

## AFRICA RISK CONSULTING

### Kenya Monthly Briefing April 2017

#### Kenya Summary 4 April 2017

*Treasury cabinet secretary Henry Rotich introduces the 2017/2018 budget to parliament. The budget targets 5.9% growth and is predicated on a deficit of 6.3% of gross domestic product (GDP). President Uhuru Kenyatta (2013-present) delivers the final state of the nation address (SONA) before the 8 August general election. Kenyatta cites implementation of the 2010 constitution as his central achievement during his first term in office. Kenyatta signs into law the Proceeds of Crime and Anti-Money Laundering (Amendment) Act 2017, amid increased concerns about the risk of terrorist groups and drugs traffickers using Kenya to finance their operations.*

#### Government introduces budget to parliament

Treasury cabinet secretary **Henry Rotich** introduced the budget to parliament on 30 March.<sup>1</sup> The government brought forward the budget from the standard **East African Community** June deadline, to avoid clashing with the 8 August general election. There is concern that the government's commitment to public financial management may slip before the election. The budget is predicated on 5.9% gross domestic product (GDP) growth.<sup>2</sup> This is the same level of growth as the first three quarters of 2016.<sup>3</sup> The early budget date means that the government's estimates for the first three quarters of the financial year are relatively rough.

The budget is predicated on a fiscal deficit of 524.6 billion Kenya shillings (KSh) (\$5.10 billion).<sup>4</sup> The deficit will stand at 6.3% of GDP, compared to 9.3% in the current fiscal year.<sup>5</sup> The government is targeting a 4% fiscal deficit in 2019/2020.<sup>6</sup> The government plans a marginal 2.6% increase in spending to KSh2.29 trillion (\$22.2 billion), 27.6% of GDP.<sup>7</sup> The cut in relative spending from 30.4% of GDP in the last financial year is due to a 15.3% decrease in capital outlays. Recurrent spending will however increase 11% to KSh1.35 trillion (\$13.1 billion) due to increases in public sector wages. As part of the government's fiscal consolidation, Rotich introduced a public sector recruitment freeze outside strategic sectors.<sup>8</sup> The government is targeting a 12.3% increase in revenue to KSh1.76 trillion (\$17.1 billion), 21.2% of GDP. This is largely on the back of a KSh300 billion (\$2.9 billion) increase in **Kenya Revenue Authority (KRA)** tax collections.<sup>9</sup>

*"There is apprehension about how the government would hit its revenue collection target in light of lower tax collections by the authorities who have cited lower payroll and corporate taxes. Economists on their part have pointed out that lower collections from these two sources are an indicator that the general economy is losing steam. Rotich however stuck to his script and did not introduce new taxes or additional income taxes, but for this fiscal year the government announced a raft of tax increases for the alcohol and betting industries, raising concerns about whether the treasury may be killing the golden goose."<sup>10</sup>*

<sup>1</sup> Daily Nation, 30 Mar 2017.

<sup>2</sup> Daily Nation, 30 Mar 2017.

<sup>3</sup> Daily Nation, 30 Mar 2017.

<sup>4</sup> Daily Nation, 30 Mar 2017.

<sup>5</sup> Daily Nation, 30 Mar 2017.

<sup>6</sup> Daily Nation, 30 Mar 2017.

<sup>7</sup> Daily Nation, 30 Mar 2017.

<sup>8</sup> Daily Nation, 30 Mar 2017.

<sup>9</sup> Daily Nation, 30 Mar 2017.

<sup>10</sup> Source, journalist, Nairobi

The government will borrow KSh256 billion (\$2.49 billion), 2.9% of GDP, from external sources, and KSh268.6 billion (\$2.61 billion), 3.1% of GDP, from domestic sources.<sup>11</sup> According to Rotich, the government will amend the **Public Finance Management Act** to allow the issuance of Islamic finance compliant Sukuk bonds.<sup>12</sup> Rotich said **Central Bank of Kenya (CBK)** monetary policy will target keeping inflation within the government's range of 2.5% and 7.5%. To support price stability, the government's fiscal policy will prioritise low and stable interest rates, and a steady and competitive exchange rate to support exports.<sup>13</sup> The **International Monetary Fund (IMF)** welcomed the budget, praising its objective of fiscal consolidation.<sup>14</sup> However, the IMF warned that the revenue target may prove overly ambitious.<sup>15</sup>

The budget includes a number of policy amendments including a revision of income tax bands to increase household disposable incomes; exemptions on dividends paid to foreign investors in special economic zones; tax incentives for vehicle assembly and maritime sectors; and an increase in gambling taxes.

