# Balancing act

## *Kenya's 2017/18 National Budget*
## *PwC insight and analysis*

March 2017

## *Welcome*

*PwC Kenya's Budget Bulletin provides insight and analysis on the 2017/18 budget speech and other relevant materials.*

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

***In this bulletin***



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# Direct taxes

## Positioning Kenya as a motor vehicle assembly hub

The CS in his Budget Statement indicated that the Government is engaging with stakeholders in order to develop a Comprehensive Automotive Industry Development Policy that will position the country as hub for motor vehicle assembly for the region. In this regard, the CS has proposed to amend the Income Tax Act to reduce the corporate rate of income tax for "new assemblers" from the current 30% to 15% for the first five years.

This proposal is a welcome incentive in attracting investments in this automotive assembly sector owing to the significant capital outlay that is required in setting up the manufacturing plants. The incentive could be made more attractive and have more impact if:

- The reduced corporate rate of tax is extended to existing automotive assembly players who make significant investments to their existing assembly lines; and
- The period for the reduced tax rate is extended to ten years as the new investors are likely to be in a tax loss position for the first few years owing to the tax deductions that would be claimed on their capital investments. As such, restricting the benefit to five years would make it spurious as it is unlikely that significant corporate tax would be payable in the first years of operation.

## Incentivising the Blue economy

The blue economy – economic activity in the maritime sector – has been identified as being a potential sector for creating wealth and employment. In a move seen to support and facilitate the development of this sector, the CS proposed a 150% investment deduction for capital expenditures in the blue economy.

The Budget Statement does not give guidelines for an expenditure to qualify for this enhanced deduction. For example, will this be limited to fishing equipment or for all expenditure by players in this field. Further guidelines in this regard will be provided in the Finance Bill once published.

## Emboldening donors

In a move aimed at alleviating the impact of disasters on the people of Kenya, the CS has proposed to amend the Income Tax Act by granting a tax deduction for expenditure incurred on donations for the alleviation of distress during national disasters declared by the President.

For a person to enjoy the deduction, the donation should be channeled through the Kenya Red Cross, a County Government or any other institution responsible for dealing with the national disaster.

While the proposal is a welcome move, this is unlikely to have a major impact on taxpayers who channel their donations through the Kenya Red Cross as such donations are currently tax deductible.

It will also be interesting to see if the move will encourage donations to the County Governments since the mechanisms for accountability in respect of private donations have not been formulated.

## Clarifying the tax amnesty on foreign income

During last year's Budget Statement, the CS proposed a tax amnesty for persons who earned income and owned assets outside the country, provided that they submit their tax returns and accounts for the year of income 2016 between 1 January 2017 to 31 December 2017.


The Kenya Revenue Authority ("KRA") released Tax Amnesty Guidelines on Foreign Incomes on 8 March 2017 to address the circumstances under which the amnesty would be granted.

The CS has further clarified that taxpayers wishing to enjoy the amnesty should transfer back to Kenya income declared under the amnesty. In addition, the CS has extended the declaration period to 30 June 2018.

**The Special Economic Zones (SEZ) and additional income tax incentives demonstrate the Government's resolve to promote SEZ's as part of its industrialization agenda.**

## Additional tax benefits for investors in SEZ

The Special Economic Zones (SEZ) Act was enacted in 2015. The Act is aimed at establishing special economic zones that reduce the cost of doing business and promote foreign direct investments. The SEZ Act provides for various tax incentives that are anchored in the various tax legislations.

To align the tax incentives for SEZs with those that relate to Export Processing Zones (EPZ's), the CS has proposed the following additional income tax incentives:

- Dividends payable to non-residents by enterprises operating in SEZ are exempt from tax;
- Reduction of withholding tax on interest payable to non-residents by SEZ enterprises from 15% to 5%;
- Allowing a capital deduction of 100% of the cost of buildings and machinery owned by the SEZ enterprise.

In addition, goods exported from and imported by an SEZ enterprise will be exempt from export duty and Import Declaration Fees respectively.

The above benefits demonstrate the Government's resolve to promote SEZ's as part of its industrialization agenda. There will be need to consider the impact of other taxes such as compensating tax liabilities that may arise from the provision of the above such tax incentives.

# Tax incentives for all employees

## Proposal to further expand income tax bands and increase personal relief by 10%

The PAYE brackets had remained unchanged for over a decade despite the year-on-year increase in the cost of living. In a move to address the plight of the country's employees and cushion low income employees, effective January 2017, the Government expanded the tax brackets by 10% and increased the personal relief to KES 15,360 per annum.

The Cabinet Secretary has proposed to further expand the tax bands and increase the personal relief by another 10% to KES 16,898 per annum. This is a welcome move for low income earners due to the expansion of the lowest taxable income threshold from KES 12,460 to KES 13,672 per month.

However, it remains unclear when the expanded tax bands will come into effect.

The current and the new proposed monthly income tax bands are summarised below:

| Monthly current income tax bands (KES) – Effective 1 January 2017 | Tax rate (%) |
|---|---|
| 0 - 11,180 | 10% |
| Next 10,534 | 15% |
| Next 10,534 | 20% |
| Next 10,534 | 25% |
| Over 42,782 | 30% |

| Monthly proposed income tax bands (KES) | Tax rate (%) |
|---|---|
| 0 - 12,298 | 10% |
| Next 11,587 | 15% |
| Next 11,587 | 20% |
| Next 11,587 | 25% |
| Over 47,060 | 30% |

### *More low income employees to benefit from tax free bonuses, overtime and retirement payments*

Effective 1 July 2016, the Government exempted from tax for employees in the 10% band; bonuses, overtime and retirement benefits paid to employees whose earnings did not exceed KES 121,968 per year in 2016 and KES 134,165 for 2017.

With the further proposed expansion in the income tax bands, we expect this to raise the number of employees who fall into the low income earners category, since the threshold will increase to KES 147,581 per year.

This will cushion the low income earners from the high cost of living and provide them the much needed relief.

### *New welfare programme for the elderly*

The Government has proposed to enhance the coverage of the cash transfer programme to support all persons aged 70 years and above. Effective 1 January 2018, all persons above the age of 70 years will receive a cash transfer in the form of a monthly stipend and NHIF cover that will be paid by the Government. It remains unclear how much the Government will pay out as the monthly stipend and NHIF cover.

### *Umbrella Retirement Benefit Schemes*

Employers are increasingly joining Umbrella Retirement Benefit Schemes instead of the traditional standalone retirement benefit schemes. Such schemes have unique features which require a framework to regulate the operations.

The Cabinet Secretary has promised to issue regulations to govern the operations of these type of schemes.

### *Expected changes… missed out!*

- In line with the expanded tax bands and increased personal relief, one would have expected the Cabinet Secretary to increase the limit for pension contributions made to a Kenyan registered pension scheme from the current amount of KES 20,000 per month.
- In the spirit of increasing access to affordable housing, one would have expected the Government to increase the tax deductible Home Ownership Savings Plan (HOSP) from the current KES 4,000 per month. This would be in line with the recent increase in the mortgage relief from KES 12,500 per month to KES 25,000 per month effective 1 January 2017.

# Overhaul of the Income Tax Act

## New Income Tax Act... public participation required

For the third consecutive year, the Cabinet Secretary has committed to publishing the long awaited new Income Tax Act (ITA) for public input. It is important that the public actively participates in proposing any amendments to the draft ITA bill.

Some of the areas that the Cabinet Secretary indicated that could have major tax legislative changes include: taxation of cross border transactions, compensating tax, taxation of the extractive sector, taxation of pensions and tax on capital gains. We have briefly noted some issues below that should be taken into account in the draft ITA bill.

## Compensating tax

It has been noted that compensating tax discourages investment as it results in a claw-back of tax incentives meant to spur investment.

Compensating tax was introduced to capture income or gains that have not been subject to tax. This was so when companies realised gains from sale capital assets such as land as these gains were ordinarily not subject to corporation tax. It was not envisaged that companies would end up with a compensating tax liability as a result of tax incentives.

Currently, due to tax incentives granted to companies especially on projects that are capital intensive, companies may not be able to exhaust the tax benefits accrued thus may be subject to compensating tax at the point where earnings are distributed to investors. The proposed overhaul of the ITA should adequately address this challenge.

## Extractive sector

Although Kenya is looking to develop its extractive resources, the country still remains a frontier territory given the limited exploration activity completed to date. The nascent oil and gas industry should be encouraged to grow and support the economy.

In line with the second Medium Term Plan (MTP) of Kenya's Vision 2030, the tax policy direction on the extractive sector should support the growth of the sector.

The tax regime should be progressive rather than regressive where the investment phase is not hindered through taxation thereby reducing the capital resource available for exploration or development.

We hope that the various reforms instituted by the CS coupled with input from public participation will deliver an ITA that captures the essence of a modern tax law.

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# Indirect taxes

## Value Added Tax (VAT)

### Introduction

We observe that the Government has continued to place reliance on exemption as its primary VAT incentive. However, it is refreshing to note that for the first time, the CS has acknowledged the ills of exemption and has proposed to overturn VAT exemption on certain basic foods in favour of zero-rating as way of ensuring the mwananchi enjoys reprieve from VAT!

We strongly believe that there is a need for the Government to re-assess various other categories of VAT exemptions vis-à-vis its economic growth agenda – VAT exemption is laden with concealed costs that do not endear themselves to economic growth.

**It is with this backdrop that we set out below some of the prominent VAT changes proposed by the CS.**

### A boost to the ailing medical sector

As a way of promoting the health sector, the Cabinet Secretary has proposed exemption from VAT on medical equipment and apparatus for use in specialized hospitals. The exemption is granted subject to the qualifying taxpayers obtaining recommendation from the Cabinet Secretary responsible for health, who it is envisaged shall issue guidelines for the eligibility criteria for the exemption.

Whilst this is a positive move, the question that still remains unanswered is what constitutes specialized hospitals?

### VAT exemption for Sharia compliant finance products

The Cabinet Secretary has proposed to amend tax statutes to provide for equivalent tax treatment of Islamic finance products with conventional financial products.

