Kenya Budget Review 2022/2023

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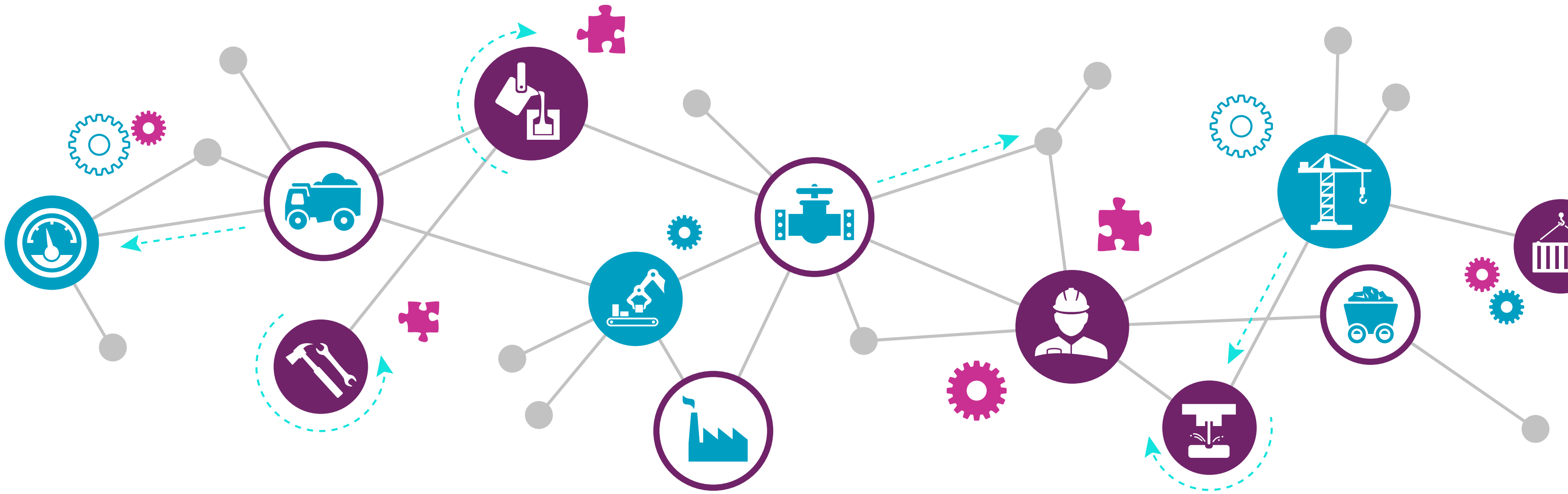

Cautionary statement: The taxation and miscellaneous proposals set-out in this document are based on the Budget Statement presented by the Cabinet Secretary. The changes proposed in the Finance Bill, 2022 are subject to parliamentary debate and ascent in the form of the Finance Act, 2022.

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ECONOMIC REVIEW 2021 & OUTLOOK 2022

1. Global GDP Performance

After bouncing back to an estimated 5.5% in the year 2021 from a contraction of estimated 4.3% in 2020, global economic growth is anticipated to drop further to 4.1% in 2022 as a result of unending COVID-19 severe impacts. According to the World Bank Group Flagship Report on Global Economic Prospects, January 2022, the current global outlook is weaker characterised by higher inflation rates than expected, hike in energy and basic prices of commodities and more detrimental disruptions in the supply chain. The growth at global level is projected to fall further to 3.2% in 2023 as demand diminishes and effective macroeconomic blueprints continue to take shape into the right direction. The conflicts between Russia and Ukraine are expected to be among major contributors of global economic recession in the near future. Wealth creation and investments in advanced economies are anticipated to return to pre-COVID levels in 2023. This, however, is likely not to be attained by Emerging Markets and Developing Economies (EMDEs) especially in conflict prone and high poverty stricken countries due to persistent effects of COVID-19, punitive monetary and fiscal policies and lower vaccination rates. The major growth hindrances in these economies are:

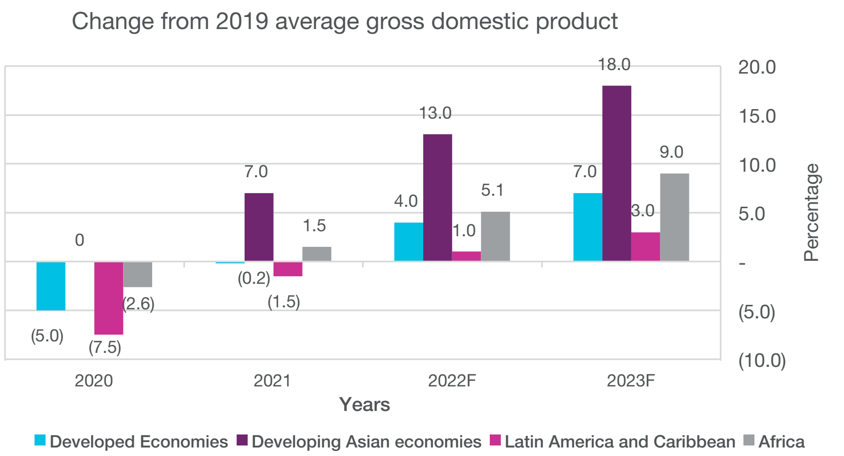
- Weak long-term growth strategies;
- Climate change related challenges;
- Unfavourable inflation rates;
- Financial distress;
- Omicron caused disruptions; and
- Continued supply hitches.

These challenges have denied growing economies, opportunities to foster global co-operation, develop sound economic and health strategies and manage debt levels. Debt levels in EMDEs are already high and continue to rise as they face challenges in securing sustainable revenue generating avenues. They are, in fact, compelled to borrow more to shield their nationals against the hazardous natural happenings. To ensure a continuous economic growth, these countries are compelled to develop economic policies that are resilient to commodity shocks, unpredictable climatic changes, health challenges and both income and gender inequalities among people.

According to a United Nations report on World Economic Situation and Prospects 2022, current forecasts indicate that the Gross Domestic Product (GDP) of 16 developing countries that were hard-hit by the COVID-19 pandemic, will be more than 5% smaller in the year 2022 compared to 2019. 28 countries, representing more than a fifth of developing countries, will see their GDP returning to pre-COVID levels in the second half of 2022. By end of 2023, around 20 countries representing a fifth of developing nations are projected to be still below their 2019 output levels. In the same year, more than half of world economies are anticipated to surpass their 2019 output levels by at least 7%. In South and East Asia, average GDP is projected to increase by 18.4% in 2023 compared to 2019. Latin America and Caribbean GDPs will grow but at a small rate of only 3.4% as per the graph in figure 1.1.

However, this does not indicate that economies are going to recover the lost output caused by the pandemic. In fact, despite vigorous recovery, South and East Asia's GDP in 2023 is forecasted to be 1.7% below the initial forecast before the pandemic. Africa and Latin America and the Caribbean are projected to be below the initial projections by 5.5% and 4.2% respectively. The report indicates GDP per capita recovery inequalities between developed and developing nations where developed ones are forecasted to almost fully recover by 2023 in relation to pre-COVID forecasts. Developing countries are projected to be 2% below pre-pandemic projections. The forecasts above have not considered the Russia Ukraine conflict and it is expected that the conflict is likely to affect the numbers negatively.

Figure 1.1: Change from 2019 average gross domestic product

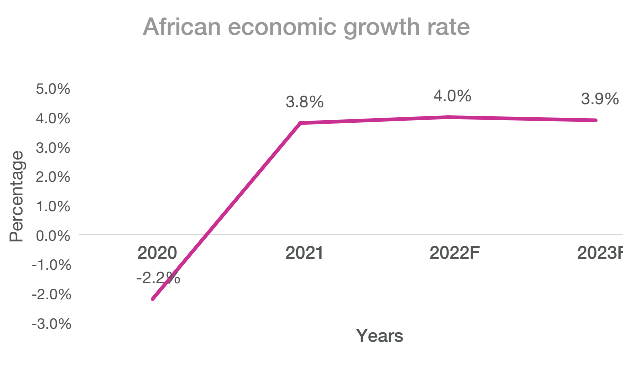


Source: United Nations Department of Economic and Social Affairs estimates and forecasts

2. Africa GDP Performance

According to a United Nations report on World Economic Situation and Prospects 2022, economic output in Africa is forecasted to grow but it will face challenges arising from instabilities and COVID-19 virus mutants with the latest one being Omicron. Many governments resorted to travel bans and lockdowns to reduce the spread of the virus which in turn crumbled economies to their toes. Economic growth rate is projected to hit 4% in 2022, an increase from 3.8% in 2021 as per figure 1.2 below. Increasing vaccination rates, improvements in investments, rising commodity prices and lifting of virus mitigating measures are among the key contributors to the projected increase. The continent would need to grow by at least 6% in 2022-2023 to go back to its pre-COVID output growth trajectory.

