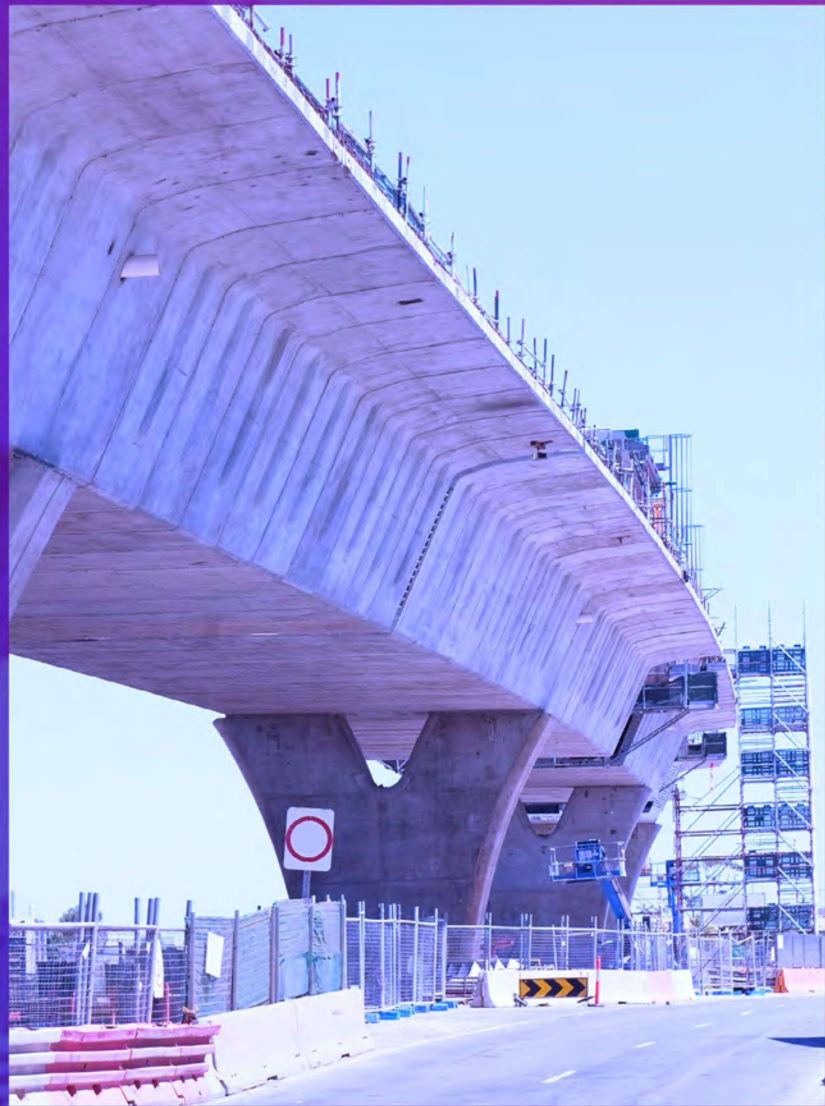
Budget brief

Accelerating Economic Recovery for Improved Livelihood



Kenya | April 2022

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Economic Highlights

Global Highlights

- The global economy experienced a growth of 6% in 2021 up from a decline of 4.9% in 2020 and growth of 2.9% in 2019 and 3.5% in 2018. This is the economy's first turn towards recovery after the decline caused by the COVID-19 pandemic.
- The East Asia and Pacific region outperformed the global average growth by rebounding to 7.1% in 2021. Europe and Central Asia is estimated to have expanded by 5.8% in 2021, as a result of a bounce-back in domestic demand and positive spill overs from firming activity in the euro area.
- Despite the recovery towards the end of 2021, in 2022, the global economy experienced significant shocks as a result of supply disruptions, supply logistics challenges, inflation. The Ukraine crisis has worsened the global economic outlook due to its direct impact on the global supplies of grains and petroleum. If the crisis continues for several months, it is likely to lead to a global recession.
- The global economy remains considerably fragile as new variants of COVID-19 spread across the globe, resulting in potential disruptions to the supply chains.
- Many countries have adopted differing strategies to combat Covid-19. China which is a key cog in the global supply chain has adopted a strict zero-covid strategy in the country's financial centre of Shanghai. The supply chain disruptions are likely to drive global inflation.

Africa Highlights

- In 2021, the continent grew at a rate of 3.5% up from a decline of 2.1% in 2020. This rebound was fueled by high commodity prices and relaxation of stringent pandemic measures. However, there is still a risk of disruptions from new COVID-19 variants, low rates of vaccination and protracted economic damage. Further, the continent continues to feel the impact the locust invasion from one year ago which ravaged the east side of the continent, delayed rains and the global increase in food prices as a result of supply disruption.
- Growth in the three largest Sub-Saharan Economies of Angola, Nigeria, and South Africa is estimated at 3.1% in 2021. In Angola and Nigeria, growth was driven by the recovery in non-oil sectors as oil production across the region remained depressed due to disruptions and declining investment in extractive industries. In South Africa, though the economy rebounded strongly, the country experienced a severe COVID-19 outbreak, limiting the performance of the economy.
- The tourism based economies faced an upturn in their performance as borders begun to open up on the continent. According to the United Nations World Tourism Organisation, Africa increased her tourism by 51% between January 2021 and January 2022.
- Several large African economies including Angola, Mozambique, Ethiopia, South Africa, Zambia and Zimbabwe, have tightened policy in 2021 over concerns about rising energy and food prices.
  In some countries such as Nigeria, Ethiopia and Angola, inflation has remained in double digits as a result of currency depreciations.
- African countries have relied on external borrowing to fund their economies over the recent years. Many countries have floated sovereign bonds to finance development projects. It is expected that to achieve economic recovery, many countries will increase their reliance on expensive sources of financing to supplement domestic revenue which is under pressure from the impact of COVID-19.
- In the coming year, economists forecast that the continent's economy will grow at a rate of 3.7%.
- On the regional front, the African Development Bank, observes that East Africa's economy recovered to an average of 4.1% in 2021, up from 0.4% posted in 2020. In 2022, average growth in East African economy is projected to hit 4.9%.
- COVID-19 containment measures, global supply and demand disruptions hit businesses in the region considerably and increased poverty. The region suffered further shocks due unrests in Ethiopia.
- The region's public debt rose as a result of slowdown in real GDP growth, emergency spending on healthcare and reduced inflows of commodity revenues.

