Setting the scene

Economic outlook and broadening the tax base

May 2016

Welcome

This newsletter is the second in our series of 2016/17 budget highlights and analysis.

The analysis is based primarily on the 2016 Economic Survey and revenue statistics as disclosed by the KRA.

We hope that you will find it insightful, and look forward to your comments.

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International economic performance 2015

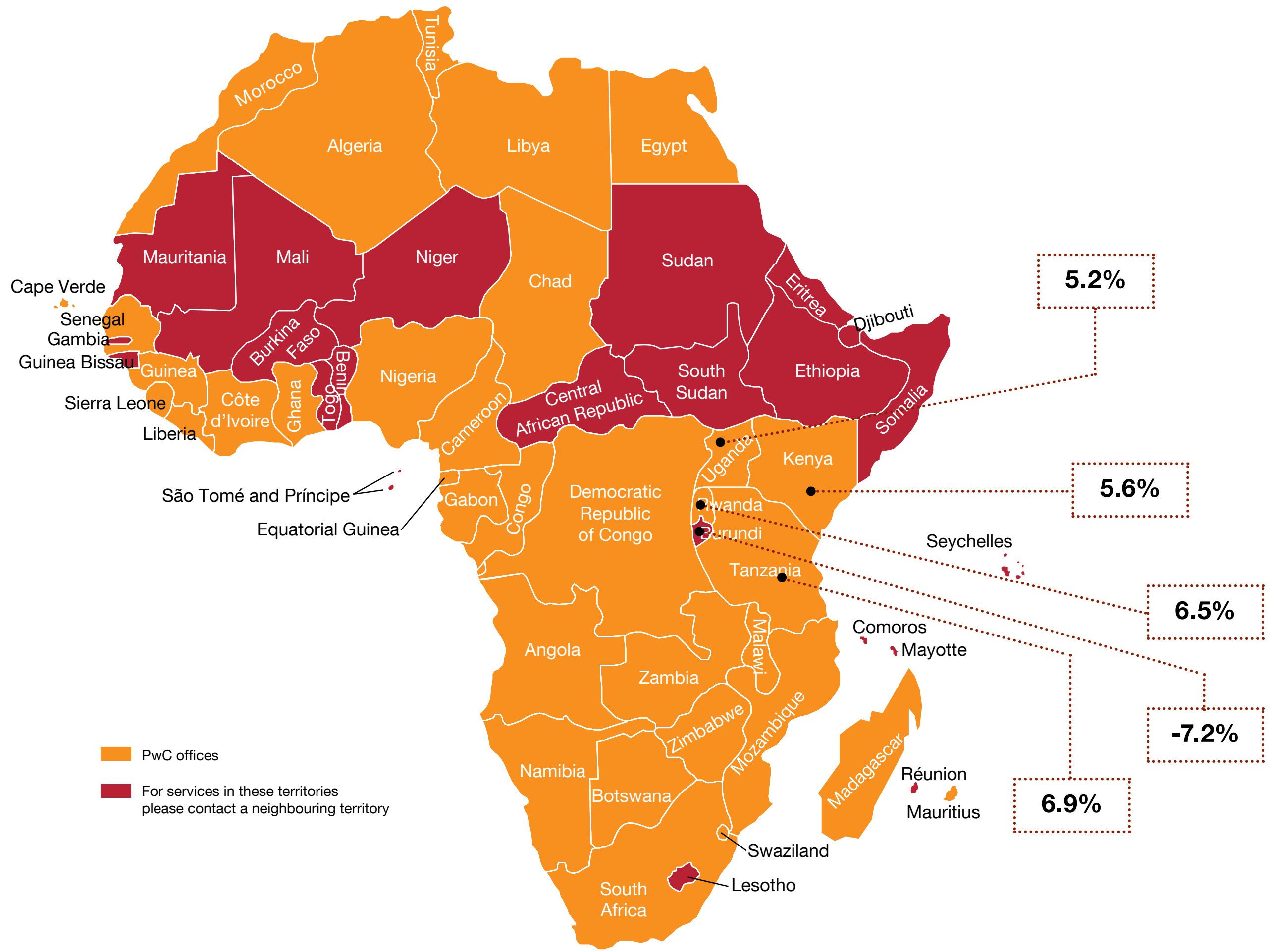
The global real Gross Domestic Product (GDP) growth declined from 3.4% in 2014 to 3.1% in 2015. The decline was as a result of:

- low commodity prices;
- weaker capital flows;
- subdued global trade; and
- increasing financial market volatility particularly in emerging markets and developing economies.

