The COVID 19 global pandemic:
Impact to the economy and policy options

The Statistics so far:

- Globally
823,626 confirmed
40,598 deaths

- European Region
464,212 confirmed
30,089 deaths

- Western Pacific Region
106,422 confirmed
3701 deaths

- South East Asia Region
5,175 confirmed
195 deaths

- Region of the Americas
188,751 confirmed
3,400 deaths

Eastern Mediterranean Region
54,281 confirmed
3,115 deaths

- African Region
4,073 confirmed
91 deaths

Source: World Health Organization, COVID 19 Situation Report – 72 (1st April 2020)

The outbreak of a novel coronavirus disease (COVID 19) in China has quickly morphed into a global pandemic that is threatening the world economy. In December 2019, China alerted the World Health Organization (WHO) to a rising number of cases of unusual pneumonia in Wuhan, a port city of 11 million people in the central Hubei Province. The viral infection was linked to the City's Huanan Seafood Wholesale Market. Over a span of days in December through January, the number of cases increased rapidly including outside Hubei province in regions such as Beijing, Shanghai and Shenzhen as well as in neighboring Thailand and Japan. Several deaths were also reported. China took decisive measures to block the spread of the virus; placing several cities in Hubei province under lockdown, imposing travel restrictions, closure of entertainment venues and restriction of movements outside homes. Meanwhile, new cases started emerging in countries outside China with rapidly rising confirmed cases in several countries in Asia, Europe, the United States, the United Kingdom, the UAE, the Gulf region and Africa[1]. Statistics from the World Health Organization indicate that as at 1st April 2020, there were 823,626 confirmed cases spanning across more than 200 countries with 40,598 deaths reported. As a result, many countries have adopted drastic mitigation strategies that include lockdowns and curfews, banning of international travel, closure of public venues and work from home directives which, though necessary, are having a significant adverse impact on economic activities.

The global economy is facing a recession that may persist through 2020. Even before the COVID 19 pandemic, global economic growth projections were modest; estimated at 2.5[2] to 3.3[3] percent for 2020 and these were downgrades from previous forecasts. Following the health pandemic, it is projected that the global economy will achieve negative growth for 2020.[4] With a significant reduction in global economic activity and the fact that the end of the pandemic is not yet in sight, negative economic growth in two successive quarters seems

1 Al Jazeera "Timeline: How the new coronavirus spread" retrieved from https://www.aljazeera.com/news/2020/01/timeline-china-coronavirus-spread-200126061554884.html

2 World Bank projections, January 2020 global Economic Prospects report
3 IMF projections, World Economic Outlook, January 2020
4 IMF Managing Director Kristalina Georgieva's Statement following a G20 Ministerial call on Coronavirus Emergency

imminent. According to UNCTAD (2020)[5], a deceleration of the global annual economic growth below 2.5 percent is often considered the recessionary threshold for the global economy. UNCTAD estimates that one percentage drop in global economic growth results in 900 billion US dollars in lost income. Thus the cost of the virus is likely to wipe out approximately 2 trillion US dollars off the global economy. This will have an adverse impact, particularly on developing economies which depend on trade and investment, tourism, foreign expertise and financial assistance from the developed economies.

Responses to the COVID 19 pandemic are not a one size fits all. Economies affected by the COVID 19 pandemic span across numerous regions and territories and are inherently different in economic structure, financial ability and systems of governance. Thus, as they develop their own mitigation strategies, countries have to look inwards and identify measures that will strengthen their own country's capacity to respond to the health pandemic.

The COVID-19 pandemic may reach a plateau nature and stabilize in the coming months, however, the impact will be felt for a longer period of time. This therefore calls for countries to adopt short-term, medium-term and long-term measures. In the case for Kenya, in the near term, we expect persistent food shortage and job losses which is likely to increase the percentage of the urban population living below the poverty line.

Kenya has put in place its own mitigation strategies and the ramifications are being felt throughout the economy. According to a vulnerability index developed by the Overseas Development Institute (Raga and Velde 2020)[6], Kenya is among the top ten most vulnerable economies to COVID 19 due to its interconnectedness with China and the fact that it is not well equipped to address the impact of the health pandemic. Since confirming its first COVID 19 case on 13th March 2020 and with the number of cases continuously increasing, the Kenyan government has instituted stringent measures to curb the spread of the disease. These include a dusk to dawn curfew; nationwide school closures; work from home directive; prohibition of public gatherings including religious services, weddings and funerals; suspension of all international travel; isolation of recent travelers for 14 days; closure of bars and restaurants (except takeaway services); and passenger distancing guidelines in public service vehicles. This is an unprecedented situation and the economy has taken a significant hit.

Transmission mechanism of the Economic Shock

The demand side: This aspect considers total demand for final goods and services. Indeed, High consumer spending (high demand) leads to increased production and thriving businesses. This results in increased employment and higher incomes which further stimulate demand thereby leading to higher economic growth.

The government's mitigation strategies have led to reduced incomes. The work from home directive, prohibition of public gatherings, closure of bars and restaurants and dusk to dawn curfew have resulted in reduced working hours with some institutions, especially MSMEs with unstable cash flows, having to lay off workers or at least requiring them to take unpaid leave for an unspecified period of time. This has resulted in declining incomes and has adversely affected aggregate demand.

