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An Evaluation of Economic Strategies in Budget Deficit Reduction in Kenya

Dr Gongera Enock George * Robert Mindila* Simion Nyakwara* Barrack O. Ouma*
School of Business and Public Administration, Mount Kenya University
P.O BOX 19501- 00100 CODE- 00100 GPO, NAIROBI, KENYA

Abstract
Budget deficits have attracted a great deal of attention over the past few decades. This is so because financial experts have blamed it on all assortments of ills that beset developing countries. Some of these ills include: high inflation rates, over indebtedness, loss of a country's sovereignty, crowding out of the private sector among others. In spite of its various attempt to widen the tax base and the numerous austerity measures to cut down on its recurrent expenditures, the Kenyan government like most of the other developing countries has over the years been a perpetual casualty of budget deficit. The purpose of this study was therefore to evaluate the economic strategies measures that the Kenyan government may put in place in order to reduce budget deficit.

Specifically the research addressed how; tax policy, Inflation, technological innovation and government expenditure affects reduction of budget deficit in Kenya. The research will be of great significance to: the Kenyan Government, future scholars as well as the government of other countries with deficit budget. The research design adopted for the study was descriptive research design; the population was the 33 tax seniors in the 5 leading audit firms in the country namely PKF Kenya, Deloitte & Touché, KPMG, Ernst & Young Kenya and Price Water House & Coopers Kenya. Census method of sampling was adopted for selecting elements under study. Moreover both primary and secondary methods of data collection were used to collect data and the results thereon analyzed using Minitab version 17 and presented in form of: tables, charts, graphs and inferential statistics.

The response rate from the questionnaires issued was 76% and most of the respondents asserted that the tax policy and the government expenditure were the main causes of the persistent budget deficits in Kenya and a number of recommendations were put forth on how best to address the same, among the recommended measures to deal with the tax policy included; widening the tax base to capture the juakali sector, revamping of the turnover tax system, more stringent measures to ensure compliance and a total overhaul of the VAT system which still has a very big growth potential. On the issue of government expenditure it was recommended that the numerous austerity measures that have over the years been proposed by the various Finance Bills be strictly adhered to so us to cut down on the avoidable public expenditures and equally the government to utilize concessional loans that have zero interest rates so as to cut down on interest repayments on its loans. Moreover the researcher found out that inflation was heavily contributing to the budget deficit in Kenya hence recommendable that the government initiates various fiscal and monetary policies to contain inflation to manageable levels. The researcher further recommended that investment in information technology be expedited as through it, KRA will be in a position to bring more persons in the tax net and consequently widen the tax base and equally fasten the tax collection process and facilitate various audit by the authority.

Key Words: Economic strategies, Budget deficit in Kenya

1. INTRODUCTION

1.0 Background of the Study

In historical terms, the term Budget isn't a relatively new invention. Its origin lies in centuries of monarchs and mismanagement of the country's finances. However, it was not until the early 18th century that a version of the annual Budget emerged. The origins of the word Budget lie in the term "bougette" - a wallet in which documents or money could be kept. While at first referring only to the Chancellor's annual speech on the country's finances in the United Kingdom, the word quickly became used for any financial statement or plan (Thomas, 2010).

Historically, the government of Kenya has suffered budget deficits since independence which is mainly attributed to expenditures falling short of government revenues due to limited budgetary Resources brought about by low economic performance, among other causes. Budget deficits have contributed to the weak economic performance, by accumulating the high public debt and the associated high interest rates (Eli, 2010). According to George (2009) reducing budget deficits has for long been at the core of many economies and this is as a result of its negative consequences such as, high inflation arising mainly from increased money supply by the government to pay off debt, over indebtedness from increased borrowings that has resulted to huge amounts of both principal and interest repayments, decreased sovereignty as a result of impositions of Structural Adjustment Programmes (SAP) by donors and crowding out of the private sector as a result of increased domestic borrowings, all of which have resulted to slowed economic growth in most developing countries. Miller (1983) points that budget deficit in all cases (whether monetized or not) lead to generate inflationary pressure in the economy. By analyzing the relationship between budget deficit and inflation in different countries, Fisher (1989) found that the countries with high inflation have strong relationship among inflation and budget deficit. Further high inflation has reducing effect on tax revenue which is known as Tanzi-Olivera Effect. Also, high rate of inflation increases budget deficit by declining revenue as noted by (Shabbir & Ahmed, 1994)