The advanced economies experienced a modest economic recovery, mainly driven by stronger domestic demand as a result of improved labour markets and credit conditions.

In Sub-Saharan Africa (SSA) economic growth declined from 5.1% in 2014 to 3.8% in 2015. This was attributed to the decline in the global economic growth and lower commodity prices.

Economic growth in the East African Community (EAC) declined from 5.8% in 2014 to 3.4% in 2015. This was mainly associated with political instability in Burundi and uncertainties associated with general election in Tanzania

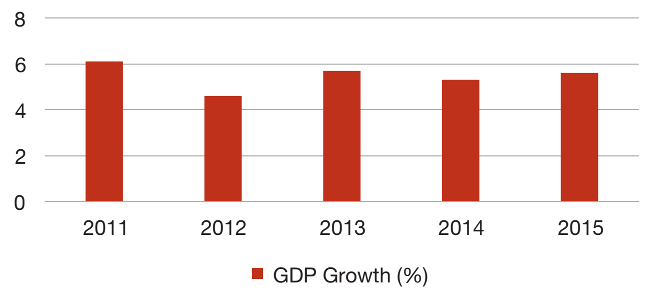


The advanced economies experienced a modest economic recovery, mainly driven by stronger domestic demand as a result of improved labour markets and credit conditions.

Kenya Economic Performance in 2015

Kenya's GDP grew by 5.6% in 2015 compared to 5.3% in 2014. Figure 1 below shows the trends in Kenya's GDP growth from 2011 to 2015.

Figure 1: GDP Growth Rate, 2011 - 2015



Data source: Economic Survey 2016

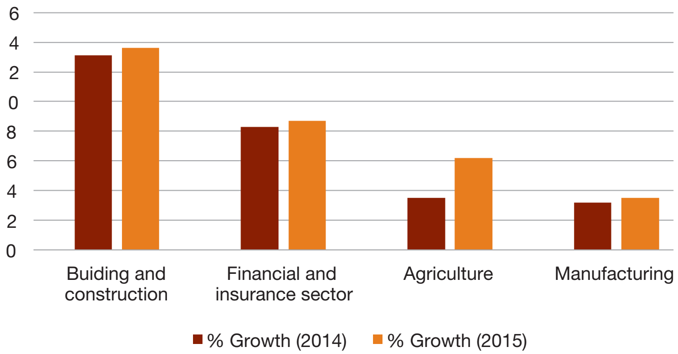
Although the GDP growth in 2015 was higher than the average GDP growth in Sub-Saharan Africa (3.8%), it was lower compared to the GDP growth in countries such as Tanzania (6.9%), Rwanda (6.5%) and Ethiopia (10.2%) during the same period.

The Economic Survey 2016 identifies the following as some of the drivers of the GDP growth in 2015:

- Growth in building and construction sector associated with public infrastructure projects such as the Standard Gauge Railway (SGR) and private sector investment in real estate;
- Good performance in the agriculture sector due to good rains;
- Stable macro-economic environment with inflation contained at an average of 6.6%; and
- Decline in oil prices (from an average of US$ 99.45 per barrel in 2014 to US$ 52.53 in 2015) which improved the current account position.

Figure 2 below shows selected sectoral growth in 2015.

Figure 2: Selected Sectoral Growth in 2015



Data source: Economic Survey 2016

The building and construction sector recorded the highest growth at 13.6% while the financial and insurance sector grew by 8.7% in 2015 compared to a growth of 8.3% in 2014.

The agricultural sector also performed well with a growth of 6.2% attributed to good rains. The manufacturing sector recorded modest growth of 3.5% in 2015, compared to 3.2% in 2014.

The balance of trade deficit improved by 7.8% in 2015 due to improvement in the balance of trade position as discussed in the next section.