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[5] UNCTAD (2020), "The coronavirus shock: a story of another global crisis foretold and what policymakers should do about it." United Nations Trade and Development Update 9 March 2020

[6] Raga and Velde (2020) "Economic Vulnerabilities to Health Pandemics: Which countries are most vulnerable to the impact of coronavirus" Overseas Development Institute (ODI)

The service sector is arguably the most affected in terms of reduced income and lost employment as it specifically caters to activities that relate to public gatherings. This sector is the biggest contributor to economic growth, having contributed approximately 3 percentage points to an estimated 5.6 percent GDP growth in 2019. The loss of income from the service sector will therefore come at a great cost to the economy. The most affected subsectors in the Service sector are wholesale and retail, accommodation and restaurant as well as transport and storage. These have been impacted as follows:

> *Transport and storage sub sector:* The work from home directive, passenger distancing guidelines and a dusk to dawn curfew means that many public service vehicles are unable to earn much revenue even with a reduced commute time due to fewer passengers per commute and restriction of working hours. Air transportation is arguably the worst hit. Even before the ban on all international flights, the suspension of flights to China had resulted in an estimated revenue loss of Ksh. 800 million per month[7]. With a ban on all international flights, the revenue loss will be much worse. Railway transportation has also been significantly affected with the Kenya railways suspending temporarily the Madaraka Express (ME) Passengers Service express train between Nairobi and Mombasa; the Nairobi-Suswa service; and the Nairobi Terminus-Ngong Commuter Service. The ME Passenger Service Inter-county train and the Nairobi Commuter rail schedules have also been revised to cater to the new reality.
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> *Accommodation and restaurant:* The ban on international travel, work from home directive and closure of bars and restaurants except for takeaway services has significantly reduced activity in this sector and with many of the workers being daily wage earners, it is possible that many have been laid off or have taken unpaid leave.
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> *Wholesale and retail:* Reduced economic activity, declining incomes and uncertainty over the future will invariably reduce consumer spending thereby reducing aggregate demand. However, a spike in spending has been experienced in the short term mostly due to panic buying in anticipation of a complete lockdown. This increased spending is expected to decline gradually as the stockpiling of goods tapers off and the purchasing power goes down. Indeed, many consumers are presently restricting their purchases to basic goods, mostly foodstuff and household supplies. Expenditure on other items not in this category is likely to decline due to uncertainty over future income.

The supply side: This aspect considers the ability of the economy to supply goods and services using a set of factors of production i.e. labor and capital.

Industries that rely on imported raw materials and intermediate goods have experienced a sudden disruption in their supply chains. In the initial stages of the pandemic, a KEPSA report had indicated that Ksh. 3.1 billion worth of imports from China may have to be sourced from other markets and this will come at a higher cost. However, with the crisis turning global, many manufacturing industries may have to suspend operations altogether. Business uncertainty and reduced working hours means that many companies including those that could potentially continue production, have had to significantly scale down operations pending the outcome of the current crisis. Even before the country reported

[7] Statement by Kenya Airways Corporate Communications, Daily Nation Article, "Fresh turbulence for KQ as coronavirus grounds most flights" Tuesday March 24 2020

its first case, approximately 61% of businesses[8] had already reported feeling the effect of COVID 19 on their businesses with some reporting financial losses. These statistics are likely to worsen as the disease continues to spread. Reduced supply/shortage of goods means higher prices for goods and services. However, with declining purchasing power of consumers, many businesses may have to scale down operations. This also feeds into the demand side as the reduced income for businesses will reduce employment leading to declining income for consumers and lowering aggregate demand.

In the Stanbic Bank PMI report for March 2020, many firms reported lost sales due to weak cash flows in households leading to reduced demand for goods and services. On the other hand, output prices increased due to inflated prices of raw materials. This has been attributed to reduced imports from china on account of COVID 19. The KEPSA report indicates that approximately 21% of Kenya's total imports are from China and by end of February, 2020 these had declined by 36.6%. Most of these import goods constitute industrial supplies, machinery and other capital equipment.

The ban on international travel has also affected business related travels as well as investments which rely on foreign expertise and foreign companies. This will significantly reduce foreign capital as well as foreign investment inflows.

Outlook of key macroeconomic variables

Inflation

Inflation is likely to remain within the government target range of 2.5% to 7.5%. In the month of March, inflation was estimated at 6.06% with the Consumer Price Index (CPI) having increased by 0.18 percent from 106.33 in February 2020 to 106.53 in March 2020. This was mostly driven by food inflation. It should be noted that these numbers are based on the new CPI whose base period is February 2019. Going forward, the food outlook for 2020 is potentially favourable if a number of ongoing challenges are addressed promptly. According to the Famine Early Warning Systems Network, food availability increased in early 2020 and with a forecast of above average rainfall in the March to May long rains season, food and pasture production should improve further. Cooler temperatures are also likely to mitigate the impact of the desert locust invasion thereby contributing to a favourable food outlook. However, anecdotal evidence suggests that some farmers are struggling to plant due to shortage of labour, seeds and fertilizer. Given the ongoing health pandemic, the social distancing directive and fear of infection have led to fewer labourers per farm. Furthermore, many farmers are finding it difficult to access seeds and fertilizers as many agrovets are closed with seed producers having suspended operations in keeping with the government directive to stay at home and minimize movement. As a result, retail shops are selling seeds at very high prices and it is feared some unscrupulous traders could be selling uncertified seeds. If this scenario is not dealt with, the country may find itself having to deal with a food crisis in addition to the health crisis in a few months to come. This requires the government to take charge of food production especially through distribution of seeds and fertilizer as well as putting in place mechanisms to ensure farmers can safely continue with their activities while avoiding infection.

