now seeking to cash in. In a move to increase revenue collection, the government proposes to levy withholding tax at a rate of 20% on demurrage fees paid to non-residents shipping lines.

Should the shipping lines shift the tax burden to the shippers, the competitiveness of the Port of Mombasa will be severely eroded especially where delays resulting in demurrage are attributable to inefficiencies in port operations.

20% CGT proposal shelved

Much to the relief of many property investors, the government has dropped the proposal in the Income Tax Bill to raise capital gains tax on disposal of property from 5% to 20%.

CGT on insurance companies clarified

The government has directed that CGT will apply on disposal of property by general insurance companies. The position adopted by the Cabinet Secretary remains vague as there is no explicit CGT exemption for general insurance companies. In our view, this provision is intended to clarify that CGT is not applicable on the transfer of property by life assurance companies, which has been a contentious issue in the past.

Caesar’s noble intentions

The Cabinet Secretary has clarified that withholding taxes collected from winnings shall be used for the development of sports, arts and cultural activities for the youth as well as critical social development initiatives such as universal health care which is part of the Big 4 Agenda.

Tax on insurance premiums

To protect local insurance companies and enhance the tax base, the Cabinet Secretary proposes to introduce a 5% withholding tax on premiums paid to non-resident insurance companies. However, premiums paid for aircraft insurance shall be exempt from tax.

This move is expected to increase the cost of reinsuring risks with foreign reinsurance companies.

Income tax: Pay As You Earn

Public participation becoming effective?

The proposed introduction of a 35% tax rate on employment income above **KES 9,000,000** per annum (**KES 750,000** per month) has been dropped owing to the concerns that came through public participation.

The move to introduce a higher income tax band was unforeseen and highly unwelcome given that the cost of living has been on a steep rise.

In the past two years, the government has expanded individual tax bands in a move to cushion low income earners from the high cost of living by providing them with more disposable income.

Tightening the noose on work permits

The government has been strict with the issuance of work permits in a move to protect the local labour market. Only expatriates whose skills support Kenya's development agenda will be considered.

Given that the work permits have generally been issued on the basis of skills, the Cabinet Secretary's statement can only be interpreted as tightening the noose on issuance of work permits.

Further, the Cabinet Secretary for Interior and Co-ordination of national government issued a directive for verification of work permits and registration of expatriates. The ongoing exercise is meant to establish the validity of the work permits and ends on 20 July 2018. Thereafter the expatriates will be issued with new digital identification cards.

Upon lapse of the sixty days work permit verification window, the Immigration Department will conduct a crackdown on the expatriates who are in Kenya illegally.

Ambitious efforts to promote affordable housing

The Cabinet Secretary proposed to amend the Employment Act to provide for contribution by the employers to the proposed National Housing Development Fund. The contribution will be 0.5% of the employee's gross monthly emoluments, subject to a maximum of **KES 5,000** while the employee will contribute 0.5% of their monthly gross earnings.

It's neither clear whether the employer/employee deductions will be tax allowable nor what the benefit to the employee who already owns a house, will be. Additionally, the contribution period and process of accessing the benefit is not spelt out.

" The Cabinet Secretary proposed to amend the Employment Act to provide for contribution by the employers to the proposed National Housing Development Fund. "

Excise Duty

20%-30%

Proposed increase in Excise Duty on the importation of motor vehicles whose engine capacity exceeds 2500cc for diesel and 3000cc for petrol powered engines

Guzzlers to fuel revenue

Currently, private passenger motor vehicles are subject to 20% Excise Duty irrespective of the engine capacity.

The Cabinet Secretary has now proposed to increase Excise Duty on the importation of motor vehicles whose engine capacity exceeds 2500cc for diesel and 3000cc for petrol powered engines from 20% to 30%.

While this move will increase tax revenues, it will drive up the cost of fuel guzzlers. Any ensuing reduction in demand for these vehicles will be a bonus for the environment.

Banking on Robin Hood

Salivating at the increasing sums being transacted through the financial sector, the government has proposed a 0.05% Excise Duty on all financial transactions above KES 500,000.

Further, the government is also proposing to increase the Excise Duty on cellular money transfer fees from 10% to 12%.

The funds generated from the Robin Hood taxes will be used to finance universal health care.

No gain in fuel adulteration

The Cabinet Secretary has proposed to harmonise Excise Duty on illuminating kerosene and gas oil to discourage fuel adulteration.

Currently, illuminating kerosene attracts Excise Duty at the rate of KES 7,205 per 1,000 litres whereas gas oil attracts Excise Duty at the rate of KES 10,305 per 1,000 litres. The differential in the rates encouraged the rampant fuel adulteration, depriving the government of revenue and endangering consumers.

While the proposed change will help to curb adulteration and increase tax revenues, it will put further pressure on the poor who rely on kerosene for lighting and cooking.