Whereas the budget speech did not mention the specific tax legislation to be amended, we expect that the VAT Act, 2013 will be amended to provide for exemption from VAT of Sharia compliant financial products, similar to the exemption currently enjoyed by conventional financial services.

This amendment is expected to harmonise the VAT incentives offered across the financial services industry.

### VAT Regulations - A light at the end of the tunnel?

In September 2013, the Government overhauled the VAT legislation through the enactment of the VAT Act, 2013. The overhaul of the VAT legislation was at the time viewed as a step in the right direction towards the Government achieving its desired revenue collection targets and the aspirational compliance levels.

However, three years since the enactment of the VAT Act, the Regulations – which are the enabling subsidiary legislation – are yet to be published! It is therefore encouraging that the Cabinet Secretary has confirmed that he will be publishing the VAT Regulations to support the smooth implementation of the VAT Act, 2013.

Whereas the Cabinet Secretary mentioned that the Regulations have been prepared and subjected to stakeholders' engagement as required by law, it appears that such engagement was not widely publicized.

All in all, this proposal was long overdue.

### Zero rating of ordinary bread and maize flour

In an effort to make ordinary bread and maize flour affordable to the mwananchi, the Cabinet Secretary proposes to zero rate these food commodities, which are currently exempt from VAT.

This is a welcome proposal as the Government has finally appreciated the fact that VAT exemption is laden with hidden sticking cost and rarely delivers the desired tax reprieve.

## Boost to local manufacturers and the agricultural sector

The Cabinet Secretary proposes to exempt from VAT all inputs used in the manufacture of pesticides. This is in a bid effort to make local manufacturers more competitive and also promote the agricultural sector by reducing the cost of production.

The Cabinet Secretary's speech mentioned that imported finished pest control products are zero rated; however, these products are in fact exempt from VAT. This means that local manufacturers of the product incur VAT (16%) on the importation of the raw materials without the right to input tax credits. The Cabinet Secretary rightly noted that this renders the local manufacturers uncompetitive vis-à-vis importers of the VAT exempt finished products.

Whilst the proposed change is welcome, it remains to be seen whether it will result in lower pesticide prices and the concomitant boost to the agricultural sector.

## VAT exemption for locally assembled tourist vehicles

In a bid to revamp the ailing tourism sector and promote local tourism, the Cabinet Secretary has proposed to exempt from VAT locally assembled tourist vehicles. While the exemption is welcome reprieve for the assemblers, it is unclear what vehicles qualify as 'tourist vehicles' as this phrase is not defined in the VAT Act.

Whereas the VAT Act does not define the term tourist vehicle, the East African Community Customs Management Act ("EACCMA") offers insight as to the type of motor vehicles the Cabinet Secretary has in mind. The EACCMA defines a 'tourist vehicle' as a vehicle specifically designed for transportation of tourists imported by licensed tour operators upon recommendation by a competent authority upon meeting conditions such as:

a) four wheel drive with open roof facility for game viewing and with seating capacity not exceeding 12 passengers;
b) having provisions for camping, rescue and first aid equipment, baggage and compartment and communication fittings;
c) are of a colour that blends with the environment where they operate and have a clear and conspicuous label or marking of "tourist vehicle";
d) any other conditions the Commissioner may impose Provided that duties shall be payable upon disposal for other use or change of use.

Hopefully, a closely aligned definition will be adopted in the VAT legislation to avoid uncertainty and subjective interpretation of the law.

## Promoting the blue economy

With a view to creating wealth and employment, the Cabinet Secretary proposes to exempt from VAT packaging materials and other inputs intended to support marine fisheries and fish processing.

It is hoped that the proposed change will revive the fisheries sector and ensure increased utilization of marine resources as part of economic growth agenda.

## Indirect taxation of REITS and ABS

The Cabinet Secretary proposes to exempt from VAT transactions related to transfer of assets into Real Estate Investment Trusts (REITs) and Asset Backed Securities (ABS). This is in line with the Government's policy to increase sources of financing for infrastructure projects by increasing the uptake of alternative infrastructure financing products. This proposal will in our view reduce the overall cost of setting up REITS and ABSs as currently such transfer are potentially subject to 16% VAT without a right to input tax credit for the transferee. That said, clarity will be required on the specific transactions that qualify for the exemption as it is unclear from the Cabinet Secretary's speech whether the intention is also to exempt the actual transfer of property to the REITS and ABSs.

## Expectations not met

We had hoped to see a policy shift from the Government's reliance on VAT exemption as the VAT incentive of choice and for greater impetus in the Government adoption of zero-rating – this was no to be.

In addition, we had expected the Cabinet Secretary to abolish Withholding VAT. We note that the Cabinet Secretary has not made any proposals on withholding VAT despite the challenges posed by the system to tax payers – we remain cautiously optimistic that changes will be made to the Withholding VAT regime to either abolish the regime or address challenges currently experienced by taxpayers! Finally, delays in the payment of VAT refunds remain a riddle as the Cabinet Secretary's speech was silent on the matter. Considering the sensitivity of the matter, we had expected the Cabinet Secretary to acknowledge the delays in the payment of VAT refunds as a challenge to Government's quest to spur economic growth.

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# Customs and Excise duty

## Customs duty

### *Introduction*

On the whole, the Government's budget proposals are aimed towards job creation and delivering a better life for all Kenyans.

The Government believes this will be achieved through the introduction of measures that promote industrialization, encourage local investment and create incentives in the agricultural and manufacturing sectors. The Cabinet Secretary for the National Treasury (CS) expressed a desire to make Kenyan products more competitive and to protect local industries from cheap imports.

It is on the back of this theme that the CS proposed the measures discussed below.

## No Customs Duty changes just yet!

The national budgets for the East African Community (EAC) countries are normally presented in the month of June each year. However, this year Kenya has presented its budget ahead of other states within the EAC to allow it prepare for the national elections in August 2017. The CS in his speech stated that there were consultations with the other EAC Partner States who agreed that Kenya may proceed with an early presentation of its national budget.

However, on the basis that customs duties are administered under a common regional legislative framework, Kenya's proposals on customs will have to be presented together with the rest of EAC Partner States' customs proposals at the beginning of July as has become the tradition.

This said, the CS alluded to the fact that the proposed customs measures are aimed at promoting industrialization, encouraging local investment and creating incentives in the agricultural and manufacturing sectors – a theme that cuts across the rest of the budget.

## Review of East Africa Community Common External Tariff (EAC CET)

Every five years the EAC CET is amended to encompass new products in the global market, changes in technology and other trade considerations.

The last review was done in the year 2012 and the CS has confirmed that the EAC CET is currently undergoing a comprehensive review. The final version is expected to be released to the general public once adopted by the EAC Council of Ministers.

## Freedom from hunger

The CS has proposed to exempt maize from import duty over the next four months. The proposal is aimed at reducing the price of imported maize, which is a basic food commodity with a view to making it affordable for the common mwananchi.

It is hoped that this will reduce the suffering and hardship that has resulted from the widespread drought in Kenya.

However, as noted above all customs duty proposals require ratification at the EAC level before implementation and it therefore remains to be seen whether the CS will deliver on his promise of duty free maize imports over the next four months.

Additionally, whilst this is a welcome move, the four months may not be enough to fully mitigate effects of famine and perhaps the CS should have considered a longer period.

## Importation of dates

The CS has proposed to exempt dates from import duty during the period of Ramadhan for the Muslim community. The proposal is aimed at reducing the price of imported dates with a view to making it affordable during the period of Ramadhan.

However, as noted above all customs duty proposals require ratification at the EAC level before implementation and it therefore remains to be seen whether the CS will deliver on his promise.

# Excise Duty

## *Introduction*

Excise duty continues to feature prominently as a revenue collection tool for the Government as was the intention when the law was introduced in the year 2015. This year, however, the Government has steered away from proposing any changes in relation to excisable services and instead concentrated on excisable goods.

## Refund of excise duty on illumination kerosene

The Cabinet Secretary has proposed to introduce refund of excise duty paid on illuminating kerosene used as a raw material in the manufacture of paints and resin by registered manufacturers. This is in order to steer growth in the industry and also to equate to the tax incentives enjoyed by manufacturers that use spirit in the manufacture of paint.

This is a welcome move that will reduce costs which would have been borne by end users in the construction industry.

## Islamic products

The Cabinet Secretary has proposed to amend the tax statutes to provide for equivalent tax treatment of these products with the conventional financial products.

It has not been clarified how these Islamic products will be aligned to other financial services under the excise duty legislation. However, under the Excise Duty Act, 2015, return on loan is exempted from excise duty alongside interest charged on loans. Although the excise duty law does not provide a definition of 'return on loan', in practice this phrase has been taken to target Islamic products. Perhaps all that is required in the Excise Duty Act is a definition of the phrase 'return on loan'.

## Excisable Goods Management System (EGMS)

Licensed manufacturers bear the cost of excise stamps at a standard rate of KES 1.50 besides paying excise duty in respect of the various excisable products. The charge enables the KRA to meet the cost of the EGMS which affixes and tracks stamps for excisable products. The uniform rate is however inequitable on the basis that it does not distinguish between high cost and low cost products.

The Cabinet Secretary has proposed to introduce Regulations that will provide for differentiated prices of excise stamps based on cost of the product being affixed with the stamp. In the Regulations, the cost of stamps will range from KES. 0.50 to KES. 2.50.

The proposal is a welcome move as it will alleviate the inequity currently associated with the uniform cost of excise stamp regardless of the value of the product.

## Remission of excise duty on beer

The Cabinet Secretary has proposed 80% remission of excise duty in respect of locally manufactured beer made from locally produced sorghum, millet or cassava or any other produce, excluding barley. The proposed change is primarily aimed at discouraging the consumption of illicit drinks.

This remission was previously granted under the Alcoholic Drinks Control (Amendment Act) 2015 at 90% remission. However, the Finance Act 2016 repealed Section 68 of the Alcoholic Drinks Controls Act, 2015 taking away the Cabinet Secretary's power of implementing tax policies and possible remission of duty on locally manufactured alcoholic drinks. The deletion of this section further removed the 90% excise duty remission provided for beer made from sorghum, millet or cassava grown in Kenya. This created uncertainty as to the remission status of this class of beer.