Fuel inflation is also expected to be low as global fuel prices have plummeted and currently stands at 26.5 US dollars per barrel from 69.9 $ per barrel in December 2019. This is on account of reduced oil demand due to reduced public and private transportation as a result of restrictions on movement which has reduced demand for transportation, decline

[8] Victor Ogalo (2020), Business Perspectives on the Impact of Coronavirus (COVID 19) on Kenya's economy. Kenya Private Sector Alliance (KEPSA)

in manufacturing and ban on international travel. As a result, fuel and transportation costs may not increase significantly.

The risk of increased cost of goods on account of supply chain disruptions is likely to be offset by a general reduction in aggregate demand therefore the impact on headline inflation may not be significant.

Interest rates

In light of the adverse economic outlook, the Central Bank of Kenya lowered the Central Bank Rate (CBR) to 7.25 percent from 8.25 percent and reduced the Cash Reserve Ratio (CRR) to 4.25 percent from 5.25 percent in order to support economic growth and stabilize financial markets. However, given the uncertainty of the business environment, the impact of this measure remains uncertain.

91 day Treasury bills rate has remained largely unchanged at 7.2 percent since January 2020. In the week ending March 20th 2020, it is reported that Treasury bills were undersubscribed with investors preferring liquidity due to reduced confidence in the market following the COVID 19 outbreak.

Lending rate, Savings and Deposit rate have remained largely unaffected and are currently at 12.24%, 4.02% and 7.11% respectively.

Given the decline in economic activity and reduced income, there is likely to be an increase in non-performing loans.

Exchange rate

The shilling is under pressure to depreciate due to reduced forex earnings mainly on account of reduced exports. As at 2nd April 2020, the exchange rate stood at Ksh. 105 to the dollar. With a depreciated currency, it will be even more expensive for industries continuing with operations to source raw materials and intermediate goods. This may lead to cost push inflation. However, given the decline in consumer spending, it may not make sense to continue with expensive production due to the likelihood of incurring losses and some importers may scale down operations.

A depreciated shilling may also wipe out the gains of a reduced oil import bill given the reduction in global oil prices. More shillings will be required to import the same amount of oil.

Going forward, declining diaspora remittances pose a risk to the exchange rate. However, reduced dollar demand as some importers suspend operations may balance out the effects thereby stabilizing the exchange rate. However, should they continue with normal operations, then a higher dollar demand may lead to further depreciation. The lack of an IMF standby loan facility to help cushion the Kenyan Shilling from economic shocks is also significant risk to the exchange rate outlook. Given the unfolding situation, it may be prudent for the Kenyan authorities to consider managing the foreign exchange rate in a manner that is beneficial to the export sector.

Trade Balance

Exports: in light of the COVID 19 pandemic, it is estimated that the country may experience a minimum 25 percent decline in export revenue[9]. Many of the affected countries particularly in Europe are key trading partners of Kenya. Declining global income implies reduced demand for Kenyan exports and with declining commodity prices, export earnings will fall significantly. Available statistics show a decline in most commodity prices[10] implying that even the little that the country is managing to export is earning much lower. Submissions by the Kenya flower council already point to a grim outcome for cut flowers exports with the country losing out on a crucial calendar period for its exports (Mother's day among others). It is estimated that the sector is losing approximately Ksh. 250 million per day and may lose half of its value (approximately Ksh. 60 billion) by end of 2020[11]. Consequently, the sector has laid off 30,000 temporary workers and sent another 40,000 workers on leave (unpaid?). Furthermore, the ban on social gatherings including weddings and funerals among other celebratory forums where flowers are likely to be needed will also further dampen performance of the sector. This will also greatly affect the economy of Nakuru County, where most of the flower farms are located (Naivasha) in form of lost employment and income for the flower farm workers.

The Tourism and hospitality sector has also suffered immense losses and on a global level, it is expected to decline by up to 40%[12]. Tourism contributes approximately 18% to Kenya's export earnings[13] . The cancellation of international travel has adversely affected the sector given that it relies directly on international travel. Furthermore, the restriction of movement, ban on public gatherings, closure of bars and restaurants and work from home directive means that even domestic patronage cannot be relied upon to salvage the sector. As a result, many hotels are experiencing extremely low occupancies and may have to shut down. Statistics from the world travel and tourism council indicate that tourism accounts for 8.3 percent of Kenya' total employment; translating to 1.1 million jobs. These jobs are now in peril.

Other key exports also likely to be affected – tea coffee, fruits but given the fluidity of the situation, the revenue loss is yet to be adequately quantified.