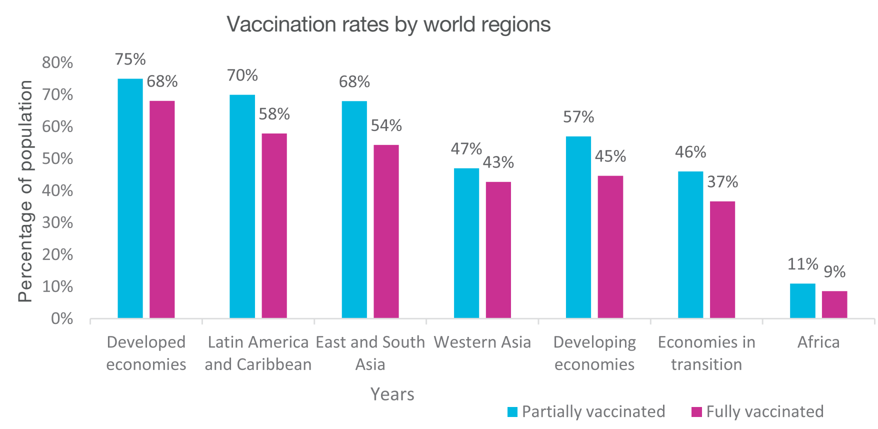
Figure 1.2: African economic growth rate



Source: United Nations Department of Economic and Social Affairs

Real GDP growth in Africa by sub region is projected to remain below pre-COVID levels through 2023, more so in the southern part of the continent indicating setbacks caused by the pandemic. In terms of preventive measures against the pandemic, Africa remains to register low vaccination numbers in the world. Out of the population of around 1.3 billion people, just over 10% had been vaccinated by January 2022 with at least one dose. Some countries had as low as 5% vaccination level by January 2022 which was below World Health Organization (WHO) vaccination objectives of 10% and 40% coverage by September and December 2021 respectively. Only 5 nations in the continent met the WHO objectives i.e. Tunisia, Seychelles, Cape Verde, Morocco and Mauritius. Vaccine roll-out has been hindered by hesitancy, affordability, logistics, vaccine hoarding and global production restraint. With the current vaccination levels, it is forecasted that a majority of nations may not attain 60% to 70% levels before 2023. The graph in figure 1.3 below indicates vaccination rates by world regions (United Nations report on World Economic Situation and Prospects 2022). 47.5% of world population is fully vaccinated.

Figure 1.3: Vaccination rates by world regions



Source: United Nations Department of Economic and Social Affairs

Exporters of commodities are likely to experience a boom while players in the tourism industries are anticipated to take longer to return to pre-COVID level of activities. The continent will continue to rely on multilateral support to regain momentum including distribution of vaccines and debt relief. Conflict and weather related events are likely to cause economic disruptions leading to increase in food prices and inflation as witnessed in Egypt, Guinea, Ethiopia, Sierra Leone and Angola. The forecasts above have not considered the Russia Ukraine conflict and it is expected that the conflict is likely to affect the numbers negatively.

3. East Africa GDP Performance

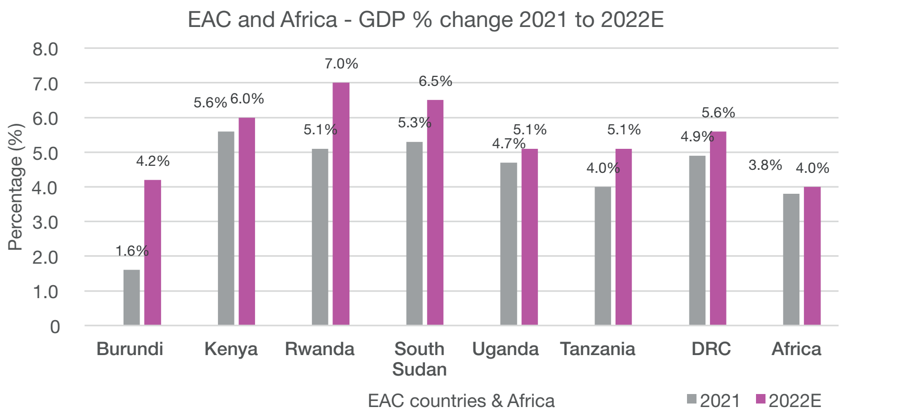
According to research by the African Development Bank on East Africa's economic outlook, the region's average growth in 2022 is projected at 4.9%. COVID-19 containment measures especially lock downs and air travel bans as well as disruptions in global forces of demand and supply hit many businesses translating to loss of livelihoods and increased poverty levels among people. Some countries were also affected by limited economic diversifications and political fragility hindering their economic growth.

The region is however recovering from the adverse effects of the pandemic through increased regional economic integration, improvements in agricultural sector characterised by close to adequate rainfall levels and infrastructure developments.

Going forward, countries in the region will have to adopt common goals to accelerate recovery and resilience against the pandemic among them digitization, economic diversification, industrialization and consolidation of peace and security resources. Increased domestic and foreign debts caused by high levels of public spending to counter the pandemic has left many countries in the region in financial distress pushing down the confidence of lenders on ability to repay. The balance of payments in the region went down in 2019 and 2020 due to reduced income caused by a reduction in exports compared to pre-COVID period. It is projected that the region will attain full recovery in the year 2023 as a result of recovery in global economy, vaccine roll-out and rising commodity prices. To attain full recovery, the region as a whole will need to implement the following strategies as other regions on the continent are already doing; increasing vaccination levels, stabilising public debt and putting in place economic stimulus packages for citizens among others.

The report warns that there is a risk that if the rate of vaccination remains low and global oil prices continue to rise as witnessed currently then the region might not fully recover by 2023. Natural happenings like climatic shocks and locusts' invasion, conflicts and civil unrests and the slow pace in structural transformation are other factors likely to slow down the region's positive economic outlook. Figure 1.4 below indicates economic growth rates for East Africa countries and Africa continent as per International Monetary Fund's World Economic Outlook Report January 2022. The forecasts above have not considered the Russia Ukraine conflict and it is expected that the conflict is likely to affect the numbers negatively.