Balance of trade position

Balance of trade is total exports of a country less total imports. According to the Economic Survey 2016, the balance of trade deficit in 2015 was Kshs 997 billion compared to Kshs 1,081 billion in 2014 as shown in Table 1 below.

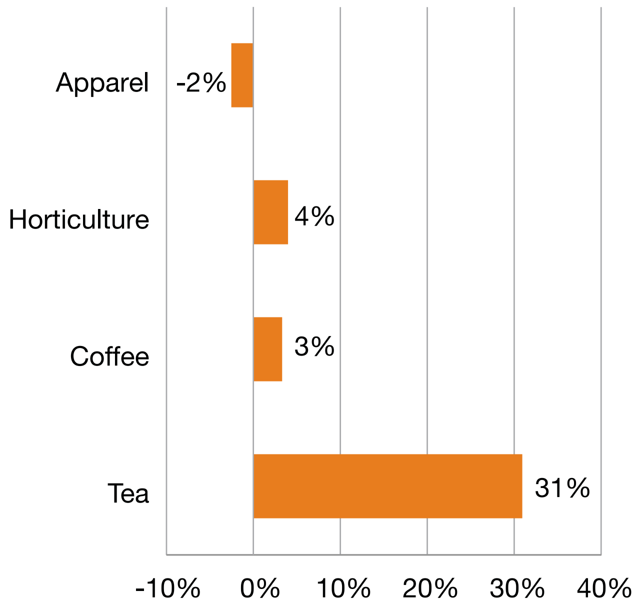
Table 1: Balance of Trade - 2014 and 2015

	2014 (Kshs Bn)	2015 (Kshs Bn)
Total exports	537	581
Total imports	1,618	1,578
Deficit	(1,081)	(997)

Exports

Tea, horticulture, apparel and coffee were the leading export earners, accounting for 54.6% of total merchandise exports. Rising tea export earnings (which grew by 30.9% in 2015) offset the modest growth in earnings from coffee and horticulture, and contraction in apparel earnings, as shown in figure 3.

Figure 3: Growth in export earnings



Data source: Kenya Economic Survey 2016

Balance of trade position

Export to African markets accounted for 41.7% of total exports, out of which 52.3% were to East African Community (EAC) countries. This appears to be in line with the current administration's commitment to deepen trade with African countries. Exports to Europe accounted for 25.1%.

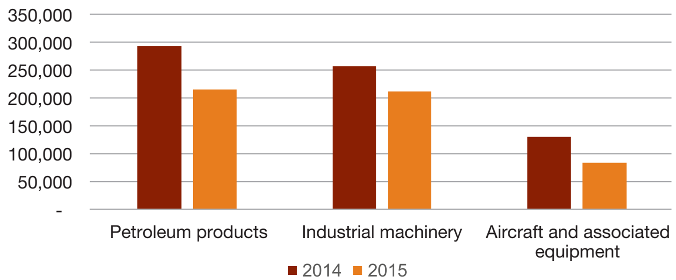
For Kenya to catch up with peers like Ethiopia and Rwanda, with annual growth above 6% over the last 2 years, it must increase exports particularly from manufacturing sector. Export earnings are expected to grow spurred by growth of world merchandise trade in 2016.

Imports

The total value of imports declined from Kshs 1.62 billion in 2014 to Kshs 1.58 billion in 2015.

Figure 4 below shows the leading imports in 2014 and 2015.

Figure 4: Comparison of leading imports in 2014 and 2015 (Kshs million)



Data source: Economic Survey 2016

The value of petroleum products imported reduced from Kshs 292,643 million in 2014 to Kshs 214,695 million in 2015. This was attributed to decline in the global oil prices from an average of US$ 99.45 per barrel in 2014 to US$ 52.53 in 2015.

Industrial machinery imports declined from Kshs 256,672 million in 2014 to Kshs 211,724 million in 2015, while imports of aircraft and associated equipment reduced to

83,094 million in 2014 compared to Kshs 129,589 million in 2014.