Imports: Reduced travel has led to a significant decline in global oil prices and this is likely to reduce the country's oil import bill which accounts for 19% of total imports. The outlook for importation of industrial supplies, machinery and other capital equipment remains uncertain given that most industries have scaled down operations due to reduced aggregate demand as well as higher input costs occasioned by supply chain disruptions. It is therefore estimated that the import value will decline by approximately 3%.[14]

Foreign Exchange reserves

Though there is some optimism expressed over the forex reserves which currently stand at 8,251 million US dollars (5.01 months of import cover) and are expected to provide adequate buffer against short term shocks, downside risks remain evident. Over the past year, Kenya's forex reserves have mostly been driven by remittances. Available statistics on foreign remittances shows a slight decline in the month of February to 218,991 USD from 259,392 USD.[15] The decline is mostly reflected from Europe. Though it is still too early to tell the impact, reduced economic activity, declining

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9 PBO Estimations
10 World Bank (2020), Commodity Prices, "Pink Sheet" data March 2020
11 Kenya Flower Council Press briefing, Thursday 19th March 2020
12 McKinsey, Coronavirus COVID 19: Facts and Insights, March 2020
13 Victor Ogalo (2020), Business Perspectives on the Impact of Coronavirus (COVID 19) on Kenya's economy. Kenya Private Sector Alliance (KEPSA)
14 PBO Estimations
15 CBK Statistics

incomes, increased cost of goods abroad and widespread uncertainty will very likely result in a much further reduction in diaspora remittances.

Nairobi Securities Exchange

Following announcement of the first case of COVID 19 in Kenya, total market capitalization shrunk by Ksh. 120 billion with major stocks like Safaricom and KCB bank significantly declining. This outcome is attributed to risk aversion by foreign investors on account of expected negative impact of the health pandemic to economies across the world.

It is observed that most of the advanced economies have cut their benchmark lending rates, initiated various stimulus packages and instituted measures such as quantitative easing so as to spur aggregate demand. Such measures being applied may negatively affect the money market due to the inherent risk of capital flight as investors opt safer havens

Economic Resilience is determined by the economy's ability to respond adequately to the economic shock. How much of the impact can the Kenyan economy absorb?

To assess the country's economic resilience, there is need to take stock of our vulnerabilities. The country's vulnerability stems primarily from a limited fiscal space. Approximately 23% of the country's ordinary revenue was to cater for interest payments in the current financial year. 71% was for recurrent spending including county allocations. This leaves very little room for maneuver and with expected revenue underperformance, the country does not have much by way of available resources to cater to emergencies of this magnitude. National savings are not adequate. As a result, the country is not financially in a position to offer an elaborate stimulus package as other countries have done.

As a result of a limited fiscal space, the country does not have much room to properly boost health spending. It should be noted that even before the health pandemic, the health system was already facing challenges. The current proposed intervention of recruitment of additional health workers, while necessary, is far from adequate in meeting the health challenge. To adequately address the needs of patients, there is need to also consider ventilators and other critical equipment, medicine, protection kits for the health workers. All public hospitals particularly the level 4 and 5 hospitals should be adequately equipped given the rising number of COVID 19 cases. This is perhaps the best time to revamp the country's healthcare system and address the bottlenecks that have always existed.

The revenue loss from the proposed measures will invariably lead to a reduction in government spending especially government investments. The proposed mitigation measures are aimed at increasing the disposal incomes of *wananchi* to facilitate consumer spending in an environment of reduced earnings. However, given the uncertainty over future income, consumer spending is still likely to remain subdued.

It should be noted also that these measures mostly favour those in formal employment. Majority of workers subsist in the informal sector and have unstable cash flows. Many of them are daily wage earners and will not benefit from the tax relief. With reduced economic activity and expected mass layoffs, many of these workers will require some form of support from the government in order to meet their basic needs

Table 1: The Unfolding Scenario (PBO Simulations)

With continued spread and no intervention measures to combat the health pandemic, it is estimated that there will be a 2.6 to 2.8 % reduction in economic growth in 2020 (GDP growth likely to average 2.8 to 3.2%)

Primary effects	Remarks
Private investment	The latest Stanbic Bank PMI report indicates a 4.3 point reduction in the PMI index with the current PMI Index at 49 denoting deterioration in business activity. Continued supply chain disruptions and decreased consumer spending due to declining incomes will lead to further deterioration of private sector activity until the situation stabilizes.
Exports	It is estimated that at minimum, there will be 25% decline in export revenues due to significant reduction of exports. Notable disruptions are in the flower industry which is estimated to be losing approximately Ksh. 250 million per day. The tourism sector is also on the brink of shutdown and globally, it is expected to decline by up to 40%.
Imports	Reduced travel has led to a significant decline in global oil prices and this is likely to reduce the country's oil import bill which accounts for 19% of total imports. The outlook for importation of industrial supplies, machinery and other capital equipment remains uncertain given that most industries have scaled down operations due to reduced aggregate demand and also higher input costs due to supply chain disruptions. It is estimated that the import value will decline by approximately 3%.
Secondary effects	
Fiscal sector	*Revenue*: taking into account the primary factors indicated above, there is an estimated revenue loss of approximately Ksh. 34 billion (impact excludes tax relief measures proposed by the government). Majority of the revenue loss is accounted for by income tax probably due to reduced profitability of businesses as well as loss of employment. VAT is also expected to reduce significantly due to reduced spending and import duty will decline on account of a lower import bill. *Fiscal deficit*: lower revenue is likely to lead to additional borrowing to meet the expenditure gaps particularly in health spending. Government borrowing may increase over and above 1.3 percent of GDP Development spending: This is likely to be delayed and could lead to creation of more pending bills as most contracts will remain running despite the current pandemic
Official reserves	Net foreign assets are likely to decline with a reduction in import cover by 1 to 2 months' worth. The impact will largely depend on how long the crisis lasts