Figure 1.4: EAC and Africa - GDP % change



Source: International Monetary Fund

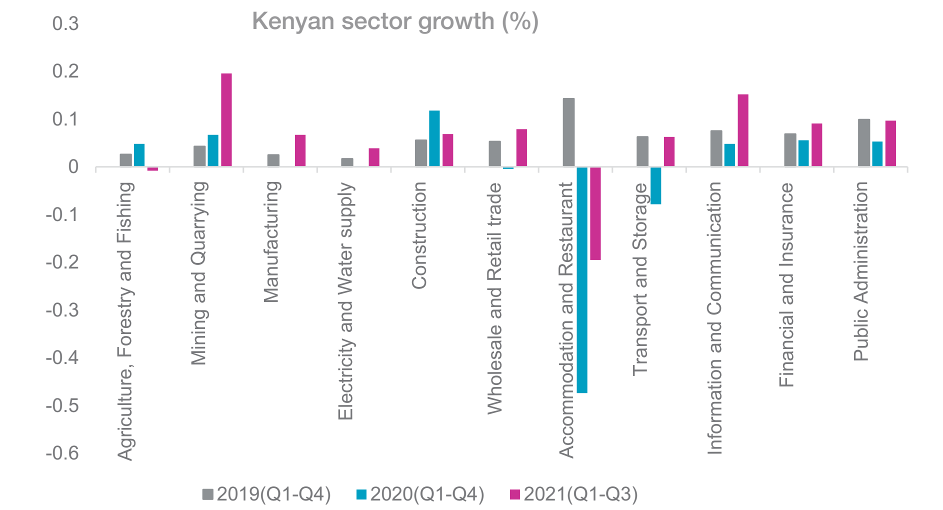
4. Kenya GDP Performance

According to the Central Bank of Kenya Quarterly Economic and Budgetary Review report for the period ended 31 December 2021, the Kenyan economy continues to stabilise as economic activities resume to normalcy following reopening of the economy and easing of the COVID-19 restrictions. The economy grew by 2.0% in quarter one, shot to 11.9% in quarter two and slightly dropped to 9.9% in quarter three of 2021. The economy in overall grew at an average rate of 7.8% in the first three quarters of 2021 in comparison to a drop of 0.8% in the same period in the previous year. In quarter three of 2021, the economy expanded by 9.9% from a drop of 2.1% in the same quarter in 2020. The growth was as a result of several sectors of the economy gaining strength i.e. transport and storage, manufacturing, accommodation and food services, education and wholesale and retail. The agriculture sector continued to strain as a result of low levels of rainfall experienced in majority of the areas in the country.

Kenyan Sectoral Contribution to GDP

A review of the sectoral performance from 2019 to third quarter of 2021 indicated that activities in agriculture, forestry and fishing sector recorded extremely low GDP growth rate (negative) in the third quarter of 2021 due to adverse weather conditions experienced by farmers. There was a drop of 1.8% in comparison to an increase of 4.2% in the same quarter in 2020 as in figure 1.5. There was a noted substantial decline in tea production, coffee and fruits exports and cane deliveries during the year. The sector was saved from further decline due to increased exports in vegetables and cut flowers as well as high milk production during quarter three. The contribution of agriculture sector to GDP growth was negative at 0.3% in quarter three, a drop from 0.7% in the same quarter in prior year.

Figure 1.5: Kenyan sectoral contribution to GDP



Source: Kenya National Bureau of Statistics

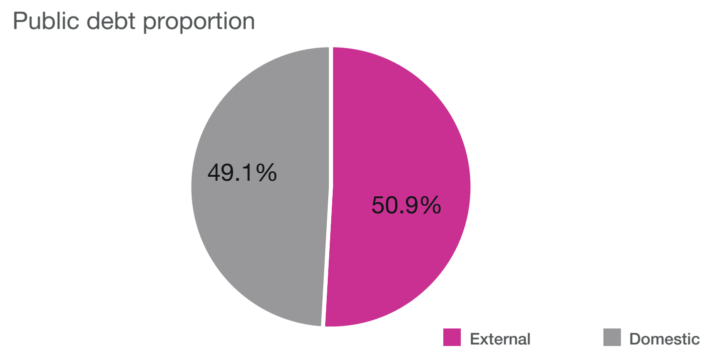
There was an improvement in the manufacturing sector in third quarter of 2021 where a growth of 9.5% was witnessed compared to a contraction of 1.7% in the same quarter in 2020. Electricity and water supply sector registered a growth of 4.5% in quarter three of 2021, a rise from 0.2% in the same quarter in previous year. The improvement was due to increased generation of all forms of electricity in the country apart from hydropower due to low levels of rainfall. A slowdown was witnessed in the construction sector with a growth of 6.4% compared to 12.5% in the third quarter of 2020 due to a reduction in quantities imported for some construction materials like steel, iron and petroleum bitumen. There was a great improvement noted in the services sector which was hard hit by COVID-19. There was a growth of 12.2% in the third quarter of 2021, a rise from 4.6% in the same quarter the year before. The growing conflict between Russia and Ukraine are likely to disrupt the Kenyan economic growth through various avenues like energy and agricultural imports.

5. Public Debt

As at 31 December 2021, Kenyan gross public debt was high at KES 8.2 trillion from KES 7.2 trillion by end of 2020. 50.9% of the debt was external while domestic debt accounted for 49.1% as per figure 1.6. The rise in the debt was due to fluctuations in exchange rates and uptake of more domestic and external loans. The total debt net of government deposits as at December 2021 was KES 7.7 trillion up from KES 6.8 trillion as at December 2020 (Central Bank of Kenya Quarterly Economic and Budgetary Review report, period ended 31 December 2021).

About 51% of Kenya's debt is held in foreign currency which exposes the country to a fiscal risk in the event of depreciation of the Kenyan Shilling. On 5 April 2022, the Kenyan Shilling had depreciated against the dollar to 115.10 from 112.90 in December 2021. Continued depreciation of the currency could increase the debt service beyond the Consolidated Fund Service Budget in local currency. The country needs prudent macroeconomic policies to counter the challenge.

Figure 1.6: Public debt proportion



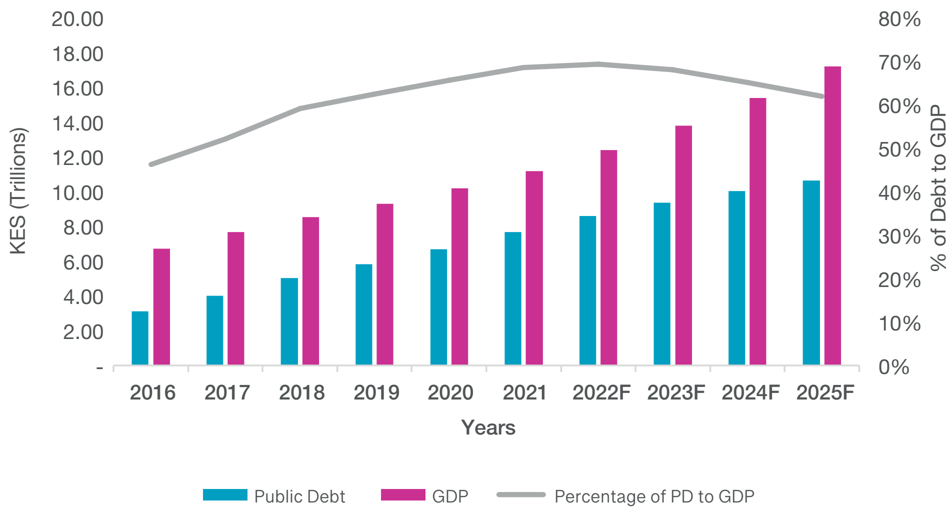
Source: National Treasury and Central Bank of Kenya

Debt and Debt Financing

According to the African Development Bank Policy Note on Public Debt Dynamics in Kenya for December 2021, Kenya was already on a high public debt trajectory before COVID-19. According to the Debt Sustainability Analysis conducted in May 2020 by the International Monetary Fund, Kenya's risk of external debt distress was downgraded from moderate to high. The International Monetary Fund also downgraded the country's debt-carrying capacity from strong to medium in April 2021. However, the report reveals Kenya's debt remains sustainable.

In June 2021, Kenya's total public and publicly guaranteed debt rose to 68.1% of the GDP. This was a significant increase from 42.1% recorded in 2013, majorly due to COVID-19 and its socio-economic effects on the economy.

Figure 1.7 Public Debt and GDP from 2016 to 2025



Source: National Treasury and Central Bank of Kenya

Private Sector Credit

The African Development Bank Policy Note on Public Debt Dynamics in Kenya further explains that liquidity in the banking sector remains strong with private credit growth remaining positive and resilient even in the middle of the COVID-19 crisis. The government's efforts to increase the share of bonds and to lengthen the average maturity of Kenyan debt is yielding results. As of June 2021, treasury bonds accounted for 77% of the domestic debt stock (2020: 70%) of USD 37 billion. Commercial banks have continued to dominate the domestic borrowing scene, holding 49% of government securities in 2021 (2020: 52%) while non-banking finance institutions held about 48% of the government securities. Liquidity in the banking sector remained sufficient to accommodate public and private borrowing.