The imbalance between public spending and public revenue in Turkey according to Yabal, Baldemir et al (2004) whose outcome was the imbalance between public spending and public revenue in Turkey, highlighted that when the government finances budget deficit by using short term advance money, this results in the money supply to increase which results in inflation to go up and they concluded that high budget deficit leads high inflation in Turkish Economy. Solomon and Wet (2004) on the other hand found a strong positive relationship between inflation and budget deficit in Tanzania. They stated that budget deficit has a significant effect on inflation. They also concluded that developing countries should give more importance to inflation because inflation tends to be affected from many economic shocks such as high budget deficit. Therefore, inflation should be controlled by efficient fiscal policies. Agha et al (2006) equally did find that inflation in Pakistan is mainly attributable to unsustainable budget deficit and financing of deficit through the banking system from printing of new money and creating interest-bearing debt affects the general price level.

Moreover, while examining the relationship between tax revenue and budget deficit in Latin America countries Tanzi (2000) found that in Latin American countries the budget deficit and public deficit increase even after rise in the tax revenue. He observed that this imbalance results from the deficient and inefficient social programs. Vieira (2000) on the other hand examined the relationship between budget deficit and inflation for six major European countries. The author provided a little support for the proposition that budget deficit has been an important contributing factor to inflation in these economies over the last 45 years. On the contrary, where evidence exists of a long-run relationship between inflation and deficits, this evidence is more consistent with the view that it was inflation that contributed to deficits, rather than the reverse. Cevdet (2001) examined the long-run relationship between inflation rate, budget deficit, and real output growth. They conclude that changes in the consolidated budget deficit have no permanent long run effect on the inflation rate and Public Sector Borrowing Requirement (PSBR) from banks does have a long-run relationship with inflation rate.

The Kenyan government just like many other developing countries has for the past several years been a perpetual casualty of budget deficit. But studies reveal that the government has in the past adopted several and diversified strategies aimed at reducing the budget deficit and consequently attain surplus. Among the strategies include: measures to widen the tax base and various austerity measures to cut down on its recurrent expenditures some of these measures include: entitlement to only one official vehicle which should be less than 1800cc to the ministers and their assistants, reduction of overseas travel allowances to senior government officials, holding on of purchase of new vehicles and furniture's and reduction in budget allocation for: hospitality, printing & advertising and other low priority sectors as evidenced in the Finance Bills of 2010 & 2011.

1.1 Statement of the Problem

Budget deficits have attracted a great deal of attention over the past few decades mainly due to the negative consequences such as: high inflation as a result of increased money supply by the government to pay off debt, over indebtedness from increased borrowings that has resulted to huge amounts of both principal and interest repayments, decreased sovereignty as a result of Structural Adjustment Programmes (SAP) by donors and crowding out of the private sector as a result of increased domestic borrowings, all of which have resulted to slowed economic growth in most developing countries

In spite of the numerous austerity measures and the various attempts to widen its tax base, the Kenyan government like most of other developing countries counterparts has over the years been a perpetual casualty of budget deficit, with the 2010/11 budget hitting an all time high of 1.16 trillion with a deficit of 6.8% of the gross domestic product PKF (2012).Moreover with the implementation of the new constitution the budget is with no doubt likely to rise given the recent budget estimates of kshs 1.8 trillion for the financial year 2012/3, thus an urgent need to address the issue of how best to finance the budget, hence the need for this study.