Household sector	Poverty levels are likely to increase in the short term due to increased unemployment levels and declining GDP per capita. The urban poor, most likely to be daily wage/low income earners, are likely to be disproportionately disadvantaged in the prevailing circumstances. They are the most likely candidates for layoffs and have most likely lost income. Furthermore, they are most at risk due to lack of access to clean water, sanitation services and living in close proximity.

Assessment of likely economic and fiscal implication of Taxation Measures pronounced by H. E. the President of the Republic of Kenya

In response to the COVID 19 global pandemic, various governments world over are instituting measures to contain the spread of the virus as well as manage the reported cases. In this regard, H.E. the President of the Republic of Kenya, on 25th March, 2020 issued orders and directives regarding measures the government will take to address the health and socioeconomic effects of the pandemic.

The measures are in the areas of taxation such as in the Income Tax, Value Added Tax, and Turnover Tax; expenditure rationalization such as proposed reduction of remuneration to top government officials; expenditure reorganizations such as diverting some resources from Universal Health Care to provide recruitment of additional health workers and also enhanced social safety net among others.

TAXATION MEASURES

Among the wide range of measures pronounced by the President, five of them were relating to taxation measures the government will offer so as to protect jobs, alleviate anxiety and provide some certainty in employment. It is worth to note that these taxation measures will require approval by Parliament through legislation instruments. The measures are:

1. Provision of 100% personal income tax relief for persons earning KSh. 24,000 per month

The current income tax bands range from a rate of 10% for individuals earning KSh. 12,298 per month up to 30% for earnings above KSh. 47,057. This tax proposal of exempting earnings below KSh. 24,000 per month implies that all earnings in the current two bands, that is, 10% and 15% are tax exempt. This clearly shifts the minimum taxable income from the current amount to KSh. 24,000.

Therefore, the new income tax bands are given as follows: personal earning up to KSh. 24,000 is taxed at 10%, the next KSh. 16,667 at 15% and it moves up progressively to earnings above KSh. 57,333 which will be taxed at the highest band of 25%. It also noted that the personal relief has been proposed to be enhanced from the current KSh. 1,408 per month to KSh. 2,400 per month.

Table 2: income tax (PAYE) rate bands

Taxable pay p.m.	Current rate	Proposed rate
First 12,298	10%	0%
12,299 – 23,885	15%	0%
23,886 – 35,742	20%	10%
35,473 – 47,059	25%	15%
Above 47,060	30%	20%* (above KSh. 57,333 = 25%)

Source: ITA, PBO

It is estimated that the government will forfeit about **KSh. 19.84 billion** in tax revenue on account of this proposed tax exemption of earnings below KSh. 24,000, thus increasing the disposable income to households with members in gainful employment. The * in the table Imply that the new taxation band for income above KSh. 57,333 per month is taxed at 25% which is the new highest band.

2. Pay-As-You-Earn (PAYE) top band to be reduced from 30% to 25%

From table 1, reducing the tax rate of the highest band from 30% to 25% as well as factoring in slowdown in economic activities that may occasion reduction in remuneration or potential loss of jobs; is likely to occasion a revenue loss of **KSh. 7.08 billion.** However, this will increase disposable income to households with working individuals. It is estimated that about 2.95 million people are in the payroll and this leaves out the rest of the population who earn wages outside the payroll.

3. Corporation Income Tax (CIT) to be reduced from the current 30% to 25%

The corporation income tax constitutes the second highest component of the income tax, at about 46%. Other than the proposed tax incentive to the corporations, it is imperative to note that the pandemic is likely to reduce the overall profitability, thus, reducing the projected tax revenue. Therefore, this incentive will lead to a further reduction in revenue by about **KSh. 45.69 billion**. Given that this will take effective immediately, it should be clarified whether the CIT relief is for the 2019 tax that is due in April, 2020 or for 2020 that will be due in April, 2021.

4. Turnover Tax (ToT) to be reduced from the current 3% to 1% for all MSMEs

Currently, micro, small and medium enterprises whose annual turnover KSh. 5 million and below are required to pay 3% of turnover. This incentive of reducing the rate implies that about KSh. **50 million** of tax revenue would be forfeited but businesses would get a reprieve in an attempt to relief them from the effects of slowdown of activities.

5. Value Added Tax to be reduced from the current 16% to 14%

Value Added Tax is charged for imports as well as goods and services generated domestically. Ideally, the proportions are **56%** domestic and **44%** import VAT. The amounts of imports are likely to reduce significantly on account of transport, manufacturing, and movement restrictions. This means that the component of import VAT will be affected twice, first, by the volume of trade and second, by the reduced VAT rate. The domestic VAT will also be affected by reduced demand for goods and services as well as the reduced rate.