> "The Cabinet Secretary has proposed to harmonise Excise Duty on illuminating kerosene and gas oil at KES 10,305 per 1,000 litres to discourage fuel adulteration."

Miscellaneous Acts

End of an "error"?

The interest rate capping locked out the private sector, especially the micro small and medium enterprises (MSMEs). This in turn led to a slow-down in economic growth as banks preferred to lend to the government.

Empirical economic evidence suggests that interest rate caps are, in most cases, ineffective. Perhaps realizing this the CS proposes to repeal Section 33B of the Banking (Amendment) Act, 2016, effectively doing away with the interest rate cap. This end of an era should ease liquidity and jumpstart the economy.

Rocking the insurance sector!

If the insurance sector proposals go through, the changes will alter the playing field significantly.

The CS has proposed to amend the Insurance Act to require payment of insurance premiums directly to insurance companies. Whilst this move casts doubt about the continued relevance of insurance intermediaries such as agents and brokers, KRA will no longer collect withholding tax on agency and brokerage commissions.

There is also a proposal to introduce index based insurance to diversify from the traditional indemnity based insurance. This will encourage growth in the insurance sector as it will enable product diversification by insurance companies to the agricultural sector which is under insured, despite the vagaries of weather.

Finally, with fraud being a thorn in the flesh in the industry, the CS has proposed to criminalize insurance fraud. This should lead to manageable loss ratios in the sector.

Consolidating the entrepreneurship pennies

The government currently runs multiple funds to drive entrepreneurship.

However, there have been inefficiencies and duplications with the various funds existing independently. To partly resolve this, the CS has proposed to merge the Youth Fund, Uwezo Fund and the Women Enterprise Fund to form the Biashara Kenya Fund. With a bigger balance sheet, Biashara Kenya Fund will stretch the pennies.

> "Empirical economic evidence suggests that interest rate caps are, in most cases, ineffective."

Teeth for regulators

Kenya's rate of financial inclusion is impressive. With increased access to financial products, predatory lending has highlighted the need for enhanced consumer protection.

The Financial Markets Conduct Bill seeks curb the under regulated lending in the sector. Similarly, the CS has proposed to amend the Capital Markets Act to introduce enhanced financial controls and investor protection.

The Retirement Benefits Authority (RBA) has been mandated to develop measures to compel employers to remit pension contributions, a move seen to protect contributors from delinquent scheme sponsors and employers.

Affordable housing and universal healthcare

As part of its implementation of the fourth pillar of the Big 4 Agenda, the government has incorporated and is capitalizing the Kenya Mortgage Refinance Company (KMRC). KMRC is designed to address the mortgage financing gap, making access to affordable housing a reality for Kenyans.

The CS has also proposed to amend the Retirement Benefits (Individual & Occupational Retirement Benefit Schemes) Regulations to permit members who do not have medical cover at retirement to use a portion of their retirement benefits to finance post-retirement medical cover. Any contributions to this medical fund do not attract the retirement benefit levy.

Upping the tenor - Anti-money laundering (AML)

The fight against AML becomes more complicated with the advancement in technology and new ways of doing business.

There is a proposal to amend the PoCAMLA to address the money laundering and terrorism financing risks associated with non-face-to-face transactions such as online transactions.

Other proposed changes to the PoCAMLA to enhance the fight against AML include enlisting other regulatory bodies such as SASRA to monitor transactions for AML at the SACCO. The Betting Control and Lotteries Board will also undertake stringent fit for purpose vetting prior to issuance of casino licenses.

Double tax avoidance in the counties

Although the Constitution requires that county taxes should not hinder national trade, some county taxes have been challenged as imposing double taxation and impeding trade.

To address this risk of double taxation at the county level, the CS will be publishing the county governments Revenue Raising Regulation Process Bill, to regulate the process of introducing new taxes, fees and charges by county governments. This will ensure that any taxes being introduced by the county governments are approved and do not result to double taxing of traders and businesses.

Every coin counts!

Regulatory authorities such as the IRA and CBK have been exempt from tax but are required to remit 90% of their surpluses to the Consolidated Fund. However, the regulatory authorities have not been consistent in remitting the surplus as required.

To diversify the sources of government revenue and optimize all available funds, the CS proposes to amend the KRA Act to mandate KRA to collect and remit such surpluses to the Consolidated Fund.

With Kenya expected to join the leagues of crude oil producing nations, the CS has proposed to establish a sovereign wealth fund in order to manage revenues from crude oil reserves. This is a good move to ensure that future generations share in the country's natural resource wealth.

Streamlining public procurement

The world over, government is the biggest consumer in any economy. Though designed to ensure transparency, the public procurement regime has not lived up to its ideals. Indeed, most scandals have their roots in the complex and opaque procurement process. As a mitigation, the CS proposes to introduce Regulations to the Public Procurement and Asset Disposal Act to provide for the publication of all concluded contracts by government bodies.