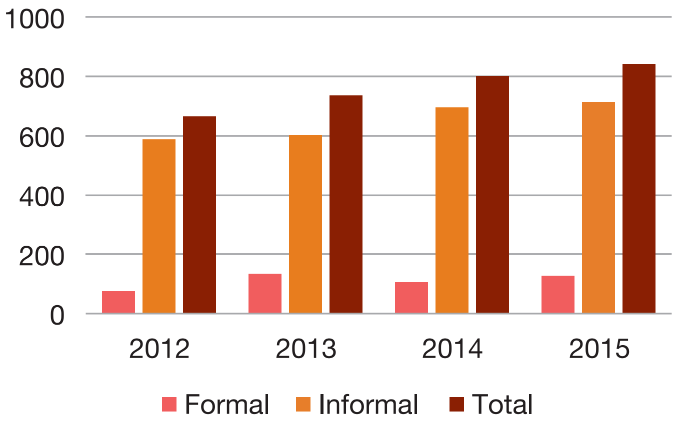
Imports are expected to reduce in 2016 especially if global oil prices continue to decline. This will contribute to an improved balance of payment position. This will further be affected by the stability of the Kenyan shilling. The shilling is expected to remain stable in 2016 against the major currencies.

Kenya is a consumption led economy and its imports are primarily driven by consumption needs. While consumption creates opportunities for domestic expansion in production of goods and services to meet demand and thus grow the economy, the cost of domestic production is in some cases higher compared to importation, which drives up imports.

Employment creation in 2015

The economy generated a total of 841.6 thousand new jobs in 2015, of which 85% were in the informal sector. This has been the trend over the last three years as shown in Figure 5 below.

Figure 5: Jobs created ('000)



Data source: Kenya Economic Survey 2016

Private sector employment growth was higher at 5.4% compared to public sector employment growth at 2.5%, while self-employment grew at 19.6%.

One of the key concerns with the employment generated by the economy is the sustainability and productivity of the jobs. Jobs generated in the formal sector are more productive and higher paying than informal sector jobs, but the economy is generating fewer of these.

According to the World Bank (Kenya Economic Update, March 2016) the jobs generated in the informal sector are low-productivity jobs. This affects disposable incomes, which in turn reduces the spending power and constrains expansion of the economy.

The projected economic growth in 2016 is expected to generate more jobs, particularly in building and construction sectors, driven by infrastructural projects by government and private developers. To address the issue of productivity, there is need for the economy to generate more jobs in the formal sector.

The government's planned investment in Technical Vocational Education and Training (TVET) is therefore a step in the right direction, as it will broaden the skills of the youth entering the jobs market, to make them more attractive to employment in formal sectors.

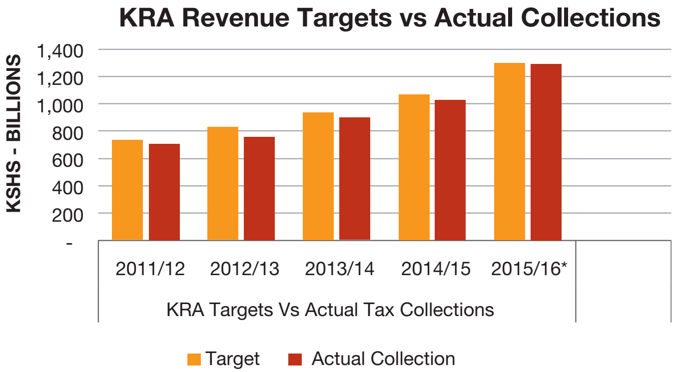
To complement this, the government should continue to reduce cost of doing business and provide opportunities for growth of small household enterprises in order to expand and enter local and global value chains.

This will improve productivity in the jobs generated, and enhance household incomes, which will spur disposable incomes and/or savings. This will in turn increase demand for goods and services and provide an opportunity for expansion in domestic production.

Status update: Tax collections, 2011-2015

Since 2011/12 tax collections have steadily grown from **KES 733 billion** to an estimated projected **KES 1.29 trillion** in 2015/16 as shown in Chart 1 below.