Kenya Highlights

- The Kenyan economy is projected to grow by 5.9% in 2022 up from projected growth of 5% in 2021. The projection assumes that economic activity will normalize due to a full reopening of the economy, the Economy Recovery Strategy being successfully implemented and capitalizing on expected improvement in external liquidity.
- In the beginning of 2022, the country has been severely affected by the global rise in price of food and fuel. The Central Bank of Kenya reported a national general inflation rate of 6.08% driven by food inflation of 8.89% and oil inflation of 8.12%.
- The food inflation is primarily attributed to the delayed rains which affected the production and price of food. Furthermore, the oil inflation has exacerbated the situation as affected the energy prices associated with the production of food and fertilizer, as well as the cost of transporting the food.
- In recent years, Kenya has increased reliance on external financing primarily for investment in infrastructure projects as well as expenditure related to the COVID-19 pandemic. Kenya's debt service to revenues is projected to stand at 74.5% in FY 20/21. The Kenya shilling has experienced significant pressure as the demand for the dollar has remained high due to the country's oil related imports.

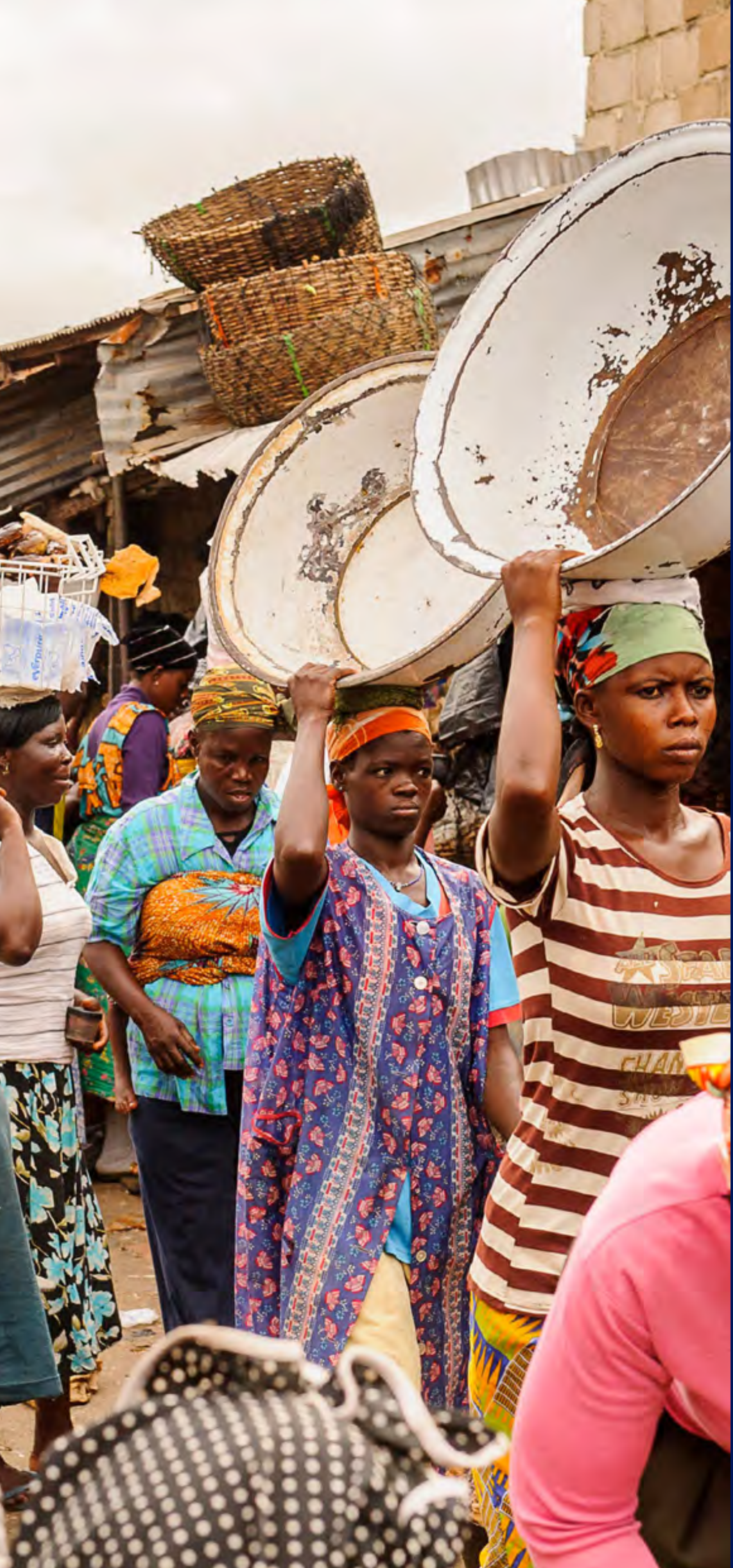
The elevated prices have outweighed the supply from key export earners in Kenya.