This uncertainty has now been clarified.

## Increase of excise duty on spirits

The Cabinet Secretary has proposed to increase the excise duty rate on spirits from the current KES 175 to KES 200 per litre. This is because of increase in demand for high value spirits.

This measure may however drive the consumers to resort to consumption of alternative products from the black market, some of which do not meet the requisite safety standards.

## Amendment of excise duty rates on cigarettes

The Cabinet Secretary has proposed to introduce a two tier tax excise duty structure for cigarettes from the current single rate of KES 2,500 per mille. The new tax rate will be as follows: cigarettes without filters, KES 1,800 per mille and cigarettes with filters, KES 2,500 per mille. The purpose of the tax measure is to promote fairness in the tobacco industry.

It is hoped that the reduced charge of excise duty on plain cigarettes will reduce the cost of such cigarettes in this segment which are targeted at a particular niche market owing to their affordability; whether the reduction in excise duty will translate to a reduction in price remains to be seen.

## Inflationary adjustment on excise duty rates

The Cabinet Secretary stated that although there would be no direct revision of the excise duty charge on beer in the budget, as provided for in the Excise Duty Act, 2015, there will be an inflationary adjustment of the existing excise duty rates on beer with effect from 1 July 2017.

## Definition of powdered beer

The Cabinet Secretary has introduced the definition of powdered beer in the First Schedule to the Excise Duty Act. In this regard, powdered beer has been defined to mean any powder, crystals or any other dry substances, which after being mixed with water or any other non-alcoholic beverages ferments to or otherwise becomes an alcoholic beverage.

Previously, there was no definition of powdered beer in the Excise Duty Act and as a result, there was uncertainty as to whether this product was taxable in powder form or upon mixing with water. This definition has brought certainty and clarity in the beer industry.

## Exemption of excise duty on St. John Ambulance

The Cabinet Secretary has proposed to amend the Second Schedule to the Excise Duty Act, 2015 to exempt excisable goods supplied to St. John Ambulance for official use in the provision of relief supplies in Kenya.


This move aims at bringing equity in the treatment of St John Ambulance and Kenya Red Cross which already enjoyed the exemption.

The exemption granted to these two bodies enables them to effectively carry out their mandate in relieving distress and humanitarian crises.

## Replacement motor vehicles for returning residents

The Cabinet Secretary has proposed to amend the Second Schedule to the Excise Duty Act, 2015 to exempt a motor vehicle purchased by a returning resident in replacement of a left hand drive motor vehicle.

This is on condition that the retail selling price of the motor vehicle shall not exceed that of the previously owned left hand drive. This move aims at harmonizing the excise duty legislation to the Value Added Tax (VAT) which already provides for exemption in relation the same category of motor vehicles.

## Conclusion

These changes are expected to address the challenges faced by the manufacturers of excisable goods with regards to the EGMS and introduction of refunds for paint manufacturers while at the same time boosting revenues for the exchequer through increased duty rate for spirit and the implementation of the inflationary adjustment.

It is expected that more changes to the Excise Duty Act will be introduced through the Finance Bill.

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# Against all odds, tax on betting increased significantly

## Proposal to increase rate of tax to 50%

The CS has proposed a signficant increase in the tax on betting, gaming, lotteries and prizes from between 7.5% to 15% to a uniform rate of 50%. The tax increase represents a percentage increase of between 233% for prize competition to 900% for lottery winning. The CS appears to have bet big on generating tax revenue from the betting and gaming sector to bridge Government revenues.

The expansion of the betting industry is, in the Government's view, beginning to have have negative social effects, in particular for the young and vulnerable members of society. At this point, the jury is still out on whether the Government's measure will achieve the intended objective of funding the newly created National Sports, Culture and Arts fund.

## What is the tax base for the new uniform rate of tax?

In 2016, the Government unsuccesfully attempted to subject winnings to withholding tax. The Government then changed the basis on which betting and gaming is taxed in January 2017. A myriad of questions arise in respect of the uniform rate of tax. For instance, what is the tax base for the new uniform rate of tax? Does the new tax rate apply on the respective tax base where the previous tax rates were applicable?

Under the January 2017 tax changes to the sector, the tax base is different for each of the respective tax type as tabulated below:

| Tax type | Current Rate/Tax base |
|---|---|
| Betting tax | 7.5% of the gaming revenue |
| Lottery tax | 5% of lottery turn-over |
| Gaming tax | 12% of the gaming revenue |
| Prize competition tax | 15% of total gross turnover |

Further clarity may be required in the Finance Bill on which tax base the uniform tax rate will be applicable.

# Other levies

## Incentives to the Special Economic Zones (SEZs) enterprises

The CS has proposed to exempt from export duty goods exported to SEZs. In addition, imports by enterprises licensed under the SEZs Act will also be exempt from Import Declaration Fees (IDF) which are ordinarily levied at a rate of 2% of customs value of the import.

This is aimed at reducing the cost of doing business within these enterprises and to spur Foreign Direct Investment (FDI). It is hoped that the FDIs will consequentially position Kenya as a business hub and increase employment opportunities.

The proposed incentives are aligned to the incentives enjoyed by SEZs under the other tax legislation including the Value Added Tax and Excise Duty legislation.

## Support of the Blue economy

The CS has proposed a 50% reduction in port charges for maritime fishing vessels. This is aimed at promoting the fishing industry in order to create wealth and employment.

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# Economic Overview

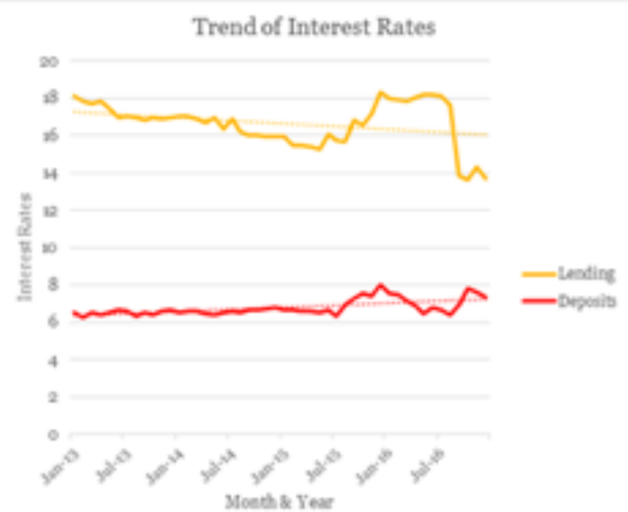
## State of the economy

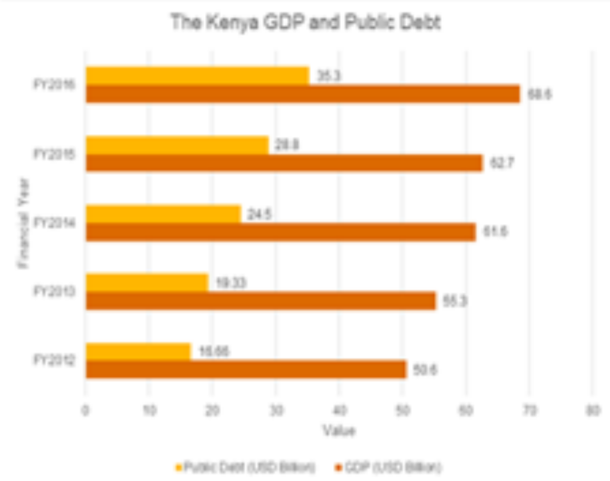
Kenya experienced robust economic growth in 2016. The economy grew by 6% driven by continued strong expansion in the construction and electricity sectors, favourable weather conditions and recovery in tourism.

However, economic growth is expected to remain constant at an average growth of 5.8% in 2017 and 2018 respectively, which is ahead of the global growth rate 3.4% for 2017.

The key economic indicators are projected below.





The average inflation for 2016 was 6.5%. However, year-on-year inflation as at February 2017 was 9%.

This was the highest over the past five years occassioned by the increase in food prices resulting from the failure of the short rains in quarter 4 and increasing oil prices.

Inflation for the remainder of the year will be determined by the weather conditions, trends in oil prices and exchange rates, but it is currently projected at 7%, which is within the Government's monetary policy to keep inflation below 7.5%.

Interest rates have declined to 14% in 2016/17 from 18% in 2015. This was occasioned by the introduction of the interest rate cap in September 2016.

In 2016, the average exchange rates remained stable ranging between Kshs 100.5-102.5 to the US$. The Kenya's economy however remains vulnerable to both global and domestic shocks particularly the uncertainities surrounding the new US administration, Britain's vote in favour of leaving the EU and the uncertainities associated with the run-up to Kenya's 2017 general elections.

As a result, the Kenya shilling is projected to weaken further in the remainder of the year to an average of KES 106.5 to the US$.

The Public debt has grown from 44.5% to the GBP in 2012 to 51.7% in 2016. This is attributable to increased investments in mega infrastructure projects such as SGR, energy and the roads network.

# Regional economic performance

Sub Sahara Africa registered a regional economic growth of 1.6% in 2016, against a projected growth of 2.8% in 2017. This improvement is expected from the  gradual pick-up in the world economy and a recovery in commodity prices.

# Investment in Key Sectors of the Economy

## *Agriculture*

Budgetary allocation for agriculture, rural and urban development increased from KES 20.8 billion to KES 38.4 billion. The government is still focused on climate change adaptation and the move from rain-fed agriculture.

The government has allocated KES 7.3 billion to on-going irrigation projects and seeks to establish the livestock and crop insurance scheme which has been allocated KES 0.7 billion. Additionally, the government has also allocated KES 5 billion for the input subsidies and KES 1.3 billion for strategic grain reserves.

The government also seeks to increase food security through the food security and crop diversification programme which was allocated KES 1 billion. However, despite these budget allocations to building resilience in the agricultural sector, the country has continued to face food insecurity in the northeast, northwest, and southeast pastoral areas, and coastal and southeast marginal agricultural areas as indicated by the World Food Programme.