2. LITERATURE REVIEW

2.0 Introduction

Traditionalists argue that a reduction in the budget deficit will significantly help the economy in the long run. This theory is based on the following logic. When the government runs a budget deficit, it is spending more than it is taking in. In this way, national savings decreases. When national savings decreases, investment-the primary store of national savings-also decreases. Lower investment leads to lower long term economic growth. Similarly, lower investment contributes to higher domestic interest rates, which decreases net exports. Based on this logic, a budget deficit is a drain on the long-term economy (Rother, 2004)

2.1 Tax Policy and Budget Deficit

Kisuu (2011) argues that for Kenya to eliminate budget deficit its imperative that it widens its tax base and he notes that the VAT system in Kenya is still an unexplored goldmine that that can generate billions of shillings in revenue if well structured. Here he argues that for the Kenyan government to realize the full potential of its VAT system, it's imperative that it adopts a unitary VAT system the way countries like Newzealand have.

Debbie (2009) notes the following to be some of the two main economic and social justifications for a higher level of government spending and borrowing: Government borrowing can benefit economic growth, that is budget deficit can have positive macroeconomic effects in the long run if it is used to finance extra capital spending that leads to an increase in the stock of national assets. For example, higher spending on the transport infrastructure improves the supply-side capacity of the economy promoting long-run growth and increased public-sector investment in health and education can bring positive effects on labour productivity and employment. The social benefits of increased capital spending can be estimated through use of cost-benefit analysis.

PKF Kenya (2012**)** notes the following to be some of the major contributors of budget deficits in Kenya: Corruption both within and without the government, unwarranted public expenditure by the government, Inability of KRA to hit its targets and the high non compliance rate among the tax payers and it further asserts that unless urgent and practicable steps are taken to address the above the issues budget deficit is here with us to stay.

Njeri (2011) on the other hand asserts that in spite of the numerous efforts by the government to eradicate budget deficits the same is yet to be realized and this could be attributed to the high level of corruption within the government together with non compliance by tax payers which is actually estimated to be at 60% and thus advises that urgent measures need to be taken to address the two issues.

2.2 Inflation and Budget Deficit

Chaudhary and Ahmad (1995) found that domestic financing of the budget deficit, particularly from the banking system, is inflationary in the long run. The results provide a positive relationship between budget deficit and inflation during acute inflation periods of the seventies. They also found that money supply is not exogenous; rather, it depends on the position of international reserves and fiscal deficit and it has emerged as an endogenous variable. The general conclusion is that the execution of monetary policy is heavily dependent on the fiscal decisions made by the government. In order to control inflationary pressure, government needs to cut the size of budget deficit. Ndungu (1995) investigated the link among the fiscal deficit, inflation and money supply on one hand and money supply and inflation on the other hand. He found that for the Keynesian economy budget deficit affects growth of monetary base and money supply affects interest and hence inflation

Institute of Economic Affairs (2010) notes the following to be the four basic methods of financing a budget deficit: The creation of currency, this is when the Central Bank holds part of the newly issued debt, thereby monetizing it, and it ends up in the hands of the public as freshly printed money or in bank vaults as excess reserves. Secondly is financing through raising reserve requirements, that is, when banks are made to hold additional required reserves in the form of cash balances with the Central Bank, or eligible government securities, Thirdly is through domestic open-market borrowing, when government debt is voluntarily held by the banks or the public for the interest it pays and lastly is through foreign borrowing where the national government borrows from abroad.

2.3 Government expenditure and budget deficit

In general, increase in government expenditure will increase fiscal deficit if revenue is not generated in the same proportion. However, there are other reasons also due to which government expenditure can increase budget deficit even after raise in tax revenue as Gondolfo (2001) noted that in Latin American countries budget deficit and public deficit increase even after rise in the tax revenue due to deficient and inefficient social programs. Ironically, Eli (2010) found that high inflation leads to decrease in tax revenue in crisis time and low level of tax revenue leads to tax loss which leads to high budget deficit. Further, Egeli (2000) stated that increasing public spending leads to increase in budget deficit and thus concluded that this disequilibrium results from governments' wrong policies such as using borrowing in order to finance the deficit.