According to the Global Trade Review Statement on doing business in Kenya, Kenya is perceived as a financial and logistics hub in East Africa. With continued government reforms to improve the business climate, the country's long-term focus on digital trade, commitment to infrastructural development and a fast growing ICT sector, the country provides a good environment for companies seeking to tap into the Kenyan market. To remain attractive to local and international investment, the government has been undertaking the following measures to cope with the debt situation:

(i) Fiscal consolidation measures which focus on expenditure rationalization and domestic revenue mobilization as a debt management strategy

(ii) Improving public debt management by aiming to establish an independent Debt Management Office

(iii) Taking part in the G-20 Debt Service Suspension Initiative (DSSI) and making a request for DSSI debt relief. The government secured a relief covering the period January to June 2022 worth USD 410 million

(iv) Deployment of non-debt creating financing instruments, for instance, the Public Private Partnerships (PPP) Bill 2021 which proposes investor friendly laws.

The following can be done to manage the debt situation in the country:

(i) Further strengthening the capacity of the Debt Management Office

(ii) Spending rationalization and public investment to be on concessional borrowing

(iii) Boosting public revenue collection

(iv) Setting up predictable tax regime to mitigate a looming external debt situation and to spur economic growth

(v) Strengthening debt refinancing efforts to extend debt maturity and limit refinancing risks

(vi) Diversification of development financing sources to reduce reliance on volatile foreign currency borrowing and domestic non-tax revenue

(vii) Addressing the financial weaknesses in State Owned Enterprises.

Overall Budget Allocations 2022/2023

Below is the summary of budget allocation for the Financial year 2022/2023 according to the 2022 Budget Policy Statement by the National Treasury and Planning.

Figure 1.8: Budget allocation for 2022/2023

Sector	Approved budget estimate KES millions	Percentage allocation
Agriculture, Rural & Urban Development	63,898	3%
Energy, Infrastructure & ICT	368,300	18%
General Economic And Commercial Affairs (GECA)	24,870	1%
Health	126,352	6%
Education	525,950	25%
Governance, Justice, Law And Order (GJLO)	231,930	11%
Public Administration And International Relations (PAIR)	346,998	17%
National Security	203,097	10%
Social Protection, Culture And Recreation	72,892	4%
Environment Protection Water And Natural Resources	110,728	5%
Total	**2,075,015**	**100**

Source: National Treasury

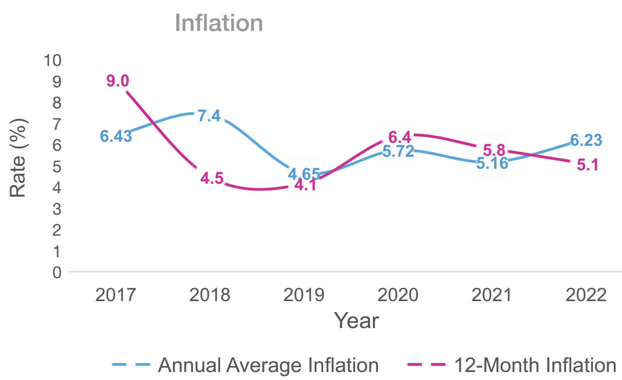
The Big 4 Agenda at a glance

There exists a gap in roles and responsibilities and involvement of various stakeholders that are key to the success of the agenda and Vision 2030. Some projects have faced challenges like poor planning at initial stages which has paralysed efforts to achieve full project implementation. One of the major challenges has been resource allocation and it is highly likely that the current leadership regime will exit the podium without realizing this dream. There are a lot of uncertainties on whether the incoming leadership after August 2022 elections will take over the development projects without reluctance given the high number of stalled projects which require financial resources. The National government must work in harmony with county governments and the establishment of Public Investment Management Unit should be adequately supported by law makers through passing a budget allocation to support the Big 4 agenda implementation.

6. Inflation

According to the Kenya National Bureau of Statistics (KNBS) report on Consumer Price Indices and Inflation Rates for February 2022, the overall year on year inflation rate as measured by the Consumer Price Index (CPI) was 5.1% as at February 2022 from 5.8% in February 2021 as per figure 1.9. The inflation rate was as a result of an increase in the prices of food and non-alcoholic beverages, furnishings, household equipment and routine household maintenance, housing, water, electricity, gas and other fuels and transport. The increase in food prices could be attributed to continuous drought in most parts of the country while increased cost of fuel is a cascading effect from the international market as a result of the ongoing Russia Ukraine conflict. However, this was the lowest inflation rate since October 2020 and followed a reduction in inflation rates for the fifth straight month since October 2021. The 15% cut on electricity tariff effective January 2022 as per the Kenyan government directive was one of the contributing factors for the low rate in 27 months.

Figure 1.9 Inflation as at February from 2017 to 2022



Source: Central Bank of Kenya

The January 2022 Market Perceptions by the Central Bank of Kenya Survey revealed the following key findings:

(i) Inflation expectations remain anchored within the target range for the remaining part of the year

(ii) Economic activities were expected to moderate temporarily in January and February from the festive season levels, but to improve as the year progresses

(iii) Economic growth is expected as key sectors recover from the pandemic

(iv) Banks expect an increase in private sector credit growth in 2022

(v) There is sustained optimism in the country’s economic prospects in the next 12 months.

The survey respondents expected a decline in inflation in the remaining part of the year, supported by continued reduction in food prices and government interventions on fuel and electricity prices. However, respondents indicated that increased demand for goods and services as the economy recovers and rising global oil prices could exert upward pressure on inflation. Moreover, disruptive social conditions and an uncertain political atmosphere could also potentially contribute to increased inflation rates in the months running up to the 2022 general elections due to the increase in the prices of commodities.

The annual average inflation as at February 2022 increased to 6.23% from 5.16% in February 2021.

7. Interest rates

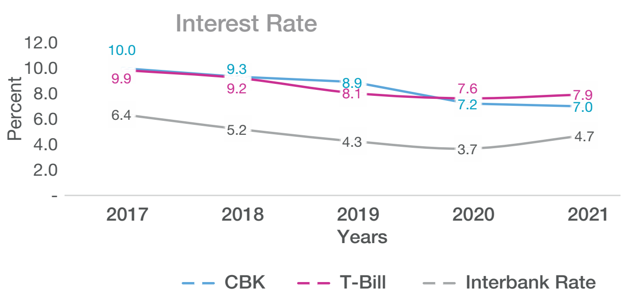
In the year 2021 the Central Bank of Kenya (CBK) held a moderate monetary policy holding the policy rate at 7% as it did in the previous year. According to the World Bank report, December 2021, this policy is aimed at supporting economic recovery post the pandemic outbreak. The CBK has also maintained a lower cash reserve ratio since 2020 in order to support liquidity in the local market. These measures are in place in order to support private sector lending and the economic recovery.

A higher local interest rate has had the effect of doubling the domestic debt servicing as compared to the external debt servicing despite the external debt being cheaper and subject to exchange rate risks.

The average lending rates by commercial banks in 2021 increased to 12.1% from 11.9 % in 2020. The rise has a significant influence on the accommodative monetary policies that have been implemented. The interbank rate increased from 3.7% in 2020 to 4.7% in 2021 as per figure 1.10 below due to the resumption of business and trading in the country post COVID-19.

The commercial banks are in negotiation with the CBK for an arrangement that will allow the commercial banks to vary interest rates according to the risk of default by customers. This is known as risk-based pricing. It will have the effect of allowing the commercial banks to manage their profitability and risk rating pegged to customer risks. Equity Group is the first bank to get approval from the CBK for the risk-based pricing model with interest rate ranging between 13.0% and 18.5% of its clientele.