The impact of the investments in irrigation projects is yet to be felt in securing food for the citizens and therefore the government needs to find measure to bring the benefits to the fore.

Other efforts towards improved performance in the agricultural sector include agricultural mechanization (KES 0.1 billion), revival of the pyrethrum sector (KES 0.1 billion) and the development of the blue economy (KES 0.3 billion). According to the Economist Intelligence Unit forecasts, it is expected that the performance of the agricultural sector as a percentage of GDP will continue to decline from 5% in 2016 to 4.2% in 2017 and see a slight improvement at 4.8% in 2018. This is largely as a result of the unseasonal dry weather which is expected to persist.

## *Financial Sector*

The financial services sector has been in the limelight in the last year. This has been as a result of increased supervision from the Central Bank which saw some banks being put on statutory management or liquidation. Some of the measures taken by the Central Bank in stabilizing the sector have been the adoption a broad surveillance strategy, increased supervisory staff component, working with international partners and on-site risk-based anti-money laundering and combating the financing of terrorism inspections for commercial and micro-finance banks.

The Banking Amendment Act 2016 which capped the interest rates is expected to inhibit private sector credit allocation. The government is however keen to assess the impact of this legislation on private sector credit allocation and its subsequent impact to economic growth. It is anticipated that the interest rates may be adjusted upwards due to the perceived negative impact on credit allocation in the coming years.

The government is however committed to reducing the cost of credit and has sought to enact the Movable Property and Security Rights Bill 2016 which allows for borrowing using movable property. Other measures taken by the government to improve the access to credit is the amendment of various legislation to facilitate for Sharia compliant finance products including the issuance of the Sukuk bond which it hopes will increase foreign direct investment.

In terms of financial inclusion, the Central Bank launched the first ever bond to be bought and sold via a mobile phone platform. This is aimed at instilling a saving and investment culture for Kenyans including the low income earners.

On the insurance sector front, the government looks to amend the Insurance Act to ensure that the risks arising out of the grouping strategy employed by the insurance companies are monitored. The sector also got a boost through the government's plan to take up insurance policies for the police and civil servants worth KES 6.8 billion and the roll out of the crop and livestock insurance scheme at KES 0.7 billion.

## *Infrastructure*

The Government will continue with the on-going public investments on roads, airports, seaports, energy and water supplies in order to propel Kenya's economy towards prosperity by generating new growth opportunities.

The key highlight in this sector is the Standard Gauge Railway (SGR) project which is expected to have a significant spillover effect on the economy through the significant reduction of the cost of transport in the region, reducing the cost of doing business hence enhancing regional competitiveness, accelerated industrialization and spurred growth and development of towns along the SGR route.

To reap these benefits, the Government should endeavor to invest in the manufacturing and other productive sectors along the SGR. These investments are expected to pay off in the long run.

The expansion of the road network connectivity across the country has also been a major focus of the Government spending and achieving ease of movement hence enhancing trade, commerce, agricultural productivity and regional trade.

The increase in the road network across the country will also create access to markets for under developed regions of the country especially in the north and northern eastern regions, as well as along the LAPSET corridor.

The Government has also made significant investment and commitment on electricity, energy and water supply. The increase in power production will to increased productivity and reduced costs of production thus encouraging economic growth.

## *Manufacturing*

Manufacturing is a priority sector contributing 10.3% share of the Gross Domestic Product (GDP) in 2015. The sub-sectors in manufacturing including special export zones and commodity exchanges are seen as contributing to the country's sustainable economic growth.

Manufacturing been a key driver in employment creation, increased foreign direct investment and growth of exports. For this reasons, the Government is keen to promote the development of industries and extractive sectors of the economy by re-engineering processes and reducing costs.

The Government manufacturing focused initiatives include promoting development of Special Economic Zones, establishment of small and medium industries (SMI), training SMEs on business management and value addition in counties, improving the ease of doing business, modernizing and enhancing regional specific industrial clusters and operationalization of the SEZ Act 2015.

The Government is specifically focusing on the following projects: modernization of RIVATEX, modernization of New KCC, development of basic infrastructure for leather industrial park in Kenanie and development of a common manufacturing facility for leather in Kariokor.

Kenya is also positioning itself as a hub for motor vehicle assembly by reducing the corporate tax for new assemblers from 30% to 15% for the first five years.

These investments are key towards ensuring that the country maintains a competitive edge to other countries on attracting new investors and maintaining the current ones.

| Indicators that determine the ease of doing business | Kenya's 2017 rank | Kenya's 2016 rank |
|---|---|---|
| Starting a business (gender component included) | 116 | 151 |
| Dealing with Construction permits | 152 | 149 |
| Getting electricity | 106 | 127 |
| Registering property (gender component included) | 121 | 115 |
| Getting credit | 32 | 28 |
| Protecting minority investors | 87 | 115 |
| Paying taxes including post-filing | 125 | 101 |
| Trading across boarders | 105 | 131 |
| Enforcing contracts (gender component included) | 87 | 102 |
| Resolving insolvency | 92 | 144 |

* World Bank ease of doing business indicator for 2017

# Budget Outlook

## *Business Community*

According to World Bank ease of doing business indicator for 2017, Kenya is ranked 92 out of 190. This records notable improvement having moved up 16 places from the previous year.

The improvement is mainly due to removing the stamp duty fees required for the nominal capital, memorandum and articles of association, elimination of requirements to sign the declaration of compliance before a commissioner of oaths, streamlining the process of getting electricity, increasing the transparency at land registry, strengthening minority investor protections by introducing greater requirements for disclosure of related party transactions to the board of directors and the adoption of a new Insolvency Act.

## *Government interventions*

The Government will be investing a further KES 250 million to address challenges in doing business. Some of the strategies adopted include:

- Removing double taxation activities by both the national and county government,
- Introducing a flat fee for company incorporation,
- Establishing a one stop centre for investors and establishing of e-opportunities available in Kenya,
- Investing in security modernization and
- Investing in energy and transport infrastructure to support special economic zones.

These strategies are aimed at making the cost of production of goods and services more competitive in Kenya and promoting foreign direct investments. Players in the manufacturing sector including manufacturers of pesticides, paints, local vehicle assembly, cigarette manufacturers and special economic zones are expected to benefit from tax incentives introduced by the Cabinet Secretary, which in turn will make the cost of production lower and more competitive.

The forex rates have been on the increase due to external global shocks and expected foreign protectionist policies. For example, in October 2013, the Shilling traded at KES 85.31 to the US$ whereas it now trades at KES 101.87 as at March 2017.

The projections based on the Economist Intelligence Unit (30 March 2017), the exchange rate is expected to reach KES 106.5 against the US$ and possibly KES 111 by 2018. This rise in exchange rate will increase the cost of imports and thereby increase inflation and reduce the available capital for firms. The government will need to do more to keep the interest rates low.

The pending review of the impact of interest rate capping will determine if it has contributed to the shrinking in the credit for the private sector and SMEs, which has slowed down to single digits within the financial year.

In addition, inflation rates could affect the purchasing power of consumers and the demand for goods and services. Factors such as the ongoing drought and the impending elections will also affect the business environment.

## Consumers

The rate of inflation has been on an upward trend, mainly due to failed rainfall. This has resulted in increased food prices hence lowering the purchasing power of consumers to procure goods and services.

The global fuel prices were on the decline in the recent years, however, fuel prices are projected to be on the rise which is expected to increase the cost of food prices, thereby contributing to inflation. The government has not provided measures to safeguard citizens against these adverse effects such as by lowering fuel levy and taxes which were introduced when global fuel prices were low.

The capping of interest has led to the reduction of available credits for households which are principally unsecured loans as banks seek less risky investments in government securities. This will affect the ability of households to make investments.

The price of ordinary bread and maize flour is set to decline as both commodities have been zero rated. In addition, the government has waived import duty on white maize imports for the next for months. This measures are aimed at cushioning the consumers from food shortages and high food prices.

The government has expanded the tax brackets for low income earners and increased the tax relief by 10% respectively. This measures are expected to increase the disposal income for low income earners.

The government continued to allocate funding for free primary and secondary education, as well as free maternal health care. In addition to the existing safety net programmes, a cash transfer allocation has been set aside for persons above 70 years of age, as well as a subsidy medical insurance scheme. This will increase the disposable income at household levels and help cushion vulnerable consumers from the adverse effects of the economy.

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# Devolution

## Counties – On the right track

Five years after the inception of devolution, counties have overcome many hurdles of establishing a new level of government. However, expectations for counties to ensure efficient and effective expenditure, enhance revenue collection, and provide good service delivery are expected to increase. Will counties maintain the balancing act?

### *Fiscal Devolution - Slow but Steady*

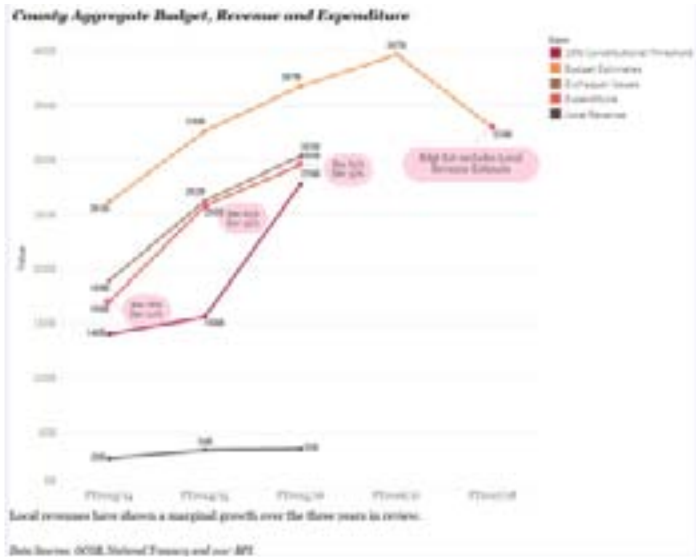
Counties' aggregate budget estimate has increased since 2013. The 2016/17 aggregate budget estimate amounting to KES 396.62 billion, of which 53.3% was allocated to recurrent expenditure and 44.7% to development, conformed to the public finance requirement of at least 30% of budget allocation to development.