On overall, it is estimated that factoring reduction of VAT on account of reduced demand as well as reduced tax rate, about KSh. **49.598 billion** may be lost in tax revenue. It is worth noting that the VAT reduced rate is applicable with effect from 1st April, 2020 as stipulated by a statutory instrument, Legal Notice Number 35 of 2020 - Value Added Tax (Amendment of the Rates of Tax) Order 2020.

Summary of Tax Measures

Table 3: summary of tax measures 2019/20

S.N.	Tax Measure	Revenue Loss (KSh. millions)
1	100% PAYE tax relief for earnings below KSh. 24,000	19,840
2	Reduction of PAYE top band from 30% to 25%	7,080
3	Reduction of Corporate Income Tax from 30% to 25%	45,691
4	Reduction of Turnover Tax from 3% to 1% for MSMEs	50
5	Reduction of VAT from 16% to 14%	49,598
	Total	**122,259**

COVID-19 IMPACT ON ECONOMIC SECTORS AND PROPOSED RESPONSE PACKAGE

As earlier indicated, the primary channel of negative effect on the economy is through potential collapse in consumer confidence, fall in consumer demand due to work and movement disruptions, loss of jobs in the labour intensive services sectors (tourism, food and entertainment, and personal services industry), job losses in labour intensive productive sectors such as flower industry and parts of manufacturing, and drastic decline in domestic taxes.

While effective health related response to help contain the spread of the virus will afford the country to stave off major loss of human life and lessen the depth of economic recession, economic harm will persist in the most externally linked sectors such as tourism and horticulture since it will take varying times to restore economic activity in the most affected foreign countries. This means that even after controlling the spread of the virus, full economic recovery for Kenya will be contingent on the recovery of major economies in Europe, US, China, India, including Kenya's African trading partners. Thus, the lagged effect of the pandemic may persist for long, well past the first quarter of 2020/21.

To soften or to help partially offset the negative impact of the COVID-19 shock, the response should comprise a package of business support, social safety nets, and a measured monetary and fiscal stimulus to maintain consumer demand and domestic production (mainly agriculture, manufacturing among others). The health response is critical, providing a unique opportunity to scale up the UHC programme. The stimulus could equally help support food and nutrition, sustenance of manufacturing capacity and employment. Other measures require a well-designed social safety to laid-off workers, urban poor and direct or indirect support to businesses.

1.0 Review of Impact Economic Sectors

1.1. Accommodation and Restaurants

Recent travel restrictions and closure of restaurant and entertainment places to limit the spread of COVID-19 has occasioned notably the biggest economic blow to the accommodation and restaurant sector. The sector contributes at least Ksh. 70 billion to the GDP, but the sector is a big employer with robust supply linkages with agriculture, wholesale and retail trade, manufacturing and other sectors. Leisure and conference tourism, both external and domestic face possible collapse owing to travel restrictions which has completely stopped international tourist arrivals, while social distancing measures have affected domestic tourism and conferencing too. Closure of restaurant and bars further depresses the performance of the sector with a risk of major job losses if the pandemic persists.

The response package for this sector should comprise keeping workers on payroll (social transfers) and business support. Despite financing and implementation challenges, supporting laid off workers in the sectors for two to three months would greatly depress the negative social-economic impact of the pandemic on workers in this sector. The government could aid businesses partially to keep their workers in the pay roll for 2-3 months. GOK funding would be from savings through extensive expenditure cuts and emergency borrowing. The second set of intervention should comprise direct or indirect support to hotels, and eligible entertainment businesses through government backed concessional lifeline credit facilities through the commercial banking system.

1.2. Agriculture

Agriculture contributes at lease Ksh. 3 trillion to the GDP annually. The pandemic appears to have halted or severely disrupted export of horticultural products and major export cash crops. Notably, closure of flower auctions, demand disruptions in destination markets in Europe and the United States nearly led to the collapse of the flower industry. Due to this, the sector will lay off workers while the flower firms will certainly face serious operational and liquidity challenges. The impact of the pandemic on food and cash crop exports is mostly moderate arising from temporary disruptions of export trade and demand in destination markets. Some job losses may be expected too. However, for production of staple foods and livestock and fisheries subsectors, the net impact could be positive if consumer demand for staple food and meat and dairy products remains high.

Greatest focus should place on the most affected flower and food export sub-sectors. Owing to possible 80% loss in jobs in the flower industry, the response should combine government support to the businesses to keep workers on payroll. This maybe done through partial social transfers to the affected workers. Equally a business support package should include provisional of government supported concessional credit access for the most affected firms. It is expected that due to lagged effects of the pandemic in the flower destination markets, the negative impact may persist for at least two quarters.

Critically, the food, livestock and fisheries sectors should be supported to keep them vibrant through the health crisis. These are important sectors to keep economic activity robust and help stave off deeper recession. The support package is essentially facilitative comprising of improving supply and transportation channels for produce.