2.4 Research Gap.

From the foregoing literature most of the research done on budget deficit have mainly aimed on addressing the adverse effects of budget deficit in the economy whilst pointing out the main variables that contributes to the same but none clearly came out to specifically outline how the aforementioned variables could be addressed and its thus under that particular backdrop that the researcher through this project gives the probable solutions to the aforementioned variables in as far as the Kenya context is concerned.

3. RESEARCH METHODOLOGY

3.0 **Research Design**

The research adopted a descriptive research design. The researcher considered this design as appropriate as it provided in-depth insights into effective measures that the Kenyan government should put in place in order to combat budget deficit. The target Populations was 33 Tax Managers in the five leading audit firms in Kenya namely: PKF Kenya, Deloitte & Touché, KPMG, Ernst & Young Kenya and Price Water House & Coopers

Kenya. The researcher adopted census method on sampling where all the thirty three (33) tax managers in the five leading audit firms in Kenya were selected for the study. This was so because the five firms have international reputation and the recommendations provided by their tax managers were likely to be more agreeable by most scholars. The researcher conducted data cleaning, which involves identification of incomplete or inaccurate responses, which was corrected to improve the quality of the responses. The researcher adopted both quantitative and qualitative approaches to data analysis. The data obtained from respondents was coded and analyzed with the aid of Mini tab v.17. The data collected was then analyzed using descriptive as well as inferential statistical tools mainly through the Pearson correlation analysis.

4. RESEARCH FINDINGS AND DISCUSSIONS

4.0 Research Findings

4.1 G.O.K expenditures and the persistent budget deficit

Table1: G.O.K expenditures and the persistent budget deficit

Do you agree that the GOK's Expenditure is to blame for the persistent Budget Deficit?	No.	%
Strongly Agree	16	68
Agree	2	8
Neither Agree nor Disagree	5	20
Disagree	1	4
Strongly Disagree	0	0
Total	30	100.0

The study further sort to establish whether the G.O.K expenditure was to blame for the persistent budget deficit.74% of the respondents agreed that the expenditure levels were to blame with 68% strongly agreeing.20% were indifferent and 4% disagreed.

Table2: Austerity measures and G.O.K expenditures

Do you think the numerous austerity measures placed by the G.O.K to cut on its expenditures are adequate in addressing the issues of budget deficit	No.	%
Yes	5	20
No	14	56
Neutral	6	24
Total	25	100.0

56% of the respondents believed that the austerity measures taken so far by the G.O.K to cut down on its expenditure and consequently combat budget deficit weren't adequate while, 24% were neutral and a further 20% were of opinion that the austerity measures were adequate.

4.3 Discussions

This section discusses the results of the research as reported above together with the literature review with an aim of answering the research questions and consequently providing recommendations in chapter five

4.4 Tax Policy and Budget Deficit

Table3: Correlation between Tax policies and budgetary deficit

		Tax Policies
Margin of budget deficit	Pearson Correlation	.444*
	Sig. (2-tailed)	.026
	N	25

A positive correlation exists r = 0.444 between responses on the rating on budget deficit, and the extent of tax policies in the country, significant at $p < 0.05$. This implies that those who cited bigger budget deficit in the country also cited that tax policies were not adequately implemented. Therefore tightening the tax policies still present opportunities for bridging the gap in budgetary deficit by the government of Kenyan argument which is supported by Debbie (2004) who conducted a study on the relationship between tax policies and government deficit in Kenya and concluded that the tax policy in the country was mainly to blame for the persistent budget deficit and that there still existed a lot of unexploited areas in as far as the tax policy was concerned. Further the tax policy was blamed for the perpetual budget deficit with most people blaming the narrow tax base and compliance issues as the main areas that lack depth in as far as tax policies are concerned. The researcher further sought to find out the measures that could be put in place in order to reduce and consequently eliminate low tax compliance in the country and it emerged that a whopping 81% believed that reduction in the various tax rate would be the panacea towards increased tax compliance in the country,