Increased revenue allocation to County Governments has resulted in increased investment in development across all 47 counties, noted by a marked shift towards infrastructure projects by counties.

This is evidenced by the shift in the overall ratio of counties recurrent to development expenditure: an average of 69.3% in recurrent expenditure to 30.6% in development expenditure over 3 years, although the development expenditure ratio improved to 35% in 2015/16 up from 22% in 2013/14. Exchequer releases increased at almost at the same pace as budget estimates and have been above the minimum constitutional threshold of 15%. However, the gap between budget estimates and exchequer issues remains wide due to delays in disbursements from the National Treasury, therefore slowing down the absorption of budget allocated.

Expenditure continues to grow year on year at almost the same pace with exchequer releases. Aggregate County Government absorption rate for development expenditure in FY 2015/16 was 33.9% of the annual development budget, a decrease from 37.8% recorded in FY 2014/15.

In FY 17/18 the National Government has allocated KES 329.3 billion (exclusive of local revenue estimate) to County Governments.

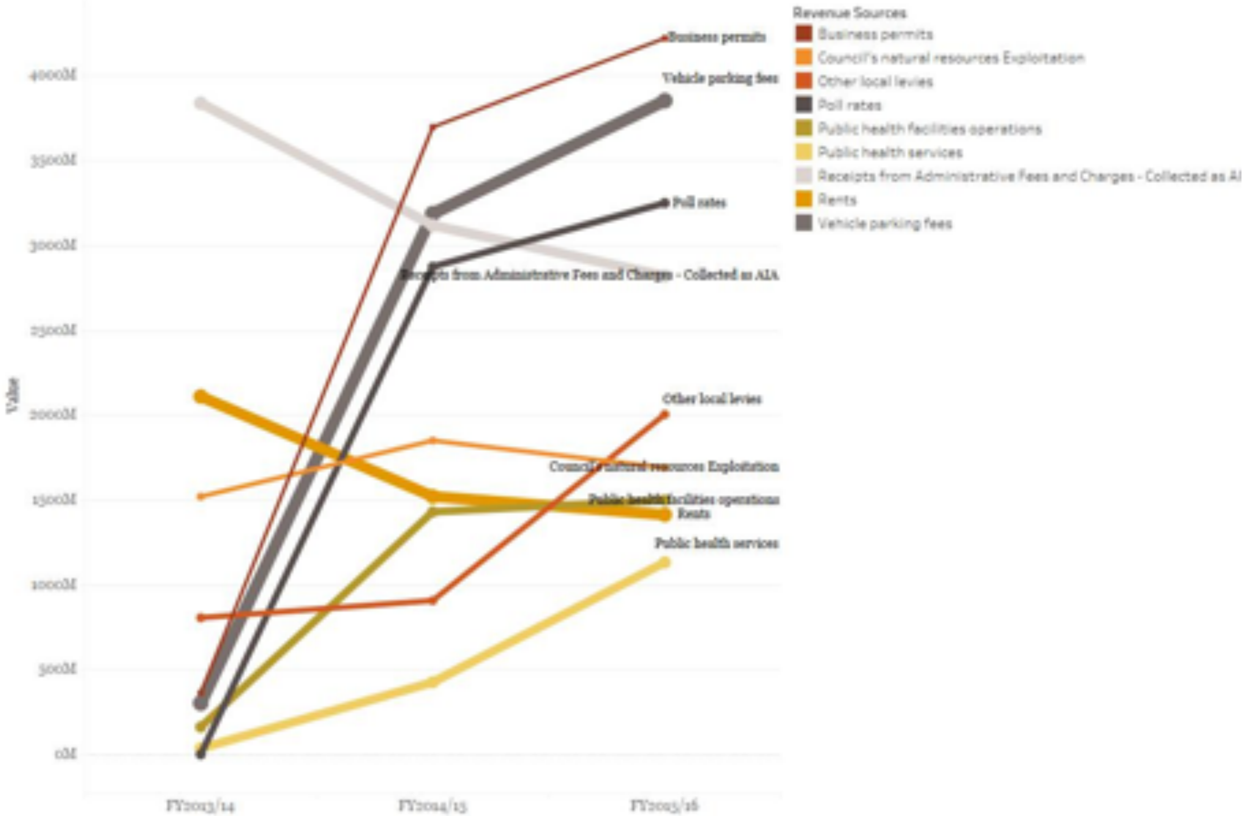



It is expected that County Governments will allocate the bulk of this amount to sectors that have a high impact on the livelihood of the citizens.

### *Revenue Split - Counties*

Counties continue to grapple with raising revenue; county local revenue since 2013/14 has shown little growth with a marked slowdown between FY 2014/15 and FY 2015/16. Despite the increase in revenue collection, revenue collection is still below targets set by respective counties with counties having achieved 65 % of their set target in FY 15/16.

***Aggregate Local Revenue for the Top Revenue Sources for Counties***




FY2013/14, FY2014/15 and FY2015/16. Color shows details about Revenue Sources. Size shows details about Revenue Sources. The marks are labeled by Revenue Sources. The view is filtered on Revenue Sources, which excludes Cesses, Market/trade centre fee, Receipts from Administrative Fees and Charges and Technical services fees.

*Data Sources: OCOB, National Treasury and 2017 BPS*

County governments should look into ways of improving this; recommendations include spatial planning which would map income to revenue generating assets, close revenue leakage points, improve the administrative and ICT structure for the collection of revenues, leverage on economic blocs for revenue generation, enhance public participation to enable the public to contribute their ideas on revenue sources and improve efficient service delivery to motivate public in paying of fees and rates.

Additionally counties should create a regulatory framework to guide private sector investment and ease the cost of doing business.

## *Sectoral Allocation – The big dilemma*

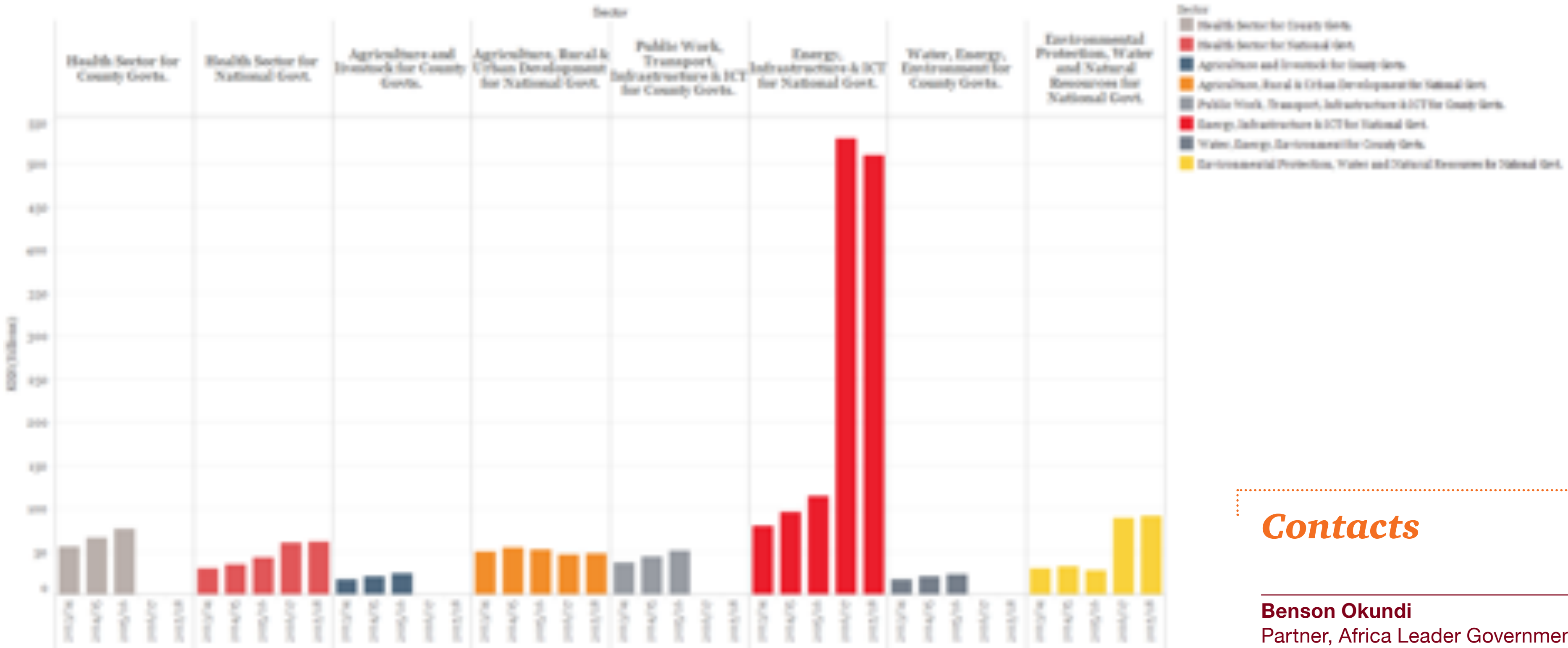
The hallmark of the next phase in Kenya's devolution will be the cooperation and interaction between National and County Governments to meet the country's development needs as envisioned in Vision 2030. Budgetary allocations at the county level to sectors over the FY 13/14, FY14/15 and FY15/16 have been to the health sector, public works, transport, infrastructure & ICT sectors and Agriculture & Livestock sector.

This sector allocation closely mirrors national sectoral budget allocation and indicates increased cooperation between the two arms of government.

However, counties allocated more to the health sector over the three years; this marked a shift from the national government's sharp spike in investment in the energy infrastructure sector. Counties should leverage on synergies with the national government to ensure sectoral expenditure creates investment spill-overs and efficiencies in development expenditure thus avoiding duplication of effort.