Figure 1.10: Interest rates



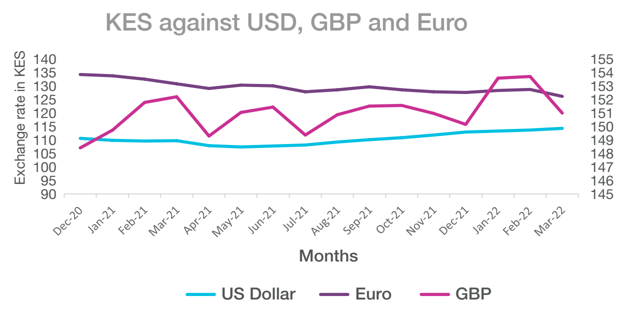
Source: Central Bank of Kenya

8. Exchange rates

The Kenyan currency has remained relatively stable and only slightly affected by the tight global financial conditions that are as a result of the COVID-19 pandemic. The stability was supported by increased remittances, adequate foreign exchange reserves and favourable horticultural exports. The Kenyan Shilling (KES) to the US dollar exchanged at KES 112.9 in December 2021 compared to KES 110.6 in the same period in 2020. The KES appreciated by 4% against the Euro to KES 127.6 in December 2021 from KES 133.8 in December 2020. The Kenya Shilling depreciated against the GBP to KES 150.2 in December 2021 from KES 148.4 in December 2020.

The Kenya Shilling has since lost value to the US Dollar depreciating to KES 115.10 per USD on 5 April 2022 from KES 112.9 in December 2021. This is due to the high external dollar debt and private sector leverage, the country's slow growth, high import bill and subtle dollarization of financial transactions. The rising crude oil prices and current war between Russia and Ukraine in the international market have also put pressure on the Kenya Shilling.

Figure 1.11: Interest rates



Source: Central Bank of Kenya

9. Employment rates

According to the World Bank report of December 2021, the unemployment rate in Kenya has been declining steadily since the third quarter of 2020 from 10.4% down to 6.0% in the first quarter of 2021; it has, however, not recovered to pre-pandemic level of 4.7%. In 2021, the main concern was job quality and security despite the labour market recovering from a severe hit from the pandemic in 2020. Unemployment has continued to decline in 2021 with majority of the growth in employment coming from utilities and construction, agriculture, transport and storage, wholesale and retail trade, manufacturing and accommodation and food services. Poverty has declined by up to one-fifth in 2021 but remained higher than pre-pandemic levels. In rural areas the decline in poverty was slower than in urban areas likely as a result of unfavourable weather conditions characterised by low levels of rainfall. The COVID-19 pandemic had large long term implications on the labour market. For instance, growth in wage employment which depends on sectors that are particularly vulnerable to future containment measures were affected permanently.

10. Economic Impacts of Russia Ukraine conflicts

Global economic implications

The conflict between Russia and Ukraine is affecting the global economy via three main channels: financial sanctions, commodities prices and supply-chain disruptions which will have an impact on global inflation and growth.

Financial sanctions on Russia

Sanctions from United States and European Union targeting the Central Bank of Russia (CBR) will prevent the CBR from accessing about half of the USD 643 billion that it holds in foreign-exchange reserves by blocking its ability to convert assets held in USD and Euros into Rubles. The measure also prevents Russia from tapping its emergency sovereign wealth fund and the National Wealth Fund (NWF). International sanctions on Russia's banking system and the exclusion of a number of banks from the Society for Worldwide Interbank Financial Telecommunication (SWIFT) have significantly disrupted Russia's ability to receive payments for exports, pay for imports and engage in cross-border financial transactions. These sanctions will therefore be insignificant outside Russia, although Western companies that are highly exposed to Russia will still be affected.

Commodity prices

The most serious effect of the Russia Ukraine conflict for the world economy is in the form of higher commodity prices mainly due to concerns around supplies, destruction of physical infrastructure and sanctions as explained in examples below:

- Oil prices are likely to remain above USD 100 per barrel as long as the conflict rages in Ukraine. The threat of sanctions on Russian hydrocarbon exports and uncertainty surrounding supplies will exacerbate existing market tightness. Some oil traders are also avoiding Russian oil out of concern about US secondary sanctions on financial transactions with Russian entities.
- Gas prices could rise by at least 50% this year, on top of a fivefold rise last year. Europe has limited gas stockpiles, and there are concerns about gas supplies for the 2022/23 northern hemisphere winter season.
- Russia is also a major producer of several base metals i.e. aluminium, titanium, palladium and nickel, all of which will register price hikes. Following spikes in all of these markets last year, prices will remain at peak levels as long as the conflict continues. This will have a substantial impact on industrial sectors such as the automotive industry across the globe.
- Prices of agricultural commodities such as wheat, maize, barley and rapeseed will soar. Taken together, Ukraine and Russia account for more than a quarter of the global wheat trade and produce 12% of calories consumed globally. Disruptions to trade routes in the Black Sea would increase pressure on grain prices.
- The conflicts between the two countries have led to shipping disruptions and hiked prices for natural gas which is a key ingredient in fertiliser manufacturing. The prices for urea and Di-ammonium Phosphate (DAP) have increased by 32% and 13% respectively since Russia begun its invasion of Ukraine in February 2022 according to Gro Intelligence's report on 'Russia-Ukraine Crisis Ignites Fertilizer Prices at Critical Time for World Crops', March 2022. Fertilizer prices have gone up by more than double in the past 18 months hitting farmers across the globe as they prepare for the 2022 growing season. The Kenyan government has relieved farmers by offering a 50% subsidy on fertilizer prices and we foresee an increase in yields which will create confidence on food safety among Kenyans.

Disruption of supply chain

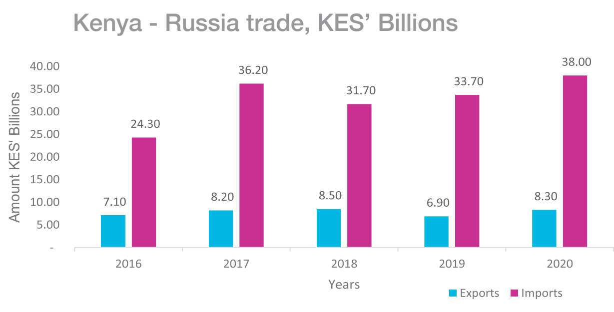
Financial sanctions have an impact on supply chains and trade, as companies have struggled to find financial channels through which to conduct trade with Russia. In addition, the possible destruction of some transport infrastructure (notably ports in Ukraine) has compounded existing supply chain issues. These disruptions have come in form of difficulties affecting land-based routes, restrictions on air links and the cancellation of sea freight routes from Ukraine.

Higher commodity prices will fuel global inflation this year and possibly in 2023. According to Economist Intelligence Unit (EIU), the forecasted global inflation mark of nearly 6% this year is expected to be exceeded, given the huge spikes in commodity prices.

Impact on Kenyan Economy

The Kenyan economy is not an exception to the economic shocks caused by the ongoing Russia Ukraine conflict which has seen global oil prices soar high and restricted wheat exports leading to high energy and food cost. Increased oil prices will result to inflation hike through costly transport, electricity and manufactured goods. According to Kenya National Bureau of Statistics (KNBS), trading between Russia and Kenya has increased from 2016 reaching KES 38 billion imports in 2020 as per figure 1.12.

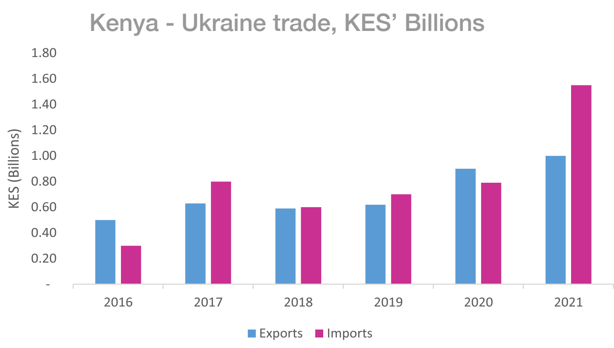
Figure 1.12: Trading between Russia and Kenya



Source: Kenya National Bureau of Statistics

Figure 1.3 below bellow indicates trading between Ukraine and Kenya from 2016 to 2021 according to the United Nations report.