- Inflation is projected to remain within the Central Bank of Kenya's target range of 2.5% to 7.5%, and fiscal and current account deficits are forecast to narrow as a result of improved revenue collection and exports. Downside risks to the outlook could emanate from delays in the full reopening of the economy, failure to secure external financing to execute the budget, a slowdown in global growth, and disruption of social relations in the run-up to the August 2022 elections.
- Europe experienced a 95% increase in the number refugees by August 2021. This staggering number is expected to rise with the increase of Ukrainian refugees which stood at 4.3 M refugees in March 2022. In 2022, UNICEF announced that it would require USD 42 billion to support host governments in supporting incoming refugees. The support going to Eastern Europe and the expected slowdown in economic growth will have a negative impact on project and budget support for developing countries such as Kenya.
- Further, in the last two decades, China has risen to become one of Kenya's most important development partners. The impact of the ongoing fight against Covid-19 and slowdown in the economy will trickle down to Kenya.
- The current public debt legal limit is KES 9 Trillion. The CS has proposed amendments to the Public Finance Management Act to change the law and move from the current ceiling of KES 9 Trillion to a debt anchor based on 55% of the country's Gross Domestic Product (GDP).
- If enacted, the legislation will allow the CS to breach the cap under certain circumstances such as abrupt fiscal disruptions, pandemics, war etc. The current debt binge is not sustainable as Kenya is susceptible to export and exchange rate shocks over and above the COVID-19 global shock.

Budget Overview

- The Cabinet Secretary for the National Treasury (CS) presented the 2022/2023 budget under the theme: "Accelerating Economic Recovery for Improved Livelihood". The budget's focus is on implementing economic policies and undertaking structural reforms geared towards improving the welfare of Kenyans. This includes accelerated implementation of the Big Four Agenda and the Third Economic Stimulus Program for sustainable growth.
- The budget seeks to re-prioritize public spending towards pro-poor expenditures in health, education and supporting the vulnerable segment of the population. The Government will also leverage on the Public Private Partnerships to fund public projects, support the private sector and narrow the fiscal deficit.
- The budget comes against a background of a moderate global growth of 4.4% in 2022, which is a slowdown from a recovery of 5.9% in 2021. There are some expected risks to this growth outlook largely from possible re-emergence of COVID-19 pandemic and the on-going conflict in Eastern Europe.
- Kenya's economy is projected to stabilize at 6% in 2022, supported by recovery in agriculture, industry and services sectors. To further strengthen this outlook, the Government will continue to safeguard macroeconomic stability by ensuring inflation remains within the Government target range while interest rates remain stable to support growth in private sector credit.
- On the domestic front, the projected economic recovery may be adversely affected by re-emergence of COVID-19 variants and possible adverse weather conditions. Externally, the ongoing conflict in Eastern Europe has created uncertainties that will affect the global economic outlook through disruption of supply chains, rising global oil prices and increased inflationary pressures.
- The fiscal policy supporting the budget for the financial year 2022/23 as well as the medium-term is designed to accelerate economic recovery for improved livelihood for Kenyans.
- The 2022/23 budget targets revenue collection including Appropriation-in Aid and grants for the FY 2022/23 budget to be KES 2.4 trillion equivalent to 17.5% of GDP, a growth from 2.04 trillion, equivalent to 16.8% of GDP in 2021/22. Of this, ordinary revenue is projected at KES 2.14 trillion equivalent to 15.3% of GDP.
- Total expenditure in the FY2022/23 is projected at KES 3.3 trillion equivalent to 23.9% of GDP. Recurrent expenditures will amount to KES 2.2 Trillion while development expenditures including allocations to Foreign Financed Projects, Contingency Fund and conditional transfers to County Governments is KES 715.5 billion

> Total expenditure in the FY2022/23 is projected at **KES 3.3 trillion** equivalent to 23.9% of GDP.



Budget Review

Financial Sector Stability and Development

- Based on reforms initiated by the Central Bank of Kenya, the Kenyan banking sector is stable and has shown great resilience with strong capital and liquidity buffers.
- The sector has continued with its transformation journey under the Kenya Banking Sector Charter issued by CBK.
- The CBK (Amendment) Act 2021 was enacted to provide CBK with powers to licence and oversight the previously unregulated digital credit providers.
- CBK has also issued a detailed guidance on Climate-Related Risk Management to all commercial banks to curb the climate related risks in their operations.

Credit Support to Micro, Small and Medium Enterprises

- Since the launch of the Credit Guarantee Scheme in December 2020, the total loans extended to MSMEs under this scheme had surpassed KES 2.2 Bn by December 2021. The Government will seek support of development partners to increase the scheme's capital from KES 4 Bn to KES 10 Bn over the medium term. Additional Participating Financial Intermediaries will also be brought on board to enhance coverage of the scheme.

Access to Financial Services

- The FinAccess Survey 2021 conducted in 47 counties revealed that access to formal financial services increased by 0.8% in 2021 while access to the informal channels reduced from 6.1% to 4.7%.
- The increase of access to formal financial services was attributed to the progress made by Kenya to expand financial access through various channels including mobile money financial platforms.

Support to Affordable Housing

- The Kenya Mortgage Refinance Company has played a leading role in the delivery of Affordable Housing in Kenya and has so far disbursed over KES 2 Bn and is currently processing an additional KES 7 Bn.
- To provide a sustainable source of funding and to complement the existing credit lines, the NSE has successfully issued its first Corporate Bond of KES 1.4 Bn under a Medium-Term program of KES 10.5Bn.

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Policy priorities and strategy

Over the recent years, the Government has focused on the "Big Four" Agenda to foster socio-economic development.

However, the COVID-19 pandemic slowed down the implementation and full realization of the expected benefits.

Despite the above, the Government has committed to continuing the implementation of the Economic Recovery Programme.

In addition to the above, the Government has continued with the implementation of various stimulus programs to manage COVID-19 pandemic, support businesses and general employment.