Administrative expenses driven by a rising wage bill continue to put pressure on recurrent expenditure, with low expenditure execution and in particular, underspending on development budgets. Nevertheless, this is improving, as counties ease into their roles and responsibilities as outlined in the constitution.

***Comparison of national and county sectoral allocations for four key sectors (in Billions)***



The Counties allocated more to Health Sector over the three years in review while the focus of the National Government was majorly in Energy, Infrastructure and ICT projects

The projected spend for Energy, Infrastructure and ICT in National Government for FY2016/17 and FY2017/18 is major, perhaps due to major projects prioritised in the MTEF period FY2017/18 - FY2019/2020

Data for projected spend on County Government sectors for FY2016/17 and FY2017/18 is not yet available

*Data Sources: OCOB, National Treasury and 2017 BPS*

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# *Sectoral reforms*

## Financial Services update

### *Stability of the banking sector*

In light of the events in the banking sector over the last two years where certain banks were placed under statutory management or in liquidation, the Cabinet Secretary provided some much needed assurance on the stability of the banking sector drawing from both the capital adequacy levels and the relative profitability of the banks.

It is reassuring to see the measures adopted by the Central Bank of Kenya (CBK) to stabilize the sector which are mainly anchored around three pillars: i) increased transparency on shareholding; ii) strengthening corporate governance and iii) ensuring the adoption of resilient business models by the banks.

The CBK itself has enhanced its own supervisory capability, in conjunction with its international partners and has rolled out key initiatives such as Anti Money Laundering legislation, in an attempt to have greater oversight of the sector.

**The Cabinet Secretary provided some much needed assurance on the stability of the banking sector drawing from both the capital adequacy levels and the relative profitability of the banks.**


### *Financial inclusion*

The Cabinet Secretary indicated that 75.3% of Kenyans now have access to financial services, up from 26.7% in 2006 (drawn from the FinAccess 2016 household survey commissionned by FSD Africa).

Broadly speaking, the high level of access to financial services in Kenya is mainly driven by innovative products that leverage on mobile phone technology.

One key example of this attempt to encourage financial inclusion is the recently issued M-Akiba bond which is the first ever government issued retail bond in the world to be traded using a mobile money platform. Kenyans now have an opportunity to earn interest on deposits from amounts as low as KES 3,000 in a tax efficient and convenient manner. This is expected to go a long way in nurturing a savings and investment culture among the general population.

A special limited offer of the M-Akiba bond was issued in March 2017 and the President is expected to launch the main M-Akiba bond with an offer of KES 4.85 billion in June 2017.

It remains to be seen what impact the M-Akiba bond will have on the level of customer deposits held by the formal banking sector given the competitive tax benefits, relatively high interest rates and convenience the bond offers investors.

## *Legislative framework*

The Cabinet Secretary promised in the 2015/2016 budget the Movable Property Security Rights Bill 2016 which was recently approved by the National Assembly. This Bill is aimed at expanding access to credit in the economy as it provides for borrowing using movable assets as securities.

Another bill promised was the Nairobi International Financial Center Bill which although approved by the Cabinet in December 2016 is yet to be approved by the National Assembly.

This Bill when approved will position Nairobi as an international financial hub. The third of last year's promised measures, the Financial Services Authority (FSA) Bill is currently undergoing legal drafting. When passed this will merge all non bank financial sector regulators and enhance efficiency of licencing currently being done by multiple regulators.

## *Assessing the impact of the interest rate cap*

Although the implementation of the Banking (Amendment) Act 2016 on capping interest rates has reduced bank lending rates (and also impacted on savings rates), the credit expansion to the private sector has slowed down from double digit levels a year ago to single digit levels.

The Cabinet Secretary together with the Kenya Bankers Association and the CBK will undertake a comprehensive assessment of the impact of the interest rate capping law with a view to informing any intervention measures that need to be undertaken.

## *Islamic Finance*

In December 2016, the Capital Markets Authority (CMA) of Kenya was admitted by the Council of the Islamic Financial Services Board (IFSB) as an associate member, at the 29th IFSB Council meeting held in Cairo, Egypt.  The IFSB is a global standards setting body aimed at promoting the development of a prudent and transparent Islamic financial services authority.

In a parallel development, President Kenyatta signed into effect the Insurance (Amendment) Act 2016; this new law provides for the licensing and regulation of Takaful insurance business in Kenya in order to encourage international investment in Kenya in this sector, which is a target area for the forthcoming Nairobi International Financial Centre.

This follows quickly on from the establishment in October 2016 of the Islamic Finance Project Management Office, overseen by the Kenyan National Treasury.

## *Changes in the regulatory environment*

In order to position Kenya as a regional hub for Islamic finance products and to tap into the global Islamic finance market (estimated at US$ 2 trillion in 2016), the CS announced a number of regulatory and legislative changes:

- Amendments will be proposed to the Capital Markets Act, the Cooperatives Societies Act and Sacco Societies Act to facilitate sharia compliant finance products;
- The Public Finance Management Act will be amended to provide for the issuance of a sukuk bond as an alternative way of financing development projects in the country;
- Tax statutes will be amended in order to ensure equivalent tax treatment of Islamic financial products with conventional financial products already addressed by tax legislation;
- Regulations will be introduced to facilitate the development of Takaful Retirement Benefits Schemes in Kenya.

## Insurance sector

The insurance industry is experiencing a wave of restructuring as groups seek to enhance their capital base and maximise efficiency with scarce talent & resources. Moreover, some groups have diversified their portfolio of activities and geographically.

Accordingly, the CS perceives there to be an insufficient legal and regulatory framework to ensure for sufficient oversight in the sector. We can therefore expect to see changes to the Insurance Act which would enhance supervision, in line with the trend in the banking sector to ensure stability.

One immediate change announced is the withdrawal of the requirement for annual licencing of insurers, affording them the same perpetual licencing granted to institutions regulated under the Banking Act and the Retirement Benefits Authority. This change will not, however, be extended to brokers or loss assessors who will continue under the annual licencing scheme.

## Conclusion

The financial services sector remains a significant contributor to the Kenyan economy in terms of taxes, jobs and economic cohesion. As the sector expands, diversifies and more complex products reach the market, it is critical that the regulatory framework keeps pace with these developments to ensure that the economy and the consumer is protected from financial "shocks".

Many of the measures announced in this year's Budget Statement play to this agenda of ensuring appropriate levels of regulatory oversight, without hindering financial services providers from being able to offer affordable services to retail and corporate consumers. Moreover, financial inclusion in the country is now at record levels, leveraging off remarkable progress which has been made in technology across both financial services and mobile telecommunications.

Ensuring that the sector remains profitable yet stable, though not at the expense of the consumer, remains part of the balancing act that the government must deliver, as Kenya expands its footprint as a regional hub of financial services.

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# Oil and Gas

***With the recent steady rise in oil prices, oil and gas exploration activities in Kenya have risen as confidence in the sector slowly returns.***

Looking back at the last financial year the Government surpassed what it had intended to achieve in the sector; 17 new petroleum blocks were gazetted against a target of seven oil blocks, and 17 exploration and appraisal wells were drilled against a target of five wells. Furthermore, 4,575MT of Liquefied Petroleum Gas ('LPG') and oil were distributed against a target of 4,358MT.

This year's budgetary allocation for oil and gas is largely geared towards ensuring availability of and access to reliable petroleum products in the country, as well as sustaining and expanding physical infrastructure to support a rapidly growing economy. To this extent KES 2 billion has been set aside for LPG Exploration and Distribution and KES 3.84 billion for Exploration and Distribution of Oil and Gas, largely in line with what was budgeted in the prior year.

Some of the key initiatives that will be undertaken in the new financial year include the delivery of 480,000 barrels of crude oil to the Mombasa refinery terminal for export under the Early Oil Pilot Scheme ('EOPS'). EOPS is expected to provide experiential learning to assist in full field development planning, and to test the market before a $2.1 billion pipeline of about 855 kilometres is built.

However, this project is not free of criticism. EOPS will see Turkana Crude transported via road using heated 20ft isotainers. It is estimated that the round trip will take approximately three days with 30 trucks being loaded per day. This lengthy and complicated procedure, which is estimated to go on for three years, will draw heavy expenditure at probably no profit.

In 2017 and 2018, the Government also endeavours to facilitate the distribution of 5,140 MT of petroleum products, construct two LPG storage facilities, and purchase and distribute 1.2 million LPG cylinders to low income households. This investment in LPG will go a long way in converting the citizenry into cleaner fuels, as well as help bring down the product costs relating to logistics.

Away from the budget but still in line with the Government's oil and gas agenda, we predict the state agencies to have a very active year. Kenya Pipeline Company ('KPC') is expected to complete the new 20 inch pipeline from Mombasa to Nairobi within the second quarter of 2017, with immediate benefits being improved product availability in Nairobi and reliable supply into East and Central Africa.

In line with this, KPC is also expected to break ground on the Kisumu Oil Jetty which will allow for oil and associated products to be efficiently exported from Kenya to the surrounding countries and give Kenya a competitive advantage as the leading oil transporter in the region. The jetty is expected to increase product flow to 350,000 tonnes per hour from the previous 110,000 tonnes per hour.

One of the major stumbling blocks inhibiting the availability of and access to reliable petroleum products is the bottleneck at the port of Mombasa caused by limited storage capacity which subsequently leads to heavy demurrage charges which are being passed onto the consumer.

The current leasing arrangement and possible, eventual acquisition of Kenya Petroleum Refineries Limited by KPC is key to mitigating this challenge.

The refinery's idle storage capacity, though in need of upgrade, presents a logical solution to increase capacity in the KPC system. KPRL's significant acreage available for future expansion is another benefit potentially contributing to Mombasa becoming a regional trading hub for petroleum products.

The facility will also allow KPC to make its maiden venture into LPG storage and catalyse the introduction of an LPG open tender system which may also help bring down the cost of LPG to consumers.

The next financial year will undoubtedly see Kenya move to a new frontier in oil and gas and indeed lead to truly exciting times.

# Renewable energy

***Kenya is one of the leading countries in renewable energy generation and is ranked first in Africa in geothermal power generation.***

Capital investment in renewable energy is one of the government's key priorities in a bid to sustain a rapidly growing economy.