Further, the Regulations will prioritize Kenyan-sourced goods and services under the "*Buy Kenya Build Kenya*" initiative. Delayed payments by the government can be financially costly and to address this risk, payment for contracts completed will be within 60 days if the proposals are accepted.

Value Added Tax

16%

VAT imposed on petroleum products effective from 2 September 2018

ICT

Exemption of VAT for parts used in the assembly of laptops is expected to encourage local assembly of computers and growth of the ICT sector.

More pain at the pump

The VAT Act, 2013 exempted petroleum products from VAT for a period of 3 years. The Finance Act 2016 extended the exemption for a further two year period to 1 September 2018. This time, the Cabinet Secretary did not give an extension, effectively imposing 16% VAT on petroleum products such as petrol, diesel, illuminating kerosene and jet fuel with effect from 2 September 2018.

VAT charged on petroleum products is part of the stringent conditions that the International Monetary Fund set for Kenya in exchange for a standby credit facility.

Petroleum products are already highly taxed and the imposition of VAT will put an upward pressure on inflation rates, increasing the pain on consumers.

Feeding the nation

To improve food security in line with the Big 4 Agenda, the Cabinet Secretary has proposed to exempt equipment used for the construction of grain storage facilities from VAT. This is in addition to the existing exemption on materials used in the construction of the facilities.

This move is primarily to ensure that there is adequate and affordable grain storage facilities to reduce post-harvest losses.

Animal husbandry not left behind

Agriculture is the backbone of Kenya's economy. To promote this sector, the Cabinet Secretary has proposed to exempt from VAT all raw materials used in the manufacture of animal feeds. This complements the existing VAT exemption on animal feeds and cushions manufacturers who are not able to claim input VAT on the raw materials.

The exemption will reduce the cost of locally manufactured animal feeds and attract investors into the sector.

Let's go digital!

One of the government's key programmes is to provide laptops to primary school children as a teaching tool. To promote the programme, the government exempted parts for the assembly of the laptops from VAT.

The Cabinet Secretary has now extended the exemption to include parts used in the assembly of all computers. It is expected that this move will encourage local assembly of computers and the growth of the ICT sector.

Import Duty

The age of protectionism!

The Cabinet Secretary has proposed higher duty rates to protect local manufacturing industries specifically, iron & steel, textile and footwear, paper, timber and vegetable oil. This move complements efforts by government to revive companies such as Panpaper and Rivatex.

The proposed import duty changes are tabulated below:

Item	New	Old
Iron ore and steel	35%	25%
Paper and paper board	35%	25%
Textile and footwear	Higher of USD 5/unit or 35%	25%
Particle Board	Higher of USD 110/MT or 35%	25%
Medium density fibre board	Higher of USD 120/MT or 35%	25%
Plywood	Higher of USD 230/M3 or 35%	25%
Block-board	Higher of USD 200/MT or 35%	25%
Vegetable oils	Higher of USD 500/MT or 35%	25%
Overland trucks and sightseeing buses	Exempt	25%
Pesticides and acaricides	100% duty remission under the East Africa Duty Remission	10%
Clean energy cooking stove	100% duty remission under the East Africa Duty Remission	10% or 25%
Export levy	20% on copper waste and scrap	N/A

As Kenya is a signatory to the Africa Continental Free Trade Area (ACFTA), it will be important to ensure that the proposed protection measures are included in any tariffs agreed under the ACFTA.

Change is the only constant

A comprehensive review of the EAC Common External Tariffs (CET) is being advanced with the intention of enhancing protection of industries in the East African region as well as creating a conducive business environment for investors.

In addition, the East African Community Customs Management Act, 2004 (EACCMA) is undergoing a review to incorporate new developments as well as address challenges faced in the implementation of this legislation.

It will be interesting to see the proposals especially in light of continuing trade liberation discussions with the European Union and the ACFTA.

The rise and fall of pests

Even though food security is one of the government's Big 4 Agenda, Kenya has continued to grapple with the scourge of armyworms and other pests that lead to destruction of crops.

In-order to triumph in the 'war' against vectors and pests, the government is encouraging the local production of pesticides through the proposed remission of import duty on raw materials and inputs imported by licensed pesticides manufacturers.

Tembea Kenya

The Cabinet Secretary has proposed to exempt from import duty sightseeing buses and overland trucks used by licensed tour operators. Currently, the sightseeing buses and overland trucks attract import duties at 25%.

This move will enhance growth in the tourism sector.

Promoting use of clean energy

The Kenyan government has instituted a raft of measures to increase Kenya's forest cover to 15% by 2022. The measures include promoting the use of environment friendly cooking equipment. To this end, the Cabinet Secretary has proposed a 100% remission of duty on raw materials used in the assembly of clean energy cooking stoves imported by local manufacturers.

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