Specifically, the Government committed to:

- Enhance the role of the private sector in the economy, including financing infrastructure projects through the PPP;
- Support micro, small and medium enterprises by facilitating access to finance;
- Invest in ICT and digital infrastructure;
- Promote and strengthen local and foreign resource mobilization efforts;
- Improve social-protection through targeted policy interventions and programmes;
    - promote local production processes and domestic supply value chains; and,
    - strengthen monitoring and evaluation systems for quality outcomes of the projects.

Capital Markets Development

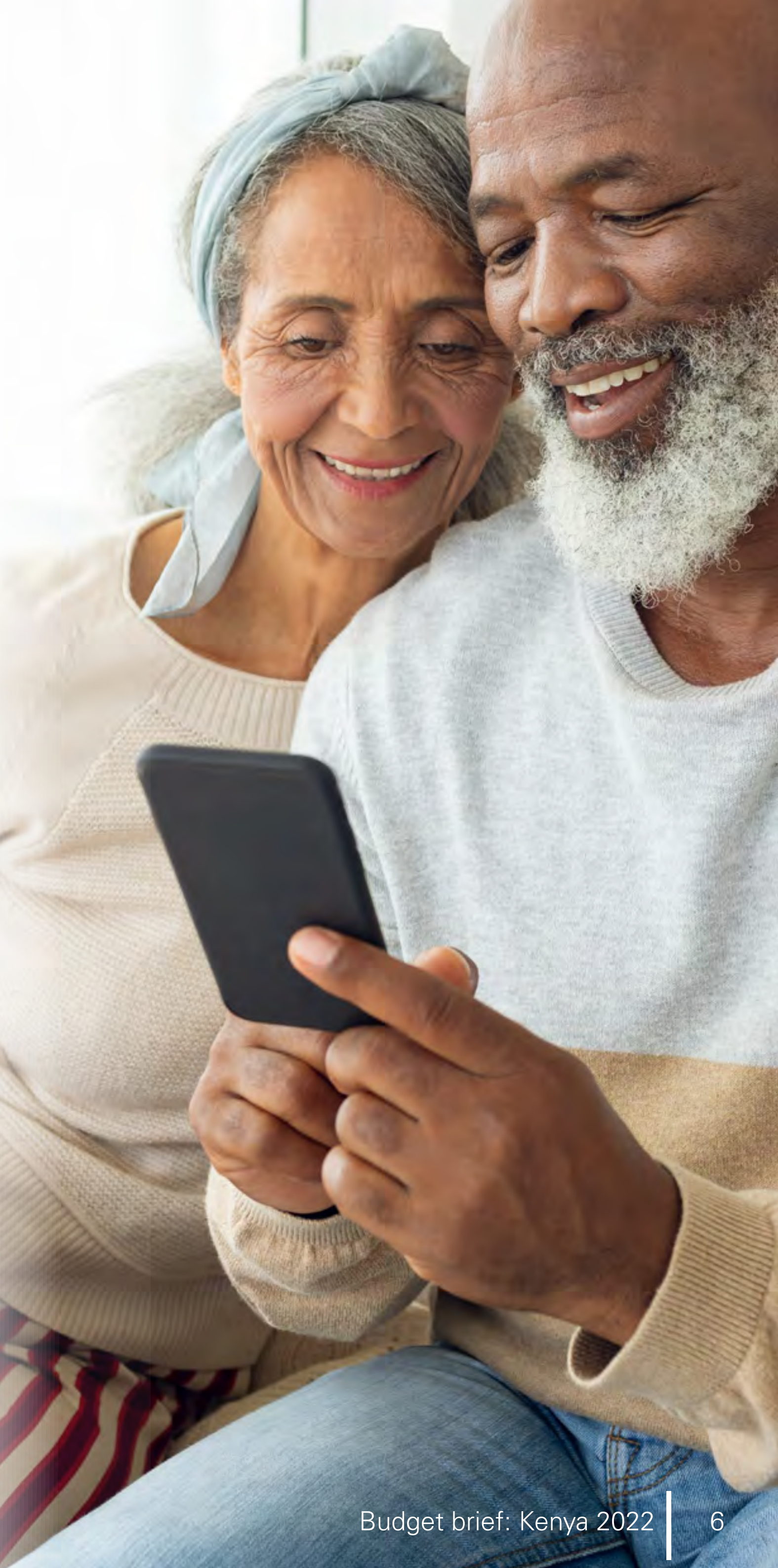
- The Government committed to addressing some of the issues in the capital markets. These include, aspects on collective investment schemes and investment-based crowd-funding.
- The Government is installing a new Central Securities Depository System at the CBK to support planned reforms in secondary trading of government bonds.
- Furthermore, the Government has committed to making changes to the Capital Markets Act to expand the spectrum of persons who can act as investment advisors. This will allow single director companies and partnerships to be licensed as investment advisors.

Pension Reforms

- The National Treasury will roll out the new pension management system in the course of the financial year.
- The system will offer an end-to-end Enterprise Resource Planning solution in the management and processing of pension benefits.
- The Scheme is eventually expected to ease pressure on the pension wage bill while guaranteeing sustainability of public service pensions.
- The National Treasury is developing an over-arching National Pensions Policy that sets the guiding principles for application across board on structuring and management of retirement benefits for public servants.

Resilience against Climate Change

- The Government committed to implement the "Financing Locally-Led Climate Action Program (FLLoCA)" – a 10-year financing program aimed at mobilizing climate finances to support local communities build their resilience and adapt to the impacts of climate change in 47 Counties.
- The Government has finalized the Long-Term Low Emission Strategy to guide a low carbon-climate resilient development path. To address the financing challenge of climate change actions, the Government will develop a Climate Finance Mobilization Strategy.



Income Tax- Corporation Tax

Cash donations - Tax deductible!

Proposed provision: All cash donations made to charitable tax exempt bodies or any project approved by the CS National Treasury will be allowable for tax purposes.