1.3. Manufacturing

Manufacturing is one of the Big Four Agenda and therefore critical for realization of economic growth and development. The sector contribute at least Ksh. 700 billion to the GDP. The pandemic presents a major shock to the vulnerable sector. The impact on the sector is mixed, with certain subsectors likely to boost production to meet essential goods demand, while other manufacturing may suffer depressed demand and production activity. Both food and health products manufacturing are likely to stay alive in absence of a total “lockdown” of the country. Food production will receive some boost from persistence of domestic demand for essential food items, while health products manufacturing will benefit from expected expansion in manufacturing of essential medical and protective equipment to deal with the unfolding pandemic.

For food manufacturing, reduction of transport and supply disruptions and any direct support to increase production capacity could help greatly. It is notable that most food products are either exempt or zero rated from VAT. The sector may thrive through the crisis and can be considered for targeted taxation to supplement government limited resources.

Direct fiscal support to businesses in the health manufacturing will be required to boost the manufacture medical and protective items and equipment for Covid-19.

1.4. Financial, Insurance and Capital Markets

The banking system has remained strong in the recent past, but the COVID-19 pandemic presents unprecedented shocks. Though the sector may not suffer major immediate impact, overtime the wider negative effects on the economy, consumer confidence and incomes could affect its performance. Broad impacts include possible rise in non-performing loans, constrained credit risk environment and therefore potential lower profitability. However, recent monetary policy measures including reduction of the cash reserve requirement could increase liquidity and therefore growth in credit. Government domestic borrowing is likely to rise as revenue collection suffers due to the pandemic. Premiums payments decline due to individual and business income shocks while risk could proliferate, affecting the sectors overall performance. In the financial sector, capital markets have borne the brunt of the pandemic since February as foreign investors exited the market. The pressure on the stock markets may persist with capital flight, limited retail activity, and negative business sentiment.

Some of the response measures suggested include helping curtail deeper economic recession by providing resources for direct on-lending to affected sectors in the economy such as manufacturing, construction and real estate, as noted above. Given expected negative shock on revenues, it may be important to restore excise duties on financial sector fees if social transfers to vulnerable populations are enhanced.

1.5. Education and Health

Education and health sectors are critical sectors for both public and private sectors. The value of the two sectors exceeds Ksh. 600 billion and has significant impact on social welfare and development. However, the two sectors are affected by the pandemic asymmetrically. Health sectors activity is expected to rise as a frontline sector to respond to COVID-19 pandemic while most education institutions have been closed indefinitely. On education, private component of education providers could suffer lost incomes due to continued school and college closure. The response by the government here should maintain teacher salaries and physical facilities.

COVID-19 represents some opportunities for the health sector. The government may use this moment to enhance health facilities and medical supplies and ensure full rollout of the Universal Health Care (UHC) programme which is a part of the Big Four Agenda. Equally, the government should increase resources for to train health workers and directly support local manufacturing firms to increase production of medical and protective supplies.

1.6. Construction and Real Estate

Combined, construction and real estate sectors contribute at least Ksh. 1,200 billion to the GDP. The two sectors are key to the well being of the economy. Thus, a major contraction in these sectors could hurt the ability of the economy to effectively weather the storm. Preliminary information shows that the major effects on construction include shorter working hours, supply disruptions, but lower demand for housing for instance could follow within the next quarter.

Fading consumer confidence could therefore greatly affect the sector. Public housing could alternatively face financing challenges as the government uses scarce resources largely to deal with the scourge and respond to emergency interventions. The rental market is also likely expected to face headwinds associated with demand for rentals and diminished incomes of tenants.

Critical interventions are therefore required to mitigate delayed negative impact on construction and real estate. For the private sector firms the government can lead effort to keep the sectors operational and workers on payroll. Equally, concessional credit facilities to support construction activity may be considered within the next two months. While rent concessions would be applicable in some cases, especially for low income earners.

Housing is a part of the Big Four Agenda, and thus requires sustained support through the pandemic. The government should ringfence resources for provision of affordable and social housing for low income earners. These should be scaled to help replace the sprawling slums and congested estates.

1.7. Other productive sectors: ICT, Transport and Storage, others

Information communication and technology is a critical sector as an enabler to the performance of other sectors. The pandemics initial imputed impact on the sector appears insignificant but may be affected due to international supply disruptions. Still call, mobile data, and mobile money usage could rise strongly during this time. Given the sector may thrive during crisis, it can be seen as a possible area to pick up taxes during the crisis. The sector is greatly affected by enhanced social distancing measures but government can mitigate the harm to the sector through direct support and social support to affected workers in case of layoffs for a fixed period.

2.0 Policy Options: Intermediate Fiscal Package to Deal with the COVID-19 Economic Shocks

2.1. Tax Measures

i. **Approve the proposed 5 taxation measures (under the Income Tax, Value Added Tax and Turnover Tax): -** may occasion revenue loss of about **KSh. 122.3 billion** in 2019/20. In addition, the population of citizens who are not in gainful employment would miss out from these tax reliefs especially the ones relating to the income tax. In addition, the effects of COVID – 19 are likely to extend to 2020/21 and beyond implying that these taxation measures may be a bit long term and not stop gap measures.

ii. **Balance these taxation measures with expenditure reduction:** - a policy mix of balancing the likely revenue loss on account of these taxation measures with expenditure cuts would be ideal. The focus should be on expenditure rationalization on some development projects which are unlikely to be implemented under the current environment as well as recurrent expenditure that is obviously hampered by reduced government activities. This saving can then be channeled towards providing subsidies such as foodstuffs and cash to households to alleviating negative effects. This will benefit even the daily casual laborers who may not benefit from the income tax relief.

iii. **Introduce another taxation measure: -** in addition to the 5 taxation measures, some more others such allowing landlords not to charge rent for a specified period of time, and utilize the rent forfeited to offset for the residential rental income tax (RRIT). This would cushion the citizens especially at the lower end who will not benefit from the income tax relief due to the nature of their daily unpredictable wage earnings. Information obtained by the revenue agency through this exercise will also be highly valuable in enhancing tax administration endeavours in this front.