Still on the tax policy and widening the tax base, the researcher further to sought to establish whether the VAT system was an unexplored goldmine in as far as revenue collection in Kenya was concerned and 80% of the respondents concurred with the assertion an outcome that conformed to the argument of Kisuu (2011) where he observed that the VAT system still has great revenue collection potential and further advised that Kenya should adopt a low and uniform VAT rate just as countries such as Newzealand and here he argued that this will not only increase tax collection through the widening of tax base but equally as a result of decreased tax defaults as most investors will find this rates favorable thus default rates will decrease and thus recommends an introduction of a standardized VAT rate of 12% and zero rating only for exports. He further supports his argument by giving a classical example of NewZealand where a decreased rate of VAT from 18.5% to 12.5% tripled VAT collection in less than two years.

4.4 Inflation and Budget Deficit

Table4: Correlation between inflation and government's budgetary deficit

		Margin of budget deficit
Level of inflation in the country	Pearson correlation	.440*
	Sig. (2-tailed)	.028
	N	25

The researcher equally sorts to establish weather inflation contributes to the persistent budget deficits in Kenya. A significant positive correlation existed between responses on the level of inflation in the country and the margin of budget deficit r = 0.44, $p<0.05$. This implies that the current high levels of budgetary deficits according to the respondents could be attributed to the high levels of inflation in the country. Therefore, managing inflation to low levels could translate to decline in budgetary deficits. An argument that is supported by PKF (2012) which argued that high rates of inflation that have resulted to increase in commodity prices and consequently resulting to high government expenditure thus the persistent budget deficits.

The researcher went ahead to further establish whether the government was doing enough to curb inflation and an 84% majority asserted the government was not doing enough to address the inflation issue and blamed: the constantly weakening of the shillings against major currencies, overreliance on rain fed agriculture, the ever increasing international oil prices, lack of constructive macro and micro economic policies to counter inflation among other causes among other causes being the main reasons for the increased inflation rates.

4.5 Information technology and budget deficit

To establish whether investing in information technologies could be used in increasing government revenue collection and thus cutting down budgetary deficits, Pearson correlation was done on the respondent's opinion on the current investment in technology and the prevailing budgetary deficits.

Table5: Correlation between technology and budgetary deficits

		Margin of budget deficit
Whether investing in information technology can facilitate combating budget deficit	Pearson Correlation	.335*
	Sig. (2-tailed)	.102
	N	25

Based on respondents view on weather the government can be in a position to increase revenue collection and consequently combat budget deficit through investment in information technology a correlation analysis between variables revealed a positive though not significant relationship $r = .335$, $p < 0.05$. This implies that the current high budgetary deficit could be attributed to the poor income tracking systems in place. Therefore, if implemented well technology could be used as an avenue to minimize budgetary deficits.

4.6 Government Expenditure

Lastly, the study further sort to establish whether the government expenditure was to blame for the persistent budget deficit, 74% agreed to it and further asserted that lack of the government implementing the numerous austerity measures to the letter were mainly to blame for the ever escalating budget deficit.

Table6: Relationship between Government expenditure and budget deficit

		Margin of budget deficit
Government Expenditure	Pearson Correlation	.425*
	Sig. (2-tailed)	.034
	N	25

As indicated on table 4.11 majority of the respondents (68%) strongly agreed that uncontrolled government expenditure was to blame for the high level of budgetary deficits. A correlation analysis between rating on government expenditure against the rating on margin of budgetary deficit revealed $r = 0.425$, $p< 0.05$, Indicating that a positive and significant relationship existed. The high levels of budgetary deficits could be attributed to the increased government expenditure thus decline in government expenditure could also be accompanied by decreased budgetary deficit. Therefore control of government expenditure could be used as a budgetary deficit control measure. An argument that conformed to Njeri (2011) who blamed lack of stringent adherence to the numerous austerity measures brought fourth by the various finance bills as being to blame for the continued increase in government expenditure thus persistent budget deficit.

5. SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.0 Summary of Findings

On the issue as to whether tax policy was to blame for the persistent budget deficit, 92% agreed to that fact stating that there were various avenues which were yet to be explored so as to widen the tax base. Equally the issue of tax compliance which is currently being put at a meager 43% was blamed for the persistent budget deficit with 64% of the respondents blaming it on the high taxation rates in the country while 12% of the respondents blamed it on lack of stringent punitive measures among the policy makers. There was a general consensus among the respondents regarding the measures to be put in place to curb the issues on non compliance with 81% majority stating that the tax rates got to be reviewed downwards with the other 12% stating that more punitive measures need to be put in place to address the same. Moreover 84% of the respondents believed that VAT system in Kenya still has a big growth potential with most of the respondents stating that by the GOK adopting a single and low VAT rate and zero rating for exports only being one of the surest way for reaping its full benefit.

Furthermore 84% majority of the respondents agreed that inflation was to blame for the government efforts in combating budget deficits thus an urgent need for the government to come up with policies to address it as 86% of the respondent noted that the government was not doing enough to curb the vice. Regarding the issue of weather investing in IT would facilitate combating of budget deficit,68% of the respondent agreed to that fact alluding that this will not only help in curbing corruption but equally facilitating the various audits by Kenya Revenue Authority by ensuring all needed reports are available in time. However 75% majority noted that the GOK wasn't doing enough in as far investing in IT is concerned with 64% of the respondents attributing this to laxity among the policy makers and 20% on the huge costs involved in the acquisition of both the hardware and soft wares.

Moreover 76% of the respondents agreed that the uncontrolled government expenditure was to blame for the persistent budget deficit and a further 59% stated that the numerous austerity measures so far taken to cut down on government expenditure haven't been effective and thus an urgent need to ensure that the austerity measures were addressed to the letter. Still on government expenditure the researcher noted that a lot more needed to be done to address the underlying conditions such as: inflation, constantly weakening shillings against major currencies, the ever increasing world petroleum prices to be the contributors to the huge government expenses.

5.1Conclusion

In conclusion it can be noted that there are quite a number of measures that the government of Kenya needs to put in place to reduce budget deficits. And these measures are in regard to: tax policy, inflationary management and conditioning strategies, investing in information technology and government expenditure as noted in the above literature.

5.2 Recommendations

From the foregoing findings its apparent that a lot need be done in reducing the budget deficit, long term budget deficit strategies should be implemented. As pertains to compliance issues, the researcher recommends that more stringent measures be put to deal with the defaulters, KRA to increase its compliance exercises by carrying out more routine audits which can be facilitated by the deployment of more audit officers. Equally on the VAT issue, its recommended that the government adopt a low and single VAT rate of around 12% and zero rating to be granted only for export, a factor that will not only facilitate revenue collection as a result of increased tax base but also decreased default as a result of more compliance.

The government should take practicable measures to address the ever rising inflation as this was found to be one of the contributors to budget deficit and thus recommended that the government initiate various fiscal and monetary policies to contain inflation to manageable levels. On the weakening shilling against the major currencies and the appreciating international oil prices that have resulted to increased commodity prices and consequently government expenditures, it's advisable that the government consider adapting the fixed exchange rate system so as to check on forex fluctuations and equally consider undertaking forward contracts with the oil dealers so as to cushion itself against adverse price movements.

The researcher further recommends that investment in information technology be expedited as through it, KRA will be in a position to bring more persons in the tax net and consequently widen the tax base. Investment in IT will equally fasten the tax collection process and facilitate various audits by the authority. On the issue of government expenditure the researcher further recommends that the numerous austerity measures being initiated by the government be strictly adhered to as some were being neglected thus curtailing attainment of their initially intended purpose.

5.3 Area for Further Research

With the introduction of the county system of governance in Kenya which was brought in through the promulgation of the new constitution on the 27th of August 2010, the researcher recommends that a detailed study be carried out to establish the effect this will have on the overall income and expenditure of the government on Kenya's fiscal budget.

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