Tax reforms on alcohol and gambling were especially unpopular. Excise tax on beer will be inflation adjusted.<sup>16</sup>

*"With the current rate of inflation standing at 10.28%, consumers are bracing themselves to dig deeper into their pockets."*<sup>17</sup>

Additionally, the budget increases the tax rate on spirits from \$1.75 to \$2 per litre.

*"By increasing taxes on alcoholic beverages the Treasury is repeating a taxation policy that it took in three years ago which proved futile. In the 2013-2014 fiscal year excise tax was introduced on non-malted beer and at the time **East African Breweries Ltd (EABL)**, warned against the move citing that the non-malted beer, which was meant for the low end of the market, was a price sensitive product. The price of non-malted beer went up and as had been foreseen, the product became expensive for the low end of the market and in the end the government failed to collect expected revenues on this source but not without forcing more than 5,000 businesses to close shop. Indirectly there was a hit on sorghum farmers whose supply contracts were cancelled by EABL."*<sup>18</sup>

There is fear that poorer households will turn to illegal alcohol when prices increase.<sup>19</sup>

*"Higher prices, even for the mainstream market, may also create a grey market where products will be smuggled from neighbouring countries where alcoholic beverages are lower priced."*<sup>20</sup>

The betting sector is another revenue target in this year's fiscal budget. The treasury has proposed to raise taxes for betting, lottery, gaming and competition from the current rates of 7.5%, 5%, 12% and 15%, respectively, to a uniform tax rate of 50% for all categories of sports and betting entertainment.<sup>21</sup> The government will transfer taxes on winnings to a fund for sports, arts and culture development.

*"The betting industry has warned that this is an unreasonable tax rate and drawing from experience from other markets, operators may be forced to move online gambling to other jurisdictions. The betting industry is also questioning the wisdom of transferring cash to a state-*

<sup>11</sup> Daily Nation, 30 Mar 2017.

<sup>12</sup> Daily Nation, 30 Mar 2017.

<sup>13</sup> Daily Nation, 30 Mar 2017.

<sup>14</sup> Reuters, 30 Mar 2017.

<sup>15</sup> Daily Nation, 30 Mar 2017.

<sup>16</sup> Source, journalist, Nairobi

<sup>17</sup> Source, journalist, Nairobi

<sup>18</sup> Source, journalist, Nairobi

<sup>19</sup> Source, journalist, Nairobi

<sup>20</sup> Source, journalist, Nairobi

<sup>21</sup> Source, journalist, Nairobi

*run fund under the sports ministry, which has a reputation for incompetence and unaccountability. Football, rugby, boxing and other sport associations are also against the proposed 50% tax on betting and gambling operators. The lucrative sponsorship deals have for the first time made it possible for teams to pay athletes on time and more important, reasonable wages and this could be at jeopardy if the gambling industry's profitability is threatened."<sup>22</sup>*

The budget was broadly in line with previous government statements so contained few surprises. However, with only three quarters' worth of data available for 2016, revisions to relative targets are probable. The alcohol and gambling sectors are likely to lobby the government to revise its proposed taxes.

### **Kenyatta delivers state of nation address**

President **Uhuru Kenyatta** (2013-present) on 15 March delivered the final state of the nation address (SONA) before the 8 August general election.<sup>23</sup> Despite frustration at government failures to curb corruption and improve service delivery, Kenyatta is the frontrunner before the election. During the SONA, Kenyatta said implementation of the 2010 constitution was his central achievement. Kenyatta in particular cited the strengthened judiciary and the devolution of political power to the new system of county governments.<sup>24</sup> In fact, devolution progress has been slow and piecemeal. The government missed the original August 2015 deadline for passing the final pieces of constitutional legislation, and simply extended it for a year. Devolution has resulted in a new tier of government, which has replicated the corruption, fiscal mismanagement and political infighting that the constitution attempted to curb. It has allowed central and county governments to blame each other for policy failings. Kenyatta, beyond repeating previous pledges to cut the government wage bill and address corruption, has not put forward a substantial election platform.