Figure 1.13: Trading between Ukraine and Kenya

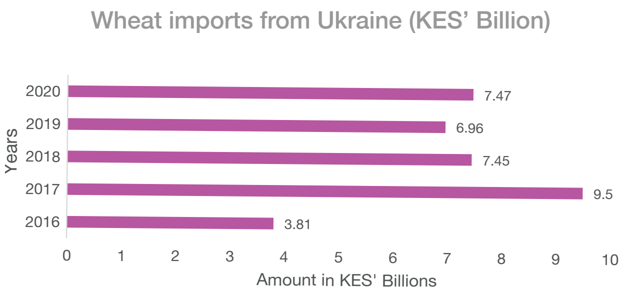


Source: United Nations COMTRADE database

Russia has been sanctioned for invading Ukraine by western powers, which includes being denied the chance to trade using the US dollar, crippling its ability to trade with countries such as Kenya. This will have an impact on Kenyan tea producers given that Russia is the fourth largest buyer of Kenyan tea having purchased KES 6.2 billion worth of the commodity in the 11 months to November 2021. According to JP Morgan Chase & Co., the price of crude oil is expected to approach USD 150 a barrel from the current USD 104.53. Traders are worried about the geopolitical tension over Ukraine which could cause disruption to Russia's fuel exports. This is owing to the fact that Russia is the world's third-largest oil producer. In the event that a conflict in Ukraine leads to a substantial decrease in the flow of Russian barrels to market, the forces of demand and supply will be disrupted hindering equilibrium. This has the potential to drive Kenya's pump prices upward and overwhelm the current state-backed subsidy. Latest fuel price review by the Energy & Petroleum Regulatory Authority on 14 March 2022 shows an increase in fuel prices by an average of 4% in gasoline and 4.5% in diesel. This was as a result of overall increase in global fuel prices pegged to impact of Russia-Ukraine conflict.

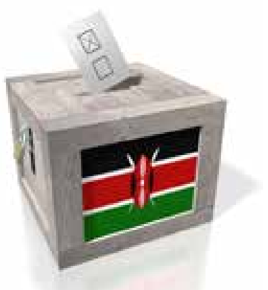
Russia and Ukraine are major sources of wheat imports for Kenya, which ship in 75% of its annual demand of 1.2 million metric tones of grain, see figure 1.13 below. Russia is the world's leading wheat exporter, and Ukraine the fourth. Both countries ship their grain from Black Sea ports, which are directly in the line of disruptions. A disruption in wheat shipments is likely to increase the cost of importing the commodity. The rising price of wheat has pushed up the cost of bread in Kenya for the first time in four years, hitting household budgets at a time when the price of milk has also gone up. Nearly all bread brands recorded a price increase in January, with the 400 grams loaf retailing at KES 5 more at KES 55 and the 600 grams loaf selling at KES 70 from KES 65. The dollar has also gained against other currencies globally amid the crisis as investors view the currency as a safe haven, potentially pointing to further pressure on the shilling locally.

Figure 1.14: Imports from Ukraine



Source: Kenya National Bureau of Statistics

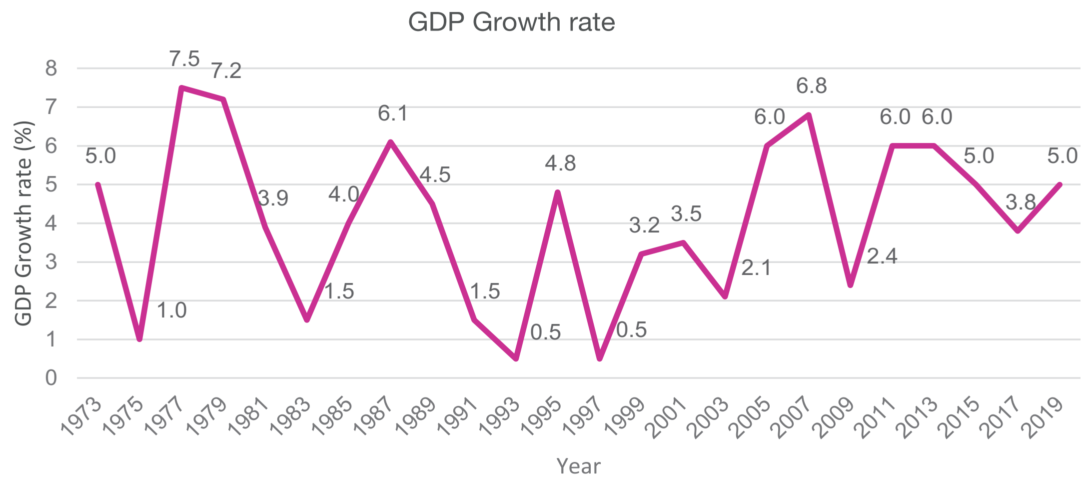
According to International Monetary Fund, the crisis is creating an adverse shock on the economy amid already elevated price pressures. Monetary authorities will need to carefully monitor the pass-through of rising international prices to domestic inflation, to calibrate appropriate responses. Appropriate fiscal policies are needed to support the most vulnerable households counter the rising cost of living. While the situation remains highly fluid and the outlook subject to extraordinary uncertainty, the economic consequences are already dire. Energy and commodity prices including wheat and other grains have surged adding to inflationary pressures from supply chain disruptions and the rebound from COVID 19 pandemic. Should the conflict escalate, the economic damage will be severe and devastating.



11. Effect of elections on Kenyan economy

The periods that precede elections in Kenya have often been characterised by aggressive campaigns. As a consequence, greater focus during this period has mostly been on political communication that is unrelated to actual policy challenges that the country is faced with. According to the Institute of Economic Affairs analysis, Kenya's GDP declines in every election year as illustrated in figure 1.15 below:

Figure 1.15 – Trend in annual GDP growth rates in Kenya



Source: World Bank

A World Bank analysis (1963 – 2014) furthers indicates that GDP growth rates on years that are midway to general elections are generally higher with an average mean of 6.6% than the GDP growth rates on election years which have a mean GDP growth rate of 4.0%. From the analysis above, it is clear that election politics have significantly hampered the country's economic development. Other sectors affected by pre and post-election periods include:

- Financial markets due to loss of confidence by investors;
- Tourism due to uncertainties in election outcome; and
- Agricultural sector due to disruptions in transportation of produced goods to the market.

According to Central Bank of Kenya, economic growth is expected to hit 5.9% in 2022 as compared to 3.82% in 2017 and 3.80% in 2013.

TAX MEASURES & PROPOSALS

Tax Appeals Tribunal Changes

Deposit of 50% of tax in dispute as a prerequisite for appeal to the High Court

The CS proposes to amend the Tax Appeals Tribunal Act 2013 to compel a taxpayer to deposit 50% of disputed taxes where the Tax Appeals Tribunal (the Tribunal) rules in favour of the Commissioner before lodging an appeal to the High Court. This amount is proposed to be deposited in a special account at the Central Bank of Kenya (CBK). In the event that the taxpayer receives judgement in their favour, the deposit is to be refunded to the taxpayer within 30 days of the final determination of the matter by the Courts.

Whilst this sounds like a mundane amendment, this is the most significant highlight of this year's budget taxation proposal. This also in our opinion represents the most recent un-constitutional proposal by the National Treasury as it violates Article 48 of the Constitution of Kenya 2010 (the Constitution), which provides that: "the State shall ensure access to justice for all persons and, if any fee is required, it shall be reasonable and shall not impede access to justice"

A simple reading of Article 48 of the Constitution affirms the natural meaning of the word "reasonable" to mean that "it is fair, proper or moderate in the circumstances. On the other hand, "unreasonable" would mean that "it is so outrageous in its defiance of logic or accepted standards that no sensible person would apply his mind to the question to be decided would arrive at such logic". Thus, the CS's proposal is out-rightly unreasonable since it defies basic economic and legal principles as it adjudges a taxpayer who is not successful at the Tribunal to be guilty as charged. In criminal law parlance, it would be akin to require an accused person to serve half of the applicable jail term before the matter is heard and determined.

In the case of Apollo Mboya v Attorney General & 2 others [2018] the court stated that; "As supreme law, the Constitution protects basic rights including the right to access Courts. In our constitutional dispensation, everyone is guaranteed access to a competent court to have their dispute resolved by the application of law and decided in a fair manner. Access to Courts is fundamentally important to our democratic order. It is not only a cornerstone of the democratic architecture but also a vehicle through which the protection of the Constitution itself may be achieved… legislation based on the Constitution is supposed to concretize and enhance the protection of these rights, amongst others, by providing for the speedy resolution of disputes"

The proposal by the CS does not enhance the protection of the right of access to justice, and amounts to a flagrant defiance to the letter and spirit of Article 48 of the Constitution.