Currently, the only cash donations which are tax deductible are the ones which relate to charitable organizations which are tax exempt and registered under the Societies Act or the Non Governmental Organizations Coordination Act, or for projects approved by the CS National Treasury.

Implication: This is a welcome move which will hopefully act as an incentive for donations to support worthy causes.

Gains from Financial Derivatives accruing to non-residents now taxable.

Proposed provision: Gains from financial derivatives such as futures, options and forwards derived from Kenya by non-residents persons will now be subject to tax.

Currently, the taxation of these gains is not specifically provided for under the legislation.

Implication: This is a move by the government to increase the tax revenue base by bringing the gains derived from derivatives by non-resident persons within the tax net.

Microfinance institutions off the Thin Cap hook.

Proposed provisions: Microfinance institutions licensed under Microfinance Act shall be excluded from the thin capitalization rules.

The Finance Act, 2021 overhauled the thin capitalization ratio of debt to equity of 3:1, to 30% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA). Banks and other financial institutions are exempted primarily due to their business operating model which largely involves lending and borrowing of funds and thus high interest expense.

Implication: Exclusion of Microfinance institutions from the thin capitalization rule is a welcome move as interest expense is a major expense for these entities. Given the key role that these entities play in revenue mobilization especially for the informal sector, this is indeed a noble proposition by the CS National Treasury.

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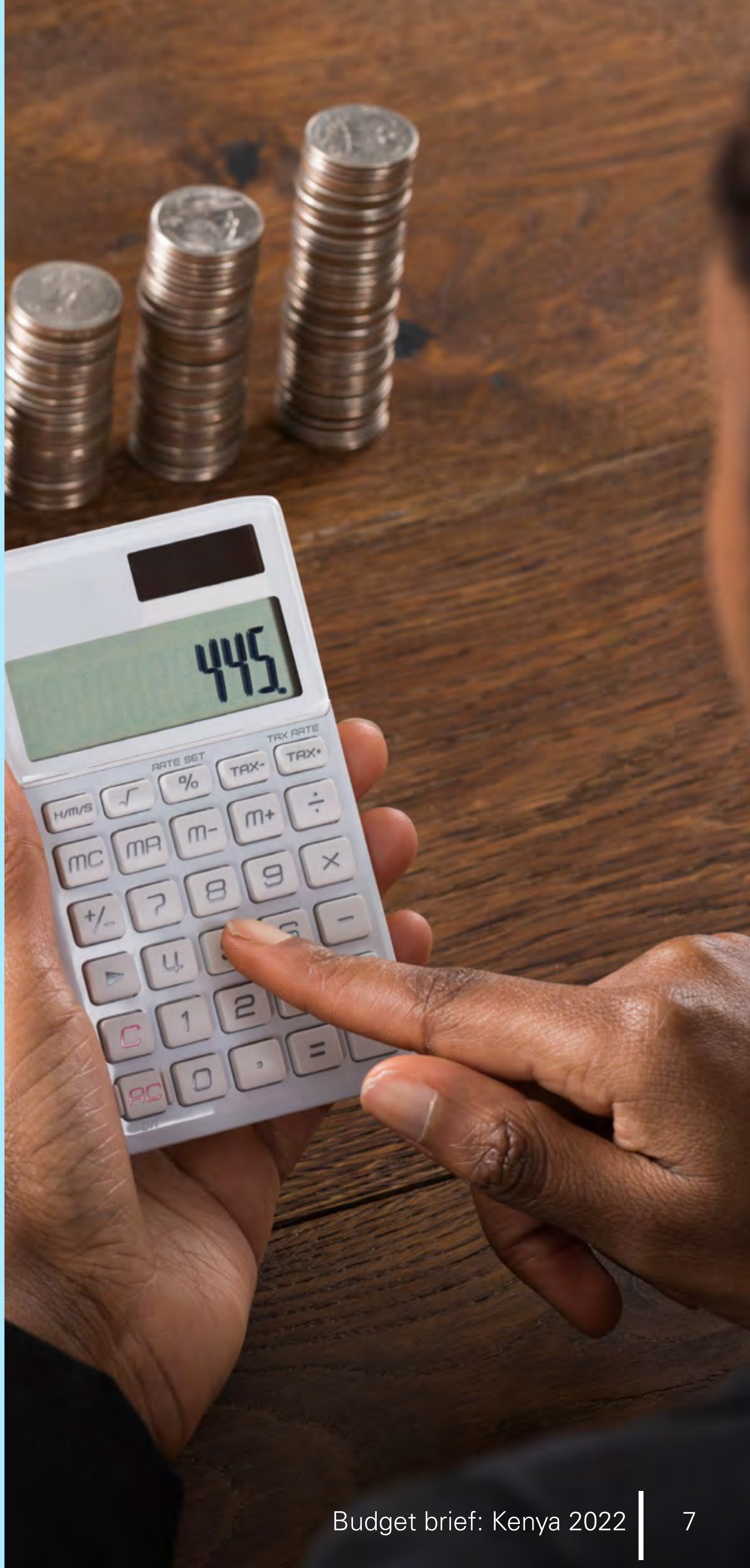


Income Tax – Transfer Pricing

Additional Reporting requirements for - MNEs

Proposed provision: Multinational enterprises (MNEs) which have operations in Kenya will be required to report their activities within Kenya and in other jurisdictions to the Commissioner General, Kenya Revenue Authority (KRA).

This proposed change follows the ratification and deposit of the Multilateral Convention for Mutual Administrative Assistance in Tax Matters (MAC) with the Global Forum on Transparency and Exchange of Information on Tax Matters in July 2020. The convention entered into force on 1st November 2020.

The MAC provides an avenue for co-operation between countries in the assessment and collection of taxes and mainly deals with the exchange of information.

Implication: The proposal follows the County-by-Country (CbyC) reporting requirement that was enacted through the Finance Act, 2021. The CbyC reporting was primarily targeted on MNEs whose Ultimate Parent Entity (UPE) was based in Kenya and had a turnover threshold of Euro 20 million.