Kenyatta also noted reforms to the **Independent Electoral and Boundaries Commission (IEBC)**, which are essential to holding successful elections in August.<sup>25</sup> Kenyatta called for peace either side of the election,

*"I urge citizens to exercise tolerance before, during and after the elections."<sup>26</sup>*

The risk of election violence is dependent upon the credibility of the IEBC and the effectiveness of the equipment it sources. The IEBC issued a contract to **France-based Safran SA** on 23 March to provide an integrated election management system for the general election.<sup>27</sup> The Safran system will integrate all aspects of the electoral process, including candidate registration, biometric voter registration and identification, and electronic results transmission.<sup>28</sup> Safran provided the biometric voter registration kits used in the March 2013 general election.<sup>29</sup>

The IEBC single-sourced Safran with IEBC chairman **Wafula Chebukati** citing time and budgetary constraints.<sup>30</sup> The IEBC was in the process of awarding the integrated election management system contract to France-based **M/S Gemalto S.A.**<sup>31</sup> However, the IEBC cancelled the Gemalto process on 22 March when the company reportedly projected the cost of the project at KSh5.2 billion (\$50.6m) compared to the IEBC's budgeted KSh3.8 billion (\$37.0m).<sup>32</sup> Gemalto vice president **Charles Meyaa** criticised the decision to cancel the contract in a letter to the IEBC, alleging the IEBC chose Safran due

<sup>22</sup> Source, journalist, Nairobi

<sup>23</sup> Standard, 15 Mar 2017.

<sup>24</sup> Standard, 15 Mar 2017.

<sup>25</sup> Standard, 15 Mar 2017.

<sup>26</sup> Standard, 15 Mar 2017.

<sup>27</sup> Daily Nation, 24 Mar 2017.

<sup>28</sup> Daily Nation, 24 Mar 2017.

<sup>29</sup> Daily Nation, 24 Mar 2017.

<sup>30</sup> Standard, 24 Mar 2017.

<sup>31</sup> Standard, 24 Mar 2017.

<sup>32</sup> Standard, 24 Mar 2017.

to their existing relationship from the 2013 election and the company's role in voter registration.<sup>33</sup> The opposition **National Super Alliance** coalition in February wrote to the IEBC for an explanation of its relationship with Safran.<sup>34</sup>

Kenyatta defended his record of public financial management, especially the increased levels of borrowing his administration has overseen.<sup>35</sup> The national debt has increased from 42% to 50% of GDP under Kenyatta.<sup>36</sup> High-profile examples of the misallocation of government funds, notably at the health ministry and the **National Youth Service**, have encouraged opposition criticism of government financial mismanagement. However, Kenyatta claimed his administration's borrowing has financed

*"... the most aggressive development agenda witnessed in **Kenya's** history... I want to assure Kenyans that at no point has the country been at risk of default or shown any inability to pay its creditors."<sup>37</sup>*

To back up his claim, Kenyatta cited average annual growth of 5.9% under his administration, the creation of 2.3 million jobs, and the building of 1,950km of new roads.<sup>38</sup>

Kenyatta acknowledged that his government has struggled to curb corruption,

*"Many Kenyans are frustrated at the seeming lack of progress in the fight against corruption. We knew that eliminating corruption would be a journey on a rocky path."<sup>39</sup>*

He also accepted criticism of the government's high wage bill, pledging to cut it should he win another term in office.<sup>40</sup> With regard to security, Kenyatta committed his government to continuing the **Kenya Defence Forces (KDF)** deployment in **Somalia**.<sup>41</sup>