Figure 6:KRA revenue targets vs. actual collections



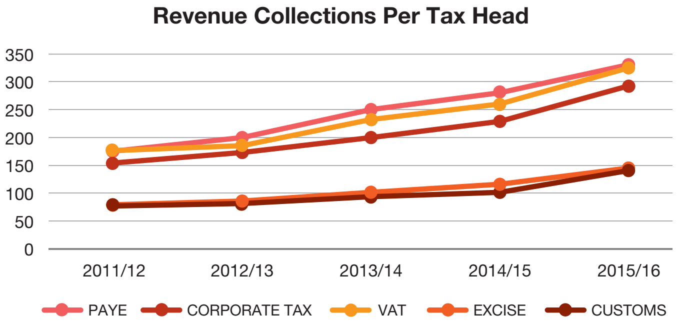
Source:
KRA & Economic survey 2016
* - Figures based on KRA projections

The targets are set based on macro-economic forecasts and, if necessary, revised over the course of the fiscal year.

Overall, revenue collection has gone up due to a combination of factors including economic growth and enhanced collection mechanisms.

This growth is across all tax heads as shown in chart 2.

Figure 7: Revenue collections per tax head



KRA & Economic survey 2016

From the chart above, VAT has realized faster growth in the immediate aftermath of the introduction of the introduction of VAT Act, 2013.

It is too soon to gauge the impact of the Excise Duty Act which was enacted in December 2015. Customs Duties have the lowest growth rate and contribute the least amount of taxes to the Government.

PAYE has consistently been the top revenue earner for the Government over the period. With the proposed Income Tax Bill, it remains unclear whether this trend will continue.

Despite the upward trend in tax collection, KRA needs to formulate mechanisms to broaden the tax base to achieve its ever growing targets. Some of the measures could include taxing the informal sector, simplifying the tax law and making it easy to pay tax. These measures are discussed in the following sections.

PAYE is the top revenue earner, but is there room for reform?

That PAYE is the top revenue earner for the Government hardly comes as a surprise. Employees are a prime cash cow as they are a relatively stable group with limited or no legal means to mitigate their tax burden.

For over a decade, the PAYE brackets have remained unchanged despite the year-on-year increase in the cost of living. For example, the average price of a loaf of bread was **KES 24** in 2004. 12 years on, this is now **KES 50.**

In a move to address the plight of the country's employees, the President recently issued a directive to the National Treasury to exempt low income earners from paying taxes on bonuses, overtime and retirement benefits.

However, this is bound to be a challenge administratively in ensuring that only those who are genuinely low income earners benefit from the tax exemption.

Currently, there is no legal definition of a low income employee. Prior to 2014, a low income earner was defined in the Income Tax Act as any employee earning **KES 29, 316** per month or below. This is merely **KES 9,576** less than the earnings threshold for the top tax bracket of 30%.

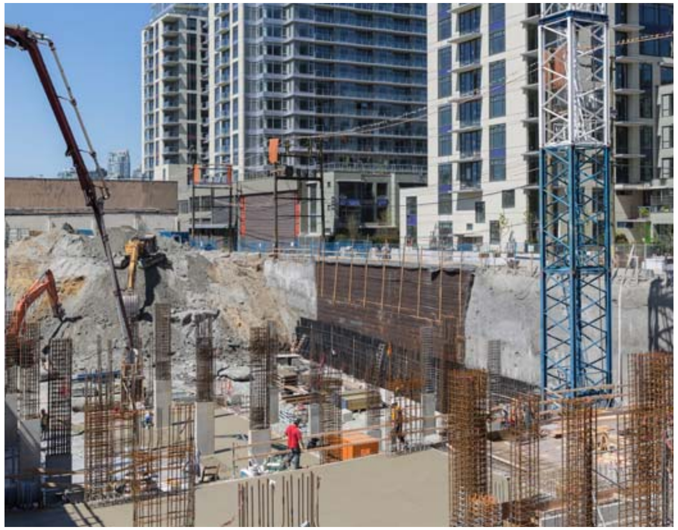
An alternative to the above would be to consider widening the tax brackets and raising the monthly tax free income to approximately **KES 25,000.** This would provide the much needed relief across all levels of employees. Additionally, this move would also ease the administrative load significantly by reducing the number of people who need to file returns. Currently, only those employees earning below **KES 11,188** per month are exempt from tax.