The proposal therefore seeks to increase the number of MNEs required to submit reports on their operations to KRA. This is expected to result in greater tax transparency among MNEs through the exchange of information between the participating member countries.

The upshot of this is an increase in administrative reporting requirements for MNEs with presence in Kenya. This will not only lead to increased compliance costs on reporting, but also increased tax and transfer pricing audits from the KRA.

Value Added Tax

Affordable health care

The CS proposes to exempt from VAT the following items:

- Plant and machinery for use by manufacturers of pharmaceutical products
- Medical oxygen supplied to registered hospitals
- Urine bags, adult diapers, artificial breasts and colostomy or ileostomy bags for medical use

Implication: With the upsurge of new Covid-19 variants and the escalating cost of treating of ailments such as cancer, the proposal to provide these exemptions is a welcome move.

These proposals, if adopted, will lower the cost of pharmaceutical products and increased access to quality medical care.

In addition, the proposal to exempt the plant and machinery for use by manufacturers of pharmaceutical products comes against the backdrop of investments into the health care such as the proposed Moderna vaccine production plant.

Buy Kenya build Kenya - Exemption from VAT on local passenger vehicles

The CS proposes to exempt from VAT, inputs and raw materials used in the manufacture of passenger vehicles and locally manufactured passenger motor vehicles.

Implication: The proposed change is intended to encourage investment in the automotive sector, specifically, spur manufacturing of passenger motor vehicles. This will make locally manufactured motor vehicles affordable, consequently reducing the dependence of second-hand motor vehicles. In addition, this will increase employment opportunities and impact the environment in a positive way.

Excise Duty

Exemption from annual inflation adjustment

The CS has proposed to give the Commissioner General discretion to exclude some products from inflation adjustments after considering the prevailing economic and social circumstances facing the country at the point the adjustment is due to take effect.

Implication:

The intention of the proposal is to protect consumers from automatic increase in prices due to annual inflation adjustments on excise duty of certain products, however, it is vague on the parameters that the Commissioner General will use to arrive at the exclusion decision.

Importation of hatching eggs

The CS proposes to exempt hatching eggs imported by licensed hatcheries from excise duty upon recommendation by the responsible Cabinet Secretary.

Implication:

The Finance Act 2021 introduced excise duty on the importation on hatching eggs in order to protect the local farmers from cheap imported eggs. This proposal has had undesired effects in the hatching business as there is no sufficient local capacity to supply all the required eggs for hatching.

This is a welcome move in the agricultural sector as Kenyans will have access to cheaper eggs for hatching, consequently enhancing poultry farming and lowering costs of eggs which in the recent past has been on the rise.

Manufacture of pharmaceutical products

The CS proposes to exempt neutral spirit used by registered pharmaceutical manufacturers from excise duty upon approval by the Commissioner General of KRA.

Implication:

Registered pharmaceutical manufacturers are required to pay the excise duty on importation of neutral spirit and claim refunds. This process was faced with delays, tying up capital for the manufacturers.

This proposal, if adopted, is likely to lower the cost of pharmaceutical products and allow Kenyans to have increased access to quality medical care. Its also intended to encourage investment in this crucial sector.

Manufacture/assembly of motor vehicles

The CS seeks to exempt from excise duty, locally manufactured passenger motor vehicles.

Implication:

The proposed change is inline with the intended changes in the VAT regime and is to encourage investment in the automotive sector, specifically to spur manufacturing of passenger motor vehicles.

This will make locally manufactured passenger motor vehicles affordable, consequently reducing the dependence on importation of second-hand motor vehicles. In addition, this will increase employment opportunities in the manufacturing sector and impact the economy in a positive way.

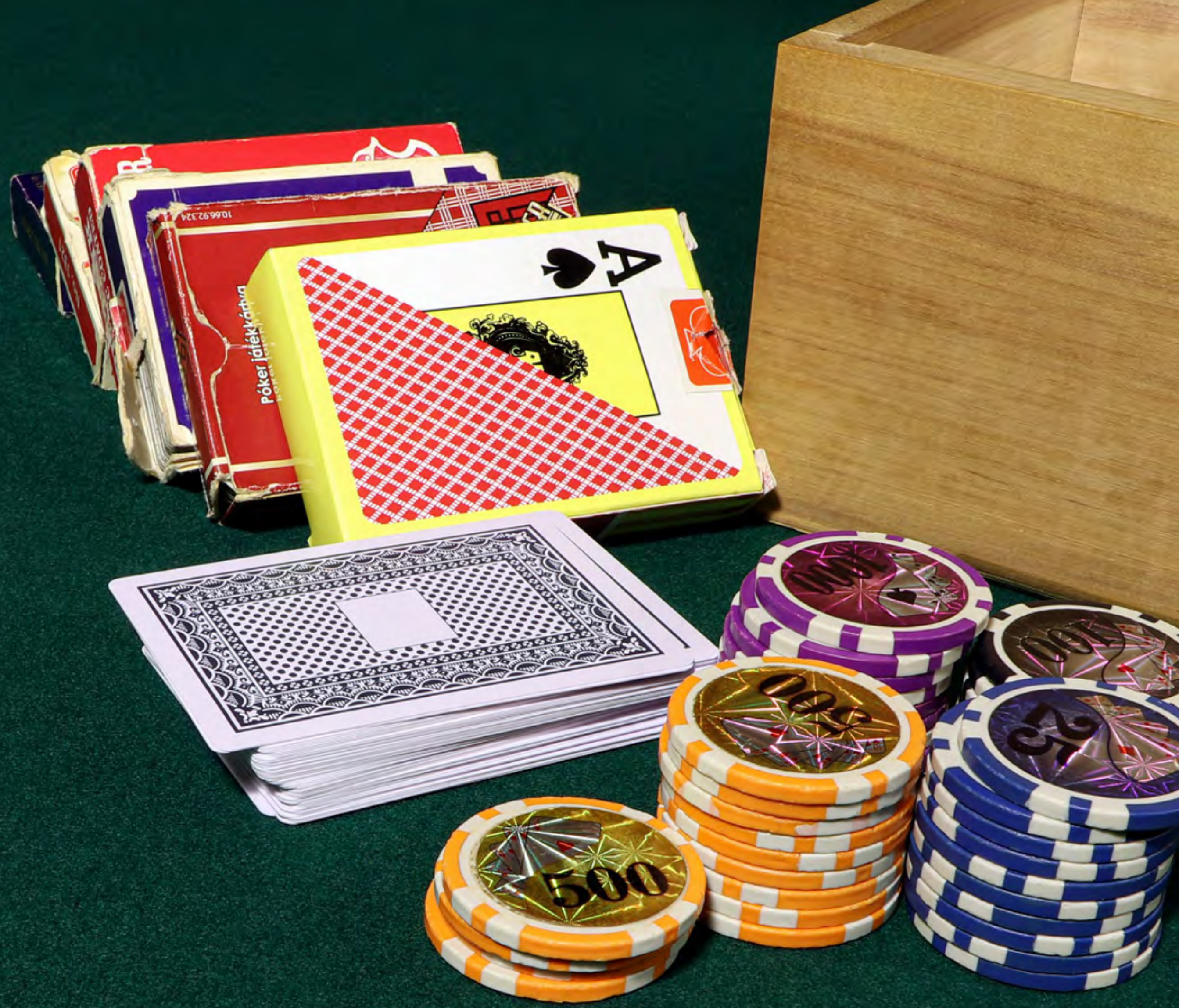
Tax on advertising of gaming and alcohol