The Government has significantly increased its allocation towards energy projects to KES 47.43 billion from KES 34.5 billion in 2016/17 reflecting its continued commitment to improving energy infrastructure countrywide for faster growth.

Since March 2013, more than 615 MW of electricity have been added to the national grid of which 371 MW are from geothermal. With this additional power, total power available on the national grid is 2,282MW. It is worth noting that the allocation to geothermal energy has been increased to KES 16.4bn in 2017/18 from 2bn in 2016/17 showing the Government's commitment to move towards green energy.

Also, an allocation of KES 1.53bn has been introduced for installation of solar lanterns. In our view, these renewable energy projects will provide reliable, cost-competitive energy with reduced vulnerability to climate by diversifying power supply away from hydropower, which currently provides the majority of Kenya's electricity.

There are twenty-one new generation projects that are at an advanced stage of planning – three being large projects using coal and geothermal technologies, and eighteen renewable energy projects that will use wind, solar and other renewable energy technologies. The Lake Turkana Wind Power Project (LTWPP) is the single largest private investment in Kenya's history and aims to provide 300MW of reliable, low cost wind power to Kenya's national grid, equivalent to approximately 13% of the country's current installed electricity capacity. The project is largely complete and is awaiting connection to the national grid.

Overall, the government has made significant positive progress and kept to its commitment to renewable energy. However, considering that the Government is obliged to purchase all energy produced, there is merit in better planning policies to avoid the burden of excess energy charges being borne by the consumer.

## *Transmission, distribution and connections*

In recent years, the Government has made tremendous strides in the coverage of the national electricity grid and in building out the low-voltage distribution network. Between 2013 and June 2016 over 81 substations have been constructed and upgraded and more than 14,000 primary schools have been connected to the power grid. Further, 810 public institutions have been connected to alternative (solar) power.

The latest statistics from Kenya Power and Lighting Company ('KPLC') show that the customer base has expanded from 2.2 million households in March 2013 to 4.9 million households in June 2016 representing a connectivity rate of 52%. The connectivity fee for Kenyans living within 600 metres away from a transformer has been reduced from KES 35,000 to KES 15,000 payable in instalments, making it affordable to the population. The increased demand has resulted in increased revenue for KPLC.

This year, the Government continues to focus on distribution and connections. To this extent, the Government has set

aside KES 9.7 billion for the last mile connectivity project, KES 7.3 billion for the Electrification of public facilities, KES 3 billion for the installation of transformers in constituencies, KES 3.1 billion for national street lighting and KES1.3 billion for connectivity subsidy.

More investments in electricity connectivity are expected to continue as the Government increases the absorption of the electricity generated. The additional power supplies and distribution have significantly widened access to power, reduced costs of doing business and spurred growth of enterprises.

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# Manufacturing sector

***The 2017/2018 national budget has by and large remained consistent with the previous year's budget on key focus areas – job creation, ease of doing business and attraction of foreign investment.***

According to Vision 2030, growth of 10% of GDP per annum was to be realised through the manufacturing sector as a key contributor to the economy.

However, the government recognises that there has been a stagnation of the sector between 10-11% of GDP for the past few years, and is putting in place measures for manufacturing to grow.

## *Ease of doing business in Kenya*

The 2017/2018 budget indicates that there will be promotion of local industries including leather, textiles and apparels, pharmaceuticals and the extractive industry. Towards this goal, the government:

- Has allocated KES 1.6 billion for the leather industrial park and textile development, KES 450 million for modernisation of Rivatex and KES 250 million for the modernisation of New KCC; and
- Will leverage on the Special Economic Zones (SEZs) in key urban areas including Mombasa, Lamu and Kisumu as part of the Vision 2030 goal to diversify manufacturing activities, create employment, and boost Kenya's investment profile.

## *Automotive sector*

To encourage investment in the sector, the government, in consultation with stakeholders, will complete the development of a Comprehensive Automotive Industry Development Policy and finalise an actionable 10 year Automotive Industry Development Plan. In addition to these interventions, several tax incentives have been granted as summarised in the tax section.

## *Ban on plastic bags*

This is the third attempt to introduce the ban on the use, manufacture and importation of all plastic bags used for commercial and household packaging. While the benefits arising from the ban are significant, the loss of jobs and investments for companies in this sector cannot be overlooked. It remains to be seen what the actual effect to the economy will be.

## *Gaps…*

The iron and steel industries are a key component of the manufacturing sector as outlined in Vision 2030. It is worth noting that the 2017/2018 budget remains silent on development of these industries.

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# Prioritizing agriculture?

***Agriculture contributes approximately 23% of the national GDP. However, recent reports indicate a slowdown from previous years occasioned by a let-down of rains, with Q3 2016 growth slowing to 3.9% for the sector.***

The 2017/18 budget appears to have considered some of the strategic priorities of bolstering the strategic grain reserve, and boosting agricultural mechanization.

Although KES 1.3 billion was allocated for the strategic grain reserve, and KES 0.1 billion for mechanisation (both of which appear inadequate), there was also no mention of allocation for drought resistant crops.

This was surprising given the anticipated adverse weather conditions which have resulted in exempting or zero-rating of maize imports for the next four months, possibly widening the budget deficit.

## *Boosting agricultural output*

The CS has allocated KES 6.3 billion to support irrigation projects. However, faster progress and more effective implementation of the projects is required to combat the effects of recent food shortages.

Measures to reduce the cost of doing business in the agribusiness sector include legislative proposals to be introduced to address double taxation by county governments and exempting inputs used in the manufacture of pesticides from VAT.

## *More action needed to transform the sector*

Despite recognising the importance of agro-processing in the drive towards industrialisation, there was no specific linkage to value addition to agricultural produce such as tea, coffee and horticulture.

Some developmental activities the budget could have focussed on include combatting plant and livestock diseases, better farmer extension services through the use of technology, increasing access to funding for farmers and improving farmer access to market information.

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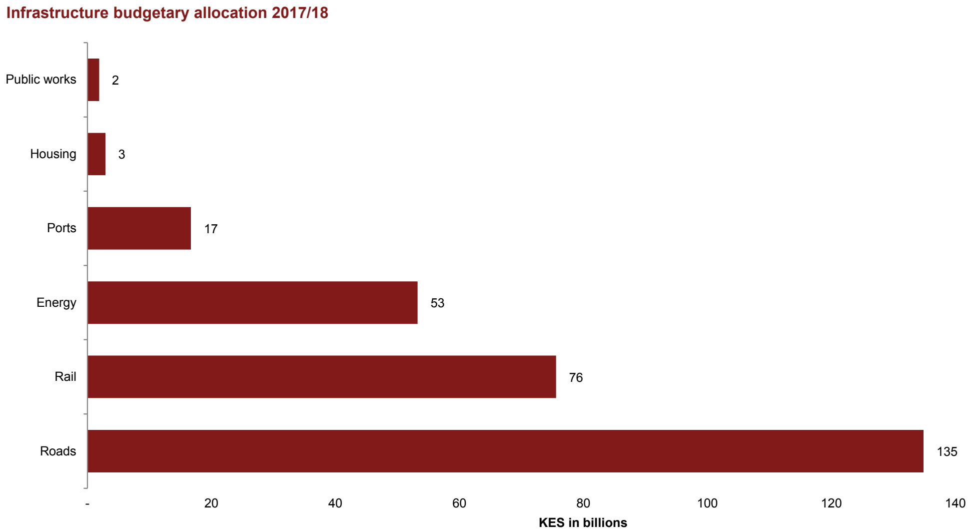
# Infrastructure, capital projects and PPPs

***The government is focusing on completing the ongoing infrastructure development projects to enhance mobility and connectivity necessary to accelerate the transformation of Kenya into a globally competitive economy.***

The infrastructure budgetary allocation (Ksh 285 billion) represents approximately 12% of the government's total expenditure. It focuses on large scale infrastructure projects in transport, energy, ports and housing.

The 2017/18 fiscal budget has also focused on attracting investment to Special Economic Zones (SEZs) by providing tax incentives.




## Standard Gauge Railway (SGR)

In the 2017/18 budget, an additional Ksh 15.5 billion has been allocated to facilitate completion of Phase 1 of the 472km modern standard gauge railway line from Mombasa to Nairobi.

Ksh 59.7 billion has been allocated for the construction of Phase 2A (Nairobi to Naivasha – 120km). No budgetary allocation were provided for phase 2B (Naivasha to Kisumu) and Phase 2C (Kisumu to Malaba).

An additional Ksh 400 million has allocated for land acquisition to address encroachment issues and for the construction of alternative settlements.

**It is envisioned that the SGR will be an engine for economic growth through job creation, increased trade, lower transport costs and local beneficiation.**

## Ports

### *Aviation infrastructure*

Kenya's aviation industry is a central driver in the growth of the local economy, international trade and tourism. The Government recognizes the need to facilitate transportation of passengers, cargo and mail at minimal costs, by accommodating the needs of domestic and international airlines, through efficient and reliable airports.

To this extent, the government has set aside Ksh 2.6 billion for the upgrading of Malindi, Isiolo and Lokichogio Airports and Suneka Airstrip. The expansion of the Malindi and

Isiolo Airports is envisaged to progress to 30% completion during 2017/18 while the extension of the Lokichogio Airport runway is planned for 50% completion.

The Kenya Airport Authority has scheduled to complete construction of the terminal at the Suneka Airstrip in 2017/18. The government also plans to expand the Eldoret International Airport in a bid to position the airport as a transport hub.

## *Mombasa Port Development Project (MPDP)*

The MPDP includes construction of a container terminal and provision of cargo-handling equipment at the Port of Mombasa.

Phase 1 of the Project was completed in early 2016, increasing the capacity at the port from 900,000 TEUs in 2012 to 1.3 million TEUs in 2016. Once completed, the MPDP will increase the total capacity of the Mombasa Port from the current 1.3 million TEUs to 2.5 million TEUs. For 2017/18, the government has allocated Ksh 3.6 billion for the multi phased project.