A comparison of Kenya's PAYE bands to Ghana, Nigeria and South Africa reveals that the starting income of KES 38,892 per month for Kenya's top bracket of 30% would be taxed at between 18%-20% in those countries.

Furthermore, the countries have mechanisms in place that allow for periodic review of the tax brackets. Kenya should also put in place mechanisms that allow for periodic review of the tax bands.

Tapping the potential of the informal sector to increase tax collection

In Kenya, the informal economy is commonly referred to as "Jua Kali". By most indications, the growth in this sector far outstrips that in the formal economy.



Due to its very nature, the informal sector is largely off the grid hence it has limited contact with the tax system. Most of the sector's interaction with the tax system is in the form of indirect taxes on consumption.

There is need to include this sector in the tax base. However, what is unclear is the manner in which this should be done. Moves in this direction are bound to be administratively difficult and costly to implement. Conventional methods of taxation and collection are unlikely to be effective for this sector.

In recent years, we have seen new initiatives introduced by the KRA such as i-Tax and mobile payment platforms. While these measures are aimed at increasing compliance, they are less applicable to players in the informal sector.

Most players in this sector still find it too costly and burdensome to meet the requirements of the tax system which involves book-keeping, record-keeping and multiple filings and tax payments to different authorities.

In Kenya, the informal sector is characterized by cash or mobile money transactions. The KRA is currently seeking to gain access to mobile money transactions in a bid to expand the tax net.

However, this is likely to lead to players in the informal sector opting to transact in cash as much as possible since such transactions are more difficult to track. Long term policy moves such as transitioning to a cashless economy are therefore necessary.

More novel approaches ought to be identified and pursued e.g raising taxes through the permit and licensing infrastructure and making use of existing County and Municipal Government structures to undertake collections on behalf of KRA.

Simplifying the tax law

Many taxpayers in Kenya struggle with their compliance obligations due to the complexity of the tax laws. Recently, the government has shown its commitment to modernise and simplify tax statutes. This is demonstrated by the enactments of the following pieces of legislation over the last three years:

a) VAT Act, 2013;

b) Excise Duty Act, 2015;

c) Tax Procedures Act; and

d) ax Appeals Tribunal Act.

Whilst this is commendable, a lot more ought to be done to ease compliance burden and in the process enhance tax revenue collection.

The proposed Income Tax Bill presents an opportunity to simplify and modernize the Income tax law in line with prevailing business and economic practices.

Furthermore, legislation should be put in place to allow KRA to issue practice notes and implementation guidelines. For instance, three years after the enactment of the VAT Act 2013, the subsidiary legislation (VAT Regulations) meant to aid the implementation of the Act is still to be enacted.

Easing payment of taxes

Whereas overall progress has been made towards simplifying the tax laws, there still remain several challenges hindering the payment of taxes. According to the 2016 'World Bank ease of doing business' report, Kenya's rank has dropped to 101 (from 99 in 2015) out of 189 countries in the 'paying taxes' criteria.

Kenya has considerable scope to reform the operation of its tax system and address challenges such as the availability of IT infrastructure.

In addition, KRA should consider better integrating the mobile platform to its tax payment systems to allow easier payment of taxes. For most taxpayers, a mobile platform would ease the burden of making tax payments unlike banking processes which have a comparatively lower reach.

For individual taxes, the government may also consider adopting a single registration system to be implemented from birth and which will be used for payment of all taxes and government levies (income tax, NHIF, NSSF, etc.). This can be achieved by integrating taxpayer registration information with information held by other government agencies.

Overall, the KRA ought to be lauded for embracing technology (i-Tax and payments via mobile money platforms).

Whilst the government's commitment to improved service delivery through use of technology has advanced, the KRA should continue to streamline its technology implementation processes. This will help improve tax administration and aid in broadening the tax base due to better collection of taxes.

Economic Outlook - 2016

The World Bank (Kenya Economic Update, March 2016) projects that the GDP will grow by 5.9% in 2016. Growth of the GDP in 2016 is expected to be led by the same sectors. For instance, building and construction sector is expected to expand further as a result of continued public infrastructure development and private sector investment in residential and commercial properties.