The CS seeks to introduce a 15% excise duty on fees charged by all television stations, print media, billboards, and radio stations for advertisements of gambling, gaming and alcohol. In addition, the CS seeks to increase excise duty on liquid nicotine from KES 4171.59 per unit to KES. 70 per milliliter.

Implication:

The taxation will make it more expensive to advertise these products and services, with the ultimate aim of reducing their consumption.

The change in the rate for liquid nicotine is also intended to discourage the use of this product as well as raise revenue through collection of the tax.



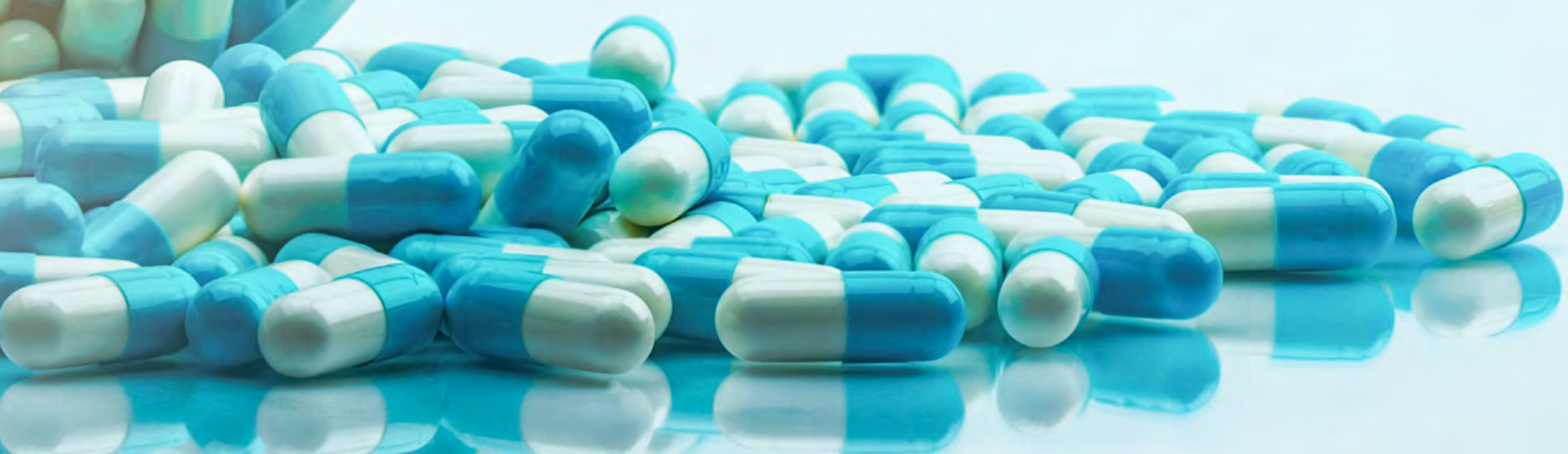
Miscellaneous Fees and Levies Act

	New rate	Old rate
Inputs and raw materials imported by manufacturers of pharmaceutical products	Exempt	IDF - 2% (registered manufacturers)/3.5% RDL - 2%
Export levy on the raw hides and skins	50 percent or USD 0.32 per Kilogram.	80 percent or USD 0.5 per Kilogram

Implication:

The proposal on exemption from IDF and RDL on inputs imported by manufacturers of pharmaceutical products, if adopted, is likely to lower the cost of pharmaceutical products and allow Kenyans to have increased access to quality medical care. It is also intended to encourage investment in this crucial sector of the economy.

In addition, the proposal on reduction of export levy is intended to support farmers who rear cows as well as pastoralist communities who depend on sale of hides and skins. It is a welcome move to boost the agricultural sector which is the biggest contributor to the GDP.



