GREEN economy Kenya

Fiscal Policy Reforms

Background

According to the Green Economy Assessment of Kenya (UNEP, 2014), Kenya needs 135 billion KSh (approximately USD1.4 billion)[1] per year to finance its green investments, representing 9 percent of the expenditure of the whole public sector. Mobilizing these resources is a challenge with tax revenue, at 18% of GDP in 2013, below the Sub-Saharan African average of 22%. In addition, environmental protection, water and natural resources account for only about 5 percent of the total budget allocation. This suggests that there is a need to both raise tax revenues, expand fiscal space for environmental expenditure and mobilize additional resources for green economy investments. At the same time, any green fiscal approach needs to take into account the current governance structure in Kenya. A new Constitution was adopted in 2010, which transferred administrative, fiscal and service provision powers from the central government to forty-seven new counties. They will also have crucial environmental competences, including the provision of water, sanitation, refuse collection and disposal, and the protection of the physical environment.

Key Green Fiscal Policy Measures

Several green fiscal measures are currently being deployed in Kenya. For instance, a special levy on fuels is used to finance road infrastructure development through the Road Maintenance Fund. In 2012/13, the levy raised KSh 24.4 billion (about USD 250 million), which is the biggest source of environmental revenue. There are also VAT and excise duties on motor vehicles; user charges and fees for solid waste management and disposal; license fees in forestry and fisheries and various tariffs in the water and electricity sectors. The government is also promoting clean energy through feed-in-tariffs (FiTs), subsidized electricity connection rates, VAT exemptions, and public investment. By December 2014, renewable energy accounted for 68 percent of the 2,173MW of total installed electric power generation capacity, suggesting that the incentives put in place are having an impact.

Options for Expanding Fiscal Space for Green Investments

- The current low level of oil prices presents a good opportunity for fuel tax reform in Kenya, in order to promote low-carbon energy alternatives. For instance, in the transport sector, corrective taxes on diesel and gasoline could help counter the externalities associated with their use, namely global damages linked to emissions of Greenhouse Gases; damages from local air pollution deriving from emissions of other gases, such as nitrogen oxide (NOx) and sulfur dioxide (SO2); traffic congestion; traffic accidents and road damages. If corrective taxes were set to fully reflect global, local and other externalities, the tax on gasoline would be set at USD 0.450 per liter and the tax on diesel would be USD 0.326 per liter, corresponding to an increase of the tax burden of 32.4 % for gasoline and of 57.1% for diesel. Such increases in taxes would generate revenues of about KSh 8,9 billion (USD 90 million) for gasoline and KSh17.5 billion (USD 182 million) for diesel, an increase of 29% and 54% in tax revenues respectively.

1. Based on an exchange rate of 1KSh: 96 USD, as report on the website of the Kenya Central Reserve Bank on 15 May 2015: https://www.centralbank.go.ke/

UNEP

- The distributional impact of higher taxes is highly progressive, implying that the proposed reform will impact more heavily on the richest quintiles of the population. However, indirect effects of tax increases could adversely impact the bottom quintiles, so an appropriate compensation scheme should follow. The cost of compensation could range from KHS 42.8 million (USD 445,000) to KHS 476 million (USD 4.95 million). The additional revenues collected from the tax increases could be used to defray the cost of the cash transfers.

- In 2012, commercial reserves of petroleum were discovered in Turkana County, Northern Kenya and production is expected to begin in 2017/18. Revenues from sales of oil as well as various taxes and fees imposed on oil companies are a potential source of financing environmentally related investments, while ensuring maximum returns and addressing associated externalities. For instance, oil spills, gas flares and effluent discharge are common externalities of oil extraction, storage and transportation. The estimated yearly revenue accruing to the government from oil revenues is expected to vary from USD 156 million, with a low oil price and low reserves, to USD 1, 06 billion with a high oil price and high reserves. The following three options for the use of oil and gas revenues could be considered :

  a) Sharing part of the rent with subnational governments to defray local expenses due to exploration and production. The Energy Bill mandates the allocation of 20% of oil revenue to counties in production areas but the allocation could range from USD 31.6 million to 212 million, with huge fluctuations associated with price variations. An alternative option would be to remunerate regional governments (presently only Turkana, but possibly other regions in the future) for the full cost of infrastructure and services they provide. In this way, the 20% share could increase and could be linked to production in the case of low oil prices, thereby limiting the impact of oil price fluctuations on revenue.

  b) A Sovereign Wealth Fund for targeted green investment. A Sovereign Wealth Fund Bill was drafted in 2014 to establish a Sovereign Wealth Fund (SWF) for recently discovered oil and other minerals in Kenya. Medium- and long-term investment by the Fund could be useful in supporting green economy objectives. The SWF is capitalized by discretionary allocations from the central government, with a minimum yearly deposit of 5% of government proceeds. To make the SWF viable, a much higher minimum deposit rate could be considered. Assuming that 50% of the central government take, after deduction of the 20% allocation to sub-national governments mentioned in a) above, goes to the SWF, the Fund would accumulate approximately USD 6.3 billion over 30 years. Moreover, assuming that investment revenue (net of management costs) is equal to withdrawals, the Fund would generate revenue amounting to USD 250 million, less than USD 5 per inhabitant depending on population growth.

  c) A Stabilization Fund. A Stabilization Fund could ease problems associated with fluctuation of oil revenues in Kenya, while helping to improve the efficiency of spending. The Fund would require rules on deposits and withdrawals, as well as caps and/or thresholds on their reserves. In line with international good practice, formulas could be used to determine the amount that is transferred into the Fund. To avoid political interference, the transfer of money should be automatic.

In addition to the measures mandated in the Energy Bill, as outlined above, the government could also consider direct cash transfers to its citizens to ensure they share in the country's oil wealth. These transfers could reach a yearly universal allocation of USD 14 per capita with a low reserves scenario and to USD 23.5 per capita with a high reserves scenario.

Ways Forward

Fiscal reforms in the energy and oil sectors in Kenya could open a path to expand fiscal space for environmental expenditure and mobilize additional resources for green economy investments. The current low level of oil prices presents a good opportunity for such reforms. In order to mitigate the distributional impact of reforms, however, appropriate compensation measures need to be put in place. In particular, strategic use of oil revenues will not only determine maximum benefits, but also catalyze Kenya's ambition to implement its Green Economy Strategy and Implementation Plan.