In addition to the development of container terminals, the project is expected to include the construction of access roads, weighbridges and capacity building for customs clearance processes. This will enhance the government agenda of transforming the port city of Mombasa into a maritime hub in the region.

## *The Lamu Port-South Sudan-Ethiopia-Transport (LAPSSET) Corridor*

The LAPPSET Project is aimed at linking Kenya, Ethiopia, South Sudan and ultimately providing a land bridge across the Great Lakes region, stretching from Eastern Coast of Africa (Lamu) to the Western Coast (Douala) Cameroon. The proposed Corridor entails a 500-meter-wide infrastructure corridor with the highways, rail, pipelines, etc. and an economic corridor of 50km on either side of the infrastructure corridor for industrial investments The Project is expected to inject 2% to 3% of GDP into the economy.

The Project incorporates several project components including the Lamu Port, Inter-regional Standard Gauge Railway, Inter-regional Highways, Crude and Product oil pipelines, 3 International airports, 3 resort cities, a merchant oil refinery, a high grand falls multipurpose dam and fibre optic cables and communication systems. The core infrastructure projects alone are estimated to cost USD 26 billion – this represents a third of Kenya's GDP.

## *LAPPSET priority projects*

The Government has prioritized the following anchor projects:

a) Lamu Port – For 2017/18, the government allocated Ksh 10 billion to facilitate delivery of these three berths by 2020. The structuring of the remaining 29 berths whose construction and operations will be concessioned to the private sector is underway.

b) Lamu – Witu – Garsen Road will facilitate the initial movement of cargo from Lamu port by connecting to existing road infrastructure. The government has proposed to construct 15 of 112km of this road in 2017/18.

c) Lamu- Lokichar crude oil pipeline will be the principal transportation route of oil from the oil fields in the Lokichar Basin in Kenya to the refinery and the market. The 30 inch trunk pipeline with a length of 868km and peak elevation of 1,360m, estimated to cost USD 3

billion, is currently at detailed engineering design stage. The first oil flow following completion of the pipeline is expected in 2021/22.

## Roads

The 2017/18 budget highlights the government's continued focus on investing in roads in line with its strategy to expand, modernize and maintain road transport and achieve an effective, efficient and secure road network.

There has been increased focus on rehabilitation and decongestion of roads, with key highlights being the ongoing construction of Outering road in Nairobi and the dualling of Ngong Road, expected to ease traffic within the city.

A total of Ksh 134.9 billion has been allocated to roads development. For the 7,000km under different phases of construction, an allocation of Ksh 63.6 billion has been made for the upcoming fiscal year, while Ksh 44.3 billion being allocated for donor funded roads.

A further Ksh 27 billion has been allocated for the construction of 1,138km of Low Volume Seal Roads (LVSR) to enhance rural connectivity.

Road maintenance is to be funded through an allocation of Ksh 49.3 billion from the Road Maintenance Levy.

## Housing

The budget highlights government's commitment to provide affordable housing to the public. Ksh 1.4 billion has been allocated for the development of housing units for the police and prison staff. This allocation is expected to be supported by funding from the African Development Bank (AfDB) in collaboration with other partners.

A further Ksh 1.5 billion has been allocated to the Civil Servant Housing Scheme Fund for improvement of civil servants' accommodation.

In line with its goal of attracting developers and the need to address growing demand for low cost housing in the country, the government has retained the corporate tax incentive introduced in last year's budget for developers who construct at least 400 units per year.

# Public private partnerships

## Alternative funding option

Given increasing fiscal constraints and budget deficits, the Kenyan government has recognised the importance of alternative financing mechanisms for the development of infrastructure projects.

The government has committed to embracing Public Private Partnerships (PPP) to deliver the existing funding gap in relation energy generation, roads development and expansion, construction of hostels for various training institutions as well as construction of affordable housing in urban centres and solid waste management.

## PPPs underway

Some of the projects currently underway through the PPP structure include the Kenyatta University hostels and geothermal power, planned development of seaports in Kisumu, expansion of Mombasa – Nairobi – Nakuru – Mau Summit highway and construction of the second Nyali Bridge in Mombasa.

Notable is the planned commencement of construction for the first batch of roads using annuity financing model. This model is supported by an Annuity Fund which is funded from the Fuel Levy.

**The government has committed to embracing Public Private Partnerships (PPP) to deliver the existing funding gap and this year's fiscal budget further aims to provide incentives to potential developers of SEZs.**

## Special Economic Zones

In line with Kenya's Vision 2030, the government has earmarked the development of Special Economic Zones (SEZs) in Mombasa, Kisumu and Lamu. Great strides have been made including the enactment of the SEZ Act, 2015, and the establishment of a Special Economic Zones Authority (SEZA).

This year's fiscal budget further aims to provide incentives to potential developers of SEZs, which include proposed amendments to the Income Tax Act on exemptions of dividend payable to non-residents, reduction of Withholding Tax on interest payable to non-residents, and the deduction of 100% of investment cost of building and machinery.

In addition, the government has proposed an amendment to the Miscellaneous fee and Levies Act to exempt duty and Import Declaration Fees for exported and imported goods by an enterprise licensed under the SEZ Act.

This is expected to reduce the cost of doing business and spur foreign direct investment, therefore expanding the local economy and promoting job creation.

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# Information, Communication and Technology Sector

***Kenya's domestic economy grew by 5.6% in 2015, an improvement from 5.3% in 2014. This growth momentum continued in 2016 with a growth estimate of 6.0%. The economy grew by 5.9% in the first quarter of 2016, 6.2% in the second quarter, and 5.7% in the third quarter.***

The growth in the third quarter of 2016 was supported by improved performance in the following sectors of the economy: accommodation and restaurant (13.8%), transport and storage (10.3%), information and communication (8.5%) and wholesale and retail trade (6.8%). This emphasizes the critical role ICT plays in Kenya's GDP.

The role of ICT to Kenya's economy is clearly stipulated in the Vision 2030 and the ICT Masterplan that aspire to position Kenya as a regional ICT leader while delivering the latest and most robust infrastructure. The budget speech clearly articulates a commitment to these priorities and builds upon the efforts of prior years.

## Key Highlights

In this Financial Year 2017/18 National Budget, resources have been allocated to key government flagship projects and devolved units of government to drive the transformative agenda. A total of KES 15.35 billion has been allocated for Information, Communication and Technology projects in this budget.

We present key highlights of Information, Communication and Technology allocation in the Financial Year 2017/18 National Budget mapped to the strategic objectives of the National ICT Masterplan below:

- KES 13.4 billion for Digital Literacy Programme
- KES 150 million for Roll out of IFMIS
- KES 0.9 billion for Digitization of Land Registries
- KES 0.6 billion for Development at Konza Technopolis
- KES 0.3 billion for Single Window Support Project

## FY2017/18 Budget Allocation – Tied to National ICT Masterplan Strategic Goals

### 1. A Society Built on Knowledge

This key strategic goal aims to make Kenya a knowledge-based society that uses ICT to improve Kenyans' knowledge, businesses and livelihood. It envisages ICT as the greatest enabler of Kenya's economic growth and has received the biggest share of the ICT budget allocation. Ksh 13.4 billion has been allocated for the Digital Literacy Program (DLP)

that will enhance access and transform the Educational System through e-Teaching and e-Learning. This was a flagship project of the current government and this amount will be used to deploy laptops to schools, develop digital content, build capacity of teachers and roll out computer laboratories for primary schools throughout the country.

The program has faced several challenges including internet and electricity connectivity in rural areas but the government continues to address them through initiatives like last mile connectivity and National Optic Fiber Backbone Infrastructure (NOFBI).

**The role of ICT to Kenya's economy is clearly stipulated in the Vision 2030 and the ICT Masterplan that aspire to position Kenya as a regional ICT leader while delivering the latest and most robust infrastructure.**

### 2. Public Services for All

This strategy envisages that public services will be available to all citizens through ICT and ICT will enable a truly integrated, open and efficient Government that delivers meaningful value to citizens. Towards this end, KES 150 million has been allocated for roll out of IFMIS. This is an automated system that enhances efficiency in planning, budgeting, procurement, expenditure management and reporting in the National and County Governments in Kenya.

The system promotes financial management reforms by ensuring that each expense is traceable and delivers optimal value to every taxpayer.

KES 0.9 billion has been allocated for digitization of land registries. So far 13 land registries in the country have been digitised and services like application and search for title deeds are transacted through electronic platforms. This will not only eliminate fraud but will also increase efficiency and transparency in land transactions.

### *3. Kenya as Africa's ICT Hub*

Kenya seeks to become the leading ICT Hub in Africa, attracting leading global players and generating globally respected entrepreneurship and innovation. This strategic goal will be key for job creation through initiatives like Business Process Outsourcing (BPO) and IT Enabled Services (ITES).

The National Treasury has allocated KES 0.6 billion for Development at Konza Technopolis which is expected to grow into a community of over 200,000 supporting the development of the BPO/ITES, life sciences, telecom, and education industries. Konza will be a sustainable, world-class technology hub and a major economic driver for the nation, with a vibrant mix of businesses, workers, residents and urban amenities.

**Kenya seeks to become the leading ICT Hub in Africa, attracting leading global players and generating globally respected entrepreneurship and innovation.**

It is envisioned to attract 17,000 jobs, and US$ 400 million in annual wages in Phase 1, helping Kenya attain middle-income status by 2030.

### *4. Strengthen ICT as a Driver for Industry*

This shall include creation of policies and infrastructure necessary to foster creativity and innovation at all levels.

The Digital Economy is a key input in propelling economic growth and has been proven to create employment and improve income levels. It will ensure the uptake of ICT infrastructure and promote economic growth.

To further avail government services to citizens through ICT, KES 0.3 billion has been allocated for the Single Window Support Project.

A single window platform allows one to lodge all customs documents and submit online payments, eliminating the bureaucracy associated with clearing goods at sea ports and border points.

This will reduce cargo dwell time at the ports and border points, maintain requisite controls and enhance collection of applicable levies, taxes and duties.

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