Other Acts

Requirement to pay 50% of disputed tax upfront on appeal

- There is a proposal for taxpayers to deposit 50% of the tax in dispute with CBK prior to appeal to the High Court.
- Refund is to be done in 30 days if the appeal is successful.
- **Implication:** Likely to result to cash-flow problems for taxpayers considering the time it takes to hear appeals at the High Court and the rigorous tax refund process.
- Uganda has a similar provisions where a taxpayer is expected to pay 30% of the disputed amount before appealing to the Tribunal.
- In Tanzania, once the Commissioner issues an assessment, the taxpayer is required to pay the higher of one-third of the disputed amount or the undisputed amount before filing an objection.

One time period of 60 days for objection decision

- The Commissioner will be expected to issue an objection decision within one cycle of 60 days from the day of receiving a valid objection by a taxpayer.
- **Implication:** This will lead to faster resolution of tax disputes. Previously KRA could extend the timelines by requesting for information close to the deadline for issuing the objection decision.

Perpetual term for tax related regulations

- Tax-related regulations are to be exempted from automatic expiry of 10 years.
- **Implication:** This will ensure continuity of the tax administration and revenue collection system, especially for regulations that were enacted prior to 2013 and the 10 year period is to lapse in 2023.

Harmonising county and national tax/levies

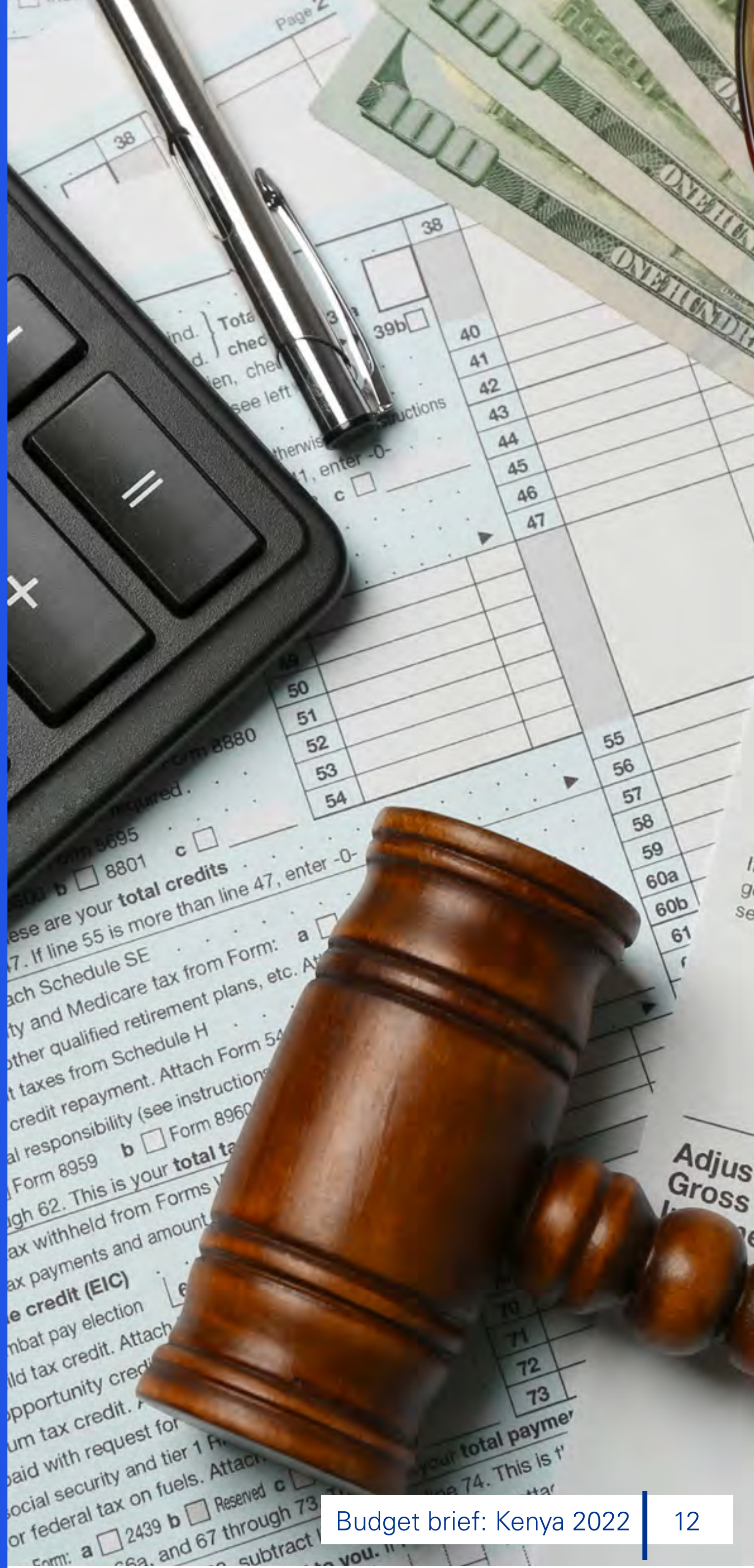
- The proposed County Governments (Revenue Raising Process) Bill will regulate introduction of fees and charges by counties. It will also avoid multiplicity of fees and charges.
- **Implication:** County revenue efforts should not to prejudice national economic policies, economic activities across county boundaries or the national mobility of goods, services, capital or labour.
- This will provide more certainty to investors who are looking to set up businesses in different counties.

Incentive to report unclaimed assets

- There is a proposal for waiver of penalties, fines and audit fees in justifiable circumstances.
- Penalties and interest will be capped so as to not exceed the value of the asset.
- New Voluntary Disclosure Program for a period of 12 months to grant relief of penalties.
- **Implication:** It remains to be seen whether the public will take up the opportunity to report to UFAA.

KRA to KRS

- There is a proposal to change the name of the Kenya Revenue Authority (KRA) to Kenya Revenue Service (KRS).
- Similar change was done from police force to police service.
- **Implication:** Intended to enhance customer centric service delivery by enhancing its public image. This is meant to improve KRA's public perception.



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