This proposal further violates the oxygen principle which is the overriding objective of litigation which requires the Courts to facilitate the just, expeditious, proportionate and affordable resolution of all cases. Requiring a taxpayer to pay 50% of the disputed taxes inevitably defies this principle.

Additionally, it is worth noting that the Tribunal is a quasi-judicial establishment whose current membership is appointed by the CS National Treasury. The membership comprises of a few lawyers (with judicial capacity and competence) and other undefined laymen. The findings of this Tribunal are quasi-judicial and should therefore not be a basis on which an appeal to the High Court should be subject to a 50% deposit on the disputed taxes. To underpin this reasoning, it was held by the High Court in Okiya Omtatah v Judicial Service Commission & 2 others petition number 197 of 2018 that any new appointment or removal of a member of any of the Tribunals under Article 169(1) (d) of the Constitution must be undertaken by the Judicial Service Commission. As a matter of fact, it is high time that this Tribunal was made fully judicial by placing its under authority of the Judicial Service Commission.

A similar proposal was rejected by the National Assembly in 2014 when the Tax Procedures Bill 2014 was tabled. Clause 51 (2) of the Bill proposed that "… in order for a notice of appeal to the Tribunal to be valid, the taxpayer should have paid 30% of the tax in dispute under the assessment at the time of lodging the notice". The National Assembly expressed its wisdom that this proposal was unreasonable and un-constitutional, and was therefore not legislated in the eventual Tax Procedures Act 2015.

It is therefore right for the National Assembly in the instant proposal to reject this unfortunate appetite by Government to unjustly take taxpayers money to finance its budget.

Income Tax Act Changes

Country by Country reporting for all Multinational Enterprises operating in Kenya

The Finance Act 2021 introduced the Country by Country (CbC) reporting requirements for Ultimate Parent Entities (UPE) of Multinational Enterprises (MNE) tax resident in Kenya with effect from July 2021. This was subsequent to Kenya signing the Convention on Mutual Administrative Assistance in Tax Matters (the Convention) that enables the automatic exchange of information on tax matters amongst jurisdictions that are signatory to the Convention. Further, the draft regulations on the implementation of CbC reporting provided certain conditions that would require an entity that is not the UPE of a MNE Group to file the CbC return with the KRA. These regulations are however yet to be gazetted as law.

The CS Treasury, in the 2022 budget statement has proposed to amend the CbC filing requirements to bring into the ambit of CbC reporting all MNEs with operations in Kenya. Consequently, all entities that are tax resident in Kenya and part of an MNE Group shall be required to file with the Commissioner the CbC return on an annual basis. The return contains information on the MNE Group's activities including revenue, profit or loss before tax, income tax paid among other stipulated information in Kenya and other jurisdictions where the Group has a taxable presence. This will provide the KRA with information on the MNE Group's operations to asses from a high level any tax risks and also enable the automatic exchange of information.

The proposal reflects Government's increased efforts to safeguard the tax base through prevention of profit repatriation and shifting of profits to low tax jurisdictions. The proposal also highlights the Government's commitment to the implementation of Action 13 of the Base Erosion and Profit Shifting (BEPS) project as provided by the OECD.

Taxation of derivatives market

The CS proposes to introduce income tax on gains or profits accruing to non-resident persons who trade in financial derivatives. The derivative market is currently untaxed despite the growing prominence in the past years with investment banks looking for business opportunities in the options market.

Whilst the move by the CS for the National Treasury which seeks to expand tax revenue collection, the proposal is detrimental to the growth of the Kenyan derivative market which is at infancy stage having commenced trading in 2019.

This proposal is clouded by desperation to tax every gain by non-resident persons and will curtail developments made in the financial sector, and more specifically the Nairobi Stock Exchange in the last three years.

It is not clear from the budget statement how the tax will be implemented and therefore we look forward to the guidelines to be issued and published by the Kenya Revenue Authority.

Micro-finance institutions now excluded from interest restriction provisions

The Government through the Finance Act 2021 overhauled thin capitalization provisions by repealing the previous provision where a foreign controlled entity was required to restrict tax deductibility of its gross interest expense based on the debt to equity ratio of 3:1. In the current provisions, companies are required to restrict deductible interest expense on any gross interest amounts to not more than 30% of Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA).

In this year's budget statement, the CS proposes to exclude microfinance institutions licensed under the Microfinance Act from the current interest restriction provision.

This proposal is a comforting change for registered microfinance companies who henceforth will be allowed to claim 100% interest expense.

The current provision on interest restriction however remains retrogressive to business owners as it discourages investments in companies that are at the early stages of operation and hence not initially profitable by restricting the amounts of interest claimable on both foreign and domestic loans. We hope that the that law makers may review this provision to encourage and enhance business investments. Generally, this provision was meant to be aligned with Article 4 of the BEPS project to protect repatriation of profits through excessive interest payments by foreign owned companies. However, there is still no commitment from the Government to exempt locally owned companies from interest restriction provisions.

Tax deductibility on all donations

The CS proposes to allow entities to claim as a taxable expense all cash donations to charitable organizations. Currently, deductibility of cash donations for tax purposes is restricted to organizations that are registered with either the Societies Act or the Non-Governmental Organizations Coordination Act and that have a valid income tax exemption status.

This proposal will end the tax inequality experienced between entities donating cash for charitable activities and the KRA where the latter demands that the former must only claim cash donations from their taxable income when the donation is made to an entity with a valid income tax exemption certificate.

Value Added Tax (VAT) changes

Tax incentives for the pharmaceutical industry

The CS proposes to exempt plant and machinery used by manufacturers of pharmaceutical products from VAT. Prior to 25 April 2020, plant and machinery of Chapter 84 and 85 were exempt from VAT. However, the Tax Laws (Amendment) Act 2020 repealed this provision thus introducing VAT on the plant and machinery of Chapter 84 and 85.

This proposal seeks to incentivize manufacturers of pharmaceutical products in the health industry. It also provides relief to new entrants and existing players in the health sector.

Access to affordable health care

The CS proposes to exempt from VAT medical oxygen, urine bags, adult diapers, artificial breasts and colostomy or ileostomy bags for medical use supplied to registered hospitals. This is a welcome proposal since it will lower the cost of health care and expand access to quality and affordable health care services.

Spurring growth of the local manufacture of motor vehicles

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

This proposal will lower production costs thus encouraging investments into the local manufacture of motor vehicles and promote the sale of locally manufactured motor vehicles.

Miscellaneous Fees and Levies Act changes

Import Declaration Fee and Railway Development Levy exemption

The CS Treasury proposes to exempt from Import Declaration Fees (IDF) and Railway Development Levy (RDL) inputs and raw materials imported by manufacturers of pharmaceutical products. Currently, IDF and RDL are applicable at the rate of 3.5% and 2% of the customs value of the goods respectively.

This incentive will result in affordable health care services.

Reduction of Export Levy on raw hides and skins

The CS proposes to reduce Export Levy on raw hides and skins from 80% of the value of the export or USD 0.5 per kilogram to 50% of the value of export or USD 0.32 per kilogram. The proposal is aimed at improving the livelihood of farmers who rear cows as well as pastoralist communities who depend on sale of hides and skins.

Excise Duty Changes

Inflation adjustment

The CS in his FY2022-23 budget statement proposes to amend the Excise Duty Act to empower the Commissioner to exempt specific products from inflation adjustment given the prevailing economic environment.

Currently, the Commissioner can only adjust the specific rates of Excise Duty by notice in the Gazette with the approval of the CS once every year to take into account inflation. However, the Commissioner does not have express power to exempt any product from inflation adjustment.

This is a welcome move for Kenyans since it will enable the Commissioner to exempt certain products from the inflation adjustment hence cushioning Kenyans against the hard economic times and high cost of living.