The SONA contained few policy announcements ahead of the election. The lack of policy platforms in both the ruling **Jubilee Party** and the opposition **Coalition for Reforms and Democracy (CORD)** increases the risk of election violence. It encourages candidates to resort to ethnic stereotyping and insults all too quickly; exactly the political culture the 2010 constitution aimed to end. According to the election timetable, the integrated election management system should be in place before 10 April, four months before the general election, with a full test of the system at least 60 days prior to voting.<sup>42</sup> Testing of the voter register is due to begin on 10 May.<sup>43</sup>

### **Kenyatta strengthens financial crime framework**

Kenyatta signed into law the **Proceeds of Crime and Anti-Money Laundering (Amendment) Act 2017** on 2 March.<sup>44</sup> The law comes amid increased concerns about the risk of terrorist groups and drugs traffickers using Kenya to finance their operations.<sup>45</sup> The bill introduces tougher sanctions for financial crimes, with individuals found guilty facing financial penalties of up to KSh5m (\$50,000), and companies penalties of up to KSh25m (\$250,000).<sup>46</sup> Continued failure to comply subsequent to a breach will result in an additional penalty of KSh10m (\$100,000) a day for up to 180 days for both individuals and companies. The act strengthens the capacity of the government to curb illicit flows. It

<sup>33</sup> Standard, 24 Mar 2017.

<sup>34</sup> Standard, 24 Mar 2017.

<sup>35</sup> Standard, 15 Mar 2017.

<sup>36</sup> Standard, 15 Mar 2017.

<sup>37</sup> Standard, 15 Mar 2017.

<sup>38</sup> Standard, 15 Mar 2017.

<sup>39</sup> Standard, 15 Mar 2017.

<sup>40</sup> Standard, 15 Mar 2017.

<sup>41</sup> Standard, 15 Mar 2017.

<sup>42</sup> Daily Nation, 24 Mar 2017.

<sup>43</sup> Daily Nation, 24 Mar 2017.

<sup>44</sup> East African, 5 Mar 2017.

<sup>45</sup> Source, partner in law firm, Nairobi

<sup>46</sup> East African, 5 Mar 2017.

also establishes the **Assets Recovery Agency** to identify, trace, freeze, seize and confiscate the alleged proceeds of crime.<sup>47</sup>

The new legislation came before the **United States (US)** state department's **Bureau for International Narcotics and Law Enforcement Affairs (BINLEA)** warned on 5 March that local and international criminals can use Kenya's mobile-money transfer network for illicit financial transactions.<sup>48</sup> The BINLEA alleged these transactions relate to transnational organised crime, Somalia-based piracy, cyber-crime, corruption, smuggling, trade invoice manipulation, illicit trade in drugs and counterfeit goods, trade in illegal timber and charcoal, and wildlife trafficking.<sup>49</sup> The BINLEA cited difficulties in tracking and investigating transactions within Kenya's mobile payment and banking systems.<sup>50</sup> The BINLEA described a *"lack of rigorous enforcement, coupled with inadequate reporting"*<sup>51</sup> in the sector. The BINLEA in particular claims that **M-Shwari, Safaricom Ltd's** online banking service, is especially vulnerable to money laundering.<sup>52</sup> It claimed that criminal gangs use illicit funds to purchase mobile credits at amounts below reporting thresholds.<sup>53</sup> The BINLEA also criticised the difficulty investigators face in obtaining bank records or seizing accounts.<sup>54</sup> Investigators need to present judges with evidence linking deposits to criminal activity. However, there is little confidentiality in the criminal justice system meaning account holders are often forewarned.<sup>55</sup>

Greater financial sector governance and an improved compliance supervisory framework will reduce legal and financial risks for investors.

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<sup>47</sup> East African, 5 Mar 2017.

<sup>48</sup> East African, 3 Mar 2017.

<sup>49</sup> East African, 3 Mar 2017.

<sup>50</sup> East African, 3 Mar 2017.

<sup>51</sup> East African, 3 Mar 2017.

<sup>52</sup> East African, 3 Mar 2017.

<sup>53</sup> East African, 3 Mar 2017.

<sup>54</sup> East African, 3 Mar 2017.

<sup>55</sup> East African, 3 Mar 2017.

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