2.2. Financing Measures

i. On the financing side, the negative shock on taxation is expected requiring targeted expenditure restructuring (expenditure cuts), reorienting spending and debt restructuring. Notable areas of expenditure cuts include unnecessary non-wage recurrent spending, and non-core development spending.

ii. Debt restructuring, including the lengthening of debt maturities, should be considered immediately to limit principal debt service pressure.

iii. Given the impact of the revenue shortfall and widening deficit there will be need to reduce the overall government spending. Non-essential services in the recurrent expenditure should be revised downwards through the introduction of supplementary estimates in the National Assembly

iv. County governments should also contribute to the financial shortfall. The Division of the Revenue Act, 2019 and County Allocation of Revenue Act,2019 need to be amended to provide some resources

v. The resources under development budget need to be reoriented to support the production of essential medical items like ventilators and face masks this resources can be channeled to Rivatex, KIKONET factory in Kitui and the vehicle assembly industries in Thika

vi. The need to amend the Pensions and Employment Act, to provide for contracting, *flexi* working hours, outsourcing and layoffs as it will be necessary. Indeed there is evidence that the country is running with less than 50% of public servants

vii. The Country has had a bumper harvest in the agricultural sector, therefore the Government needs to purchase excess quantities and distribute to low income earners, especially the urban poor.

viii. Urgent need for a framework between the National Government and County Governments on the distribution of agricultural inputs including certified seeds and fertilizers

ix. Give incentives to the local manufacturing industries through tax rebates to compensate on criteria based on goods produced locally and this should be extended in the long term to make sure that the country does not import what it can produce locally. This will enhance local capacity.

Fiscal response to the pandemic in the coming three months should take the following strategic format:

a) Ministries, departments and agencies to absorb the full impact of revenue collection shortfalls amounting to **Ksh. 122 billion** in three months by implementing expenditure cuts in all discretionary areas such as travel, training and entertainment including suspending non-critical development spending.

b) New borrowing or other financing amounting to **Ksh. 150 billion** be raised to provide intermediate fiscal stimulus and social support to vulnerable populations. The fiscal stimulus funds should be allocated to the following activities:

   i. Protecting ongoing investments critical sectors which can help support economic activity and employment during the crisis. The key sectors include the in Big Four Agenda sectors such as affordable and social housing, manufacturing and food security (Agriculture); Allocate **Ksh. 40 billion** to stimulate these critical sectors through concessional credit facilities, loan guarantees, and immediate agricultural input subsidies.
   ii. Social transfers to vulnerable persons, laid off workers, and eligible self-employed persons in the informal sectors. Target initially Ksh. 4 million urban households in Kenya with a transfer to support food and other necessities: Ksh. **70 billion** in three months. Ministry of Interior and other agencies including local administration to identify beneficiaries.
   iii. Direct and indirect support to most affected sectors and businesses in form of payroll support and concessional interim credit facilities. The sectors include hotels, restaurants, and entertainment facilities, professional and support services, transport and storage, flower industry, and affected MSMEs in various sectors. Proposed **amount Ksh. 30 billion**.
   iv. Ringfence allocation to the health sector including enhancing the UHC programme. Allocate Ksh. 10 billion Expand the health sectors capacity to respond to disasters including employment of more staff, provision of facilities and support to local manufacturing firms to scale up medical and protective supplies. Allocate about Ksh. 10 billion to support this interim effort.

c) Debt restructuring: initiate debt restructuring talks. Any savings be channeled to deal with the pandemic and its future impact.

Schedule 1: Fiscal stimulus package to various sectors, businesses and persons

Sector	Target beneficiary	Delivery channel*
Affordable and social housing, manufacturing and food security (Agriculture)	Firms, Affordable housing program, farmers, flower firms	Agricultural input subsidies, market guarantees, loan guarantees, concessional loans, tax waivers
Social transfers to vulnerable persons, laid off workers, and eligible self-employed persons in the informal sectors.	Laid off workers, older persons and other vulnerable persons, self-employed (informal sector workers)	Direct bank transfers, mobile money transfers, food delivery, to eligible households.
Hotels, restaurants, and entertainment facilities, professional and support services, transport and storage, flower industry, and affected MSMEs in various sectors	Hotels, restaurant and entertainment businesses, flower firms, transport firms, most other affected MSMEs	Loans, loan guarantees, payroll support, tax rebates
Health: UHC, direct response to pandemic including health manufacturing firms	Hospitals, UHC programme, medical manufacturing firms	Budgetary allocation, concessional loans and loan guarantees, tax rebates