The agricultural sector is also expected perform well, although lower rains in 2016 may reduce growth of the sector compared to 2015. Innovations in ICT are expected to continue to spur growth in financial services sector

In 2015, the growth of the manufacturing sector was tempered by the high cost of credit and cheap imports. Fiscal contraction and a shift from domestic to external financing of deficit is however expected to expand the credit available to private sector and spur growth in manufacturing and other sectors.

Macro economic indicators are expected to remain stable in 2016 to support growth, with inflation expected to be contained within single digit levels. The Monetary Policy Committee (MPC) has maintained the benchmark interest rate at 11.5% since July 2015, until 23 May 2016 when it was revised to 10.5%.

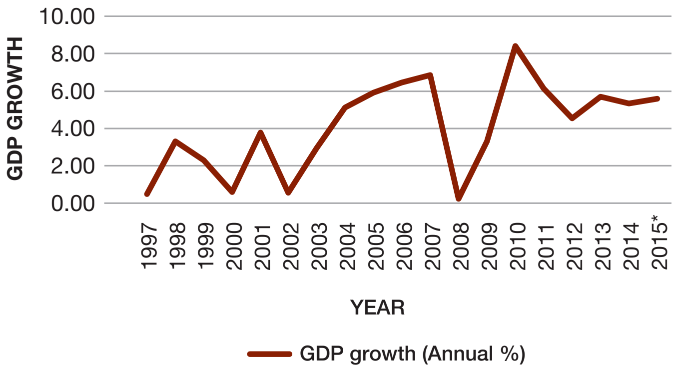
However, a number of domestic and external factors could affect the projected performance of the economy. For instance, slow down in economies that are traditional markets for Kenyan exports could lead to subdued demand for her exports, thus affecting growth in exports.

Further, weakening of regional currencies against the US Dollar and Kenyan Shilling could impact competitiveness of Kenyan exports and affect foreign exchange earnings.

The threat of violence during the upcoming elections could cause investors to hold back on investments until after the elections. The recent series of protests against the IEBC that have turned violent could have caused concerns among investors.

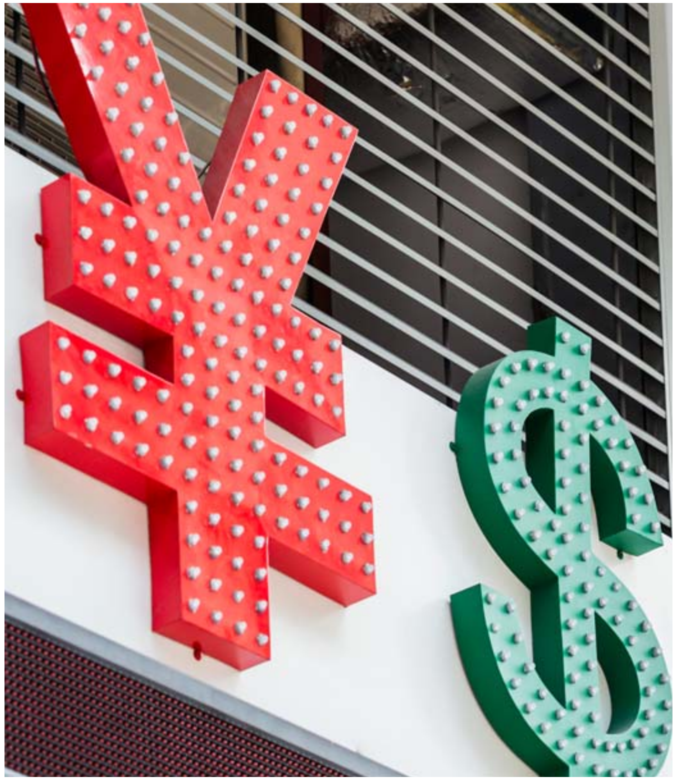
As the graph below shows, pre-election and election years have coincided with down-turn in GDP growth. This is particularly evident in 2002/03 and 2007/08, but moderate in 2012/13.

Figure 8: Annual % GDP Growth



Data source: World Bank Kenya Country Data

Further, any significant security incidents could lead to reinstatement of adverse travel advisories, which could undermine the projected recovery of the tourism sector.



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