Exemption of imported hatchery eggs

The CS proposes to exempt eggs imported by licensed hatcheries from Excise Duty. The Finance Act 2021 introduced 25% Excise Duty on all imported eggs which was aimed at protecting the local egg producers. However, this adversely affected the local hatching business since Kenya does not have the capacity to meet the local demand for eggs required for hatching.

This move is welcome since it will ensure that the hatcheries have access to sufficient eggs required for hatching and consequently, lower the cost of chicks to the farmers.

Exemption of neutral spirit for manufacturing pharmaceutical products

The CS in his budget statement proposes to exempt neutral spirit used as input for manufacture of pharmaceutical products from Excise Duty. Currently, manufacturers of pharmaceutical products are not subject to Excise Duty and therefore, are entitled to a refund of the Excise duty incurred on raw materials.

This is a welcome move for manufacturers of pharmaceutical products since the Excise Duty refunds take a long time to process thus affecting the manufacturers' cash flows.

Exemption of locally manufactured passenger motor vehicles

The CS proposes to exempt locally manufactured passenger motor vehicles from Excise Duty. This is a move meant to encourage investment in this sector and enhance competitiveness of locally manufactured passenger motor vehicles.

Currently, only locally assembled motor vehicles are exempt from Excise Duty. This move will extend the exemption to local manufacturers of passenger vehicles thus encouraging investment in the sector.

Excise Duty on advertisement of alcoholic beverages, betting and gaming

The CS proposes to introduce Excise Duty at the rate of 15% on advertisement of alcoholic beverages, betting and gaming in order to discourage consumption of the products. This Excise Duty will apply on fees charged by television stations, print media, billboards and radio station for advertisements of these activities.

This proposal is aimed at reducing the negative effects of addictive and harmful behaviour from alcohol abuse, betting and gaming among the youths, which has become prevalent in the society.

Excise Duty on liquid nicotine

Due to recent innovations in the tobacco industry that have led to introduction of new products including e-cigarettes, the CS in his budget statement proposes to change the taxation regime for liquid nicotine from the current KES 1,200 per kilogram to an excise duty of KES 70 per millilitre.

This proposal is aimed at reducing the negative effects of nicotine addiction by making the product less accessible to school children and the youth.

Increase in Excise Duty on specific products

The CS in his budget statement proposes to increase the Excise Duty by 10% for a number of products except petroleum products due to the recent global increase in oil prices. The list of the specific products that will be affected by the increase is yet to be provided.

This is a move by the government geared towards generating additional tax revenue.

Tax Procedures Act

Expansion of scope of assets to be used as securities for unpaid taxes

The TPA empowers the Commissioner to charge as security any land or building in Kenya in the event that a taxpayer fails to pay any tax by the due date. The CS Treasury in the 2022 budget statement has proposed to increase the scope of assets that can be used as security for any unpaid taxes to include ships, aircrafts, motor vehicles and any other properties. This will be through notifying the relevant registrars of the respective properties. Consequently, such assets would be restricted from disposal or transaction. The proposal is an effort by the Commissioner to protect any taxes in dispute.

Cap on the timelines for issuing an objection decision

The TPA provides that the Commissioner should issue a tax objection decision within 60 days from the date of filing a notice of objection. Further, the TPA was amended through the Finance Act 2019 to provide that the 60 day count would recommence from the day when the Commissioner requests for any additional information in relation to the objection. This provision has however been exploited by the KRA to create inordinate delays before issuing an objection decision.

In a bid to cure this, the CS Treasury has proposed that the Commissioner shall be bound to issue an objection decision within one cycle of 60 days upon receipt of a valid objection.

Changes to the KRA Act

New name for the Kenya Revenue Authority

The CS Treasury in the 2022 budget has proposed to amend the KRA Act and rename the Kenya Revenue Authority (KRA) to Kenya Revenue Service. This is with an intention to rebrand and transform the authority's public image and enhance its public relations with the taxpayers resulting to tax compliance. The amendment will also cover all tax laws that make reference to KRA.

Changes to the Statutory Instruments Act

Tax regulations exempted from automatic expiry after 10 years

The Statutory Instruments Act 2013 provides for the automatic revocation of any Statutory Instrument after 10 years from the date it was made unless it is repealed or a regulation is made to exempt the expiry. To this end, the CS Treasury has proposed to exempt from the automatic expiry any tax related regulations made under the various tax laws.

This is a welcome move as it will provide certainty and continuity in relation to the various tax regulations.

MISCELLANEOUS PROPOSED AMENDMENTS

Procurement and State Corporation Reforms

- Procurement reform is a key agenda of the Government and a procurement of an end-to-end e-Government system will be put in place whose pilot phase is expected to commence in July 2022. In addition to this, a Bill has been tabled in Parliament to consider the possibility of multiple awards for the same contract and a framework has also been put in place to assist procuring entities to determine competencies for awards for public tenders.
- The CS indicated that a restructuring proposal for Kenya Airways which includes trimming its network, rationalize its frequency of its routes, operation of a smaller fleet and staff complement is to be undertaken and a budget to meet this proposal will be allocated by the National Treasury.

Banking

- A National Payments Strategy 2022-2025 was launched in February 2022 by the Central Bank of Kenya which seeks to realize a faster, secure, efficient and collaborative payment system that supports financial inclusion and innovation. The strategy is motivated by a desire to meet the diverse needs of the people of Kenya and its economy and support the Nation's ambition for a digital, inclusive and 24/7 economy.

Capital Markets

- A review of the legal and regulatory framework is being undertaken to address emerging issues in the capital markets space. These include aspects on collective investment schemes and investment-based crowd funding.
- A new Central Securities Depository System is also being installed at the Central Bank of Kenya to support planned reforms for secondary trading of Government Bonds.
- The definition of 'investment advisor' is to be broadened in 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.

Pensions

- The National Treasury will roll out an engineered pension management system in the course of the fiscal year and this will offer an end-to-end Enterprise Resource Planning solution for the management and processing of pension benefits for Government staff.
- An over-arching National Pensions Policy that will set out the guidelines for application across board on structuring and management of retirement benefits for public servants is to be put in place.
- An amendment to the Retirement Benefits Investment Guidelines to include unlisted Real Estate Investment Trusts incorporated in Kenya, provided that these are approved by the Capital Markets Authority. This will widen the scope of investment where pension schemes can invest their funds.
- The Kenya National Entrepreneurs Savings Trust (KNEST) has been registered and the National Treasury is working with stakeholders to roll out the scheme across all the counties. KNEST aims to enhance investment of funds by the informal sector.

Insurance

- Amendment to the Insurance Regulations to require motorcycles and three wheelers used by fare paying passengers to take insurance for the passengers.

Unclaimed Financial Assets

- A waiver of penalties, fines and audit fees in justifiable circumstances is proposed to encourage reporting and recovery of identified assets by the Unclaimed Financial Assets Authority, including capping accumulated penalties and interest to the value of the asset.
- An amnesty for 12-months is also proposed, to grant relief of penalties (25% of the value of the asset) on unclaimed financial assets subsequently declared and delivered, under the program. This is welcome news and will hopefully encourage greater compliance with the provisions of the Unclaimed Financial Assets Act 2011.

Other matters mentioned in the speech

- To further accelerate economic growth and continue to implement and expand the Economic and Recovery Programme of the Country, a number of matters will be taken into consideration that include security, development of infrastructure, transformation of key economic sectors, access to quality social services, support the youth, women and persons with disabilities, support the devolved system of Government and sustain implementation of various reforms targeted at enhancing efficiency in the delivery of public services.
- The Nairobi International Financial Centre (NIFC) Authority has put in the required operating framework and regulations and will be expected to be a key catalyst in supporting economic growth.
- The Government has completed the Long-Term Low Emission strategy to guide a low carbon–climate resilient development path and will further develop a Climate Finance Mobilization Strategy in order to promote private sector investments in green projects.

PKF

right people
right size
right solutions

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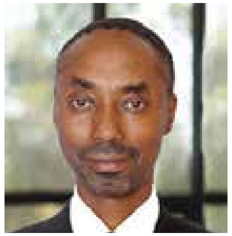

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