REVENUE WAIVERS AND NATIONAL ECONOMIC PRESSURES

The Hidden Cost of Tax Expenditures in Kenya

TWNAfrica

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LIST OF ACRONYMS

CIT: Corporate Income Tax

EPZ: Export Processing Zones

GDP: Gross Domestic Product

KNBS: Kenya National Bureau of Statistics

KRA: Kenya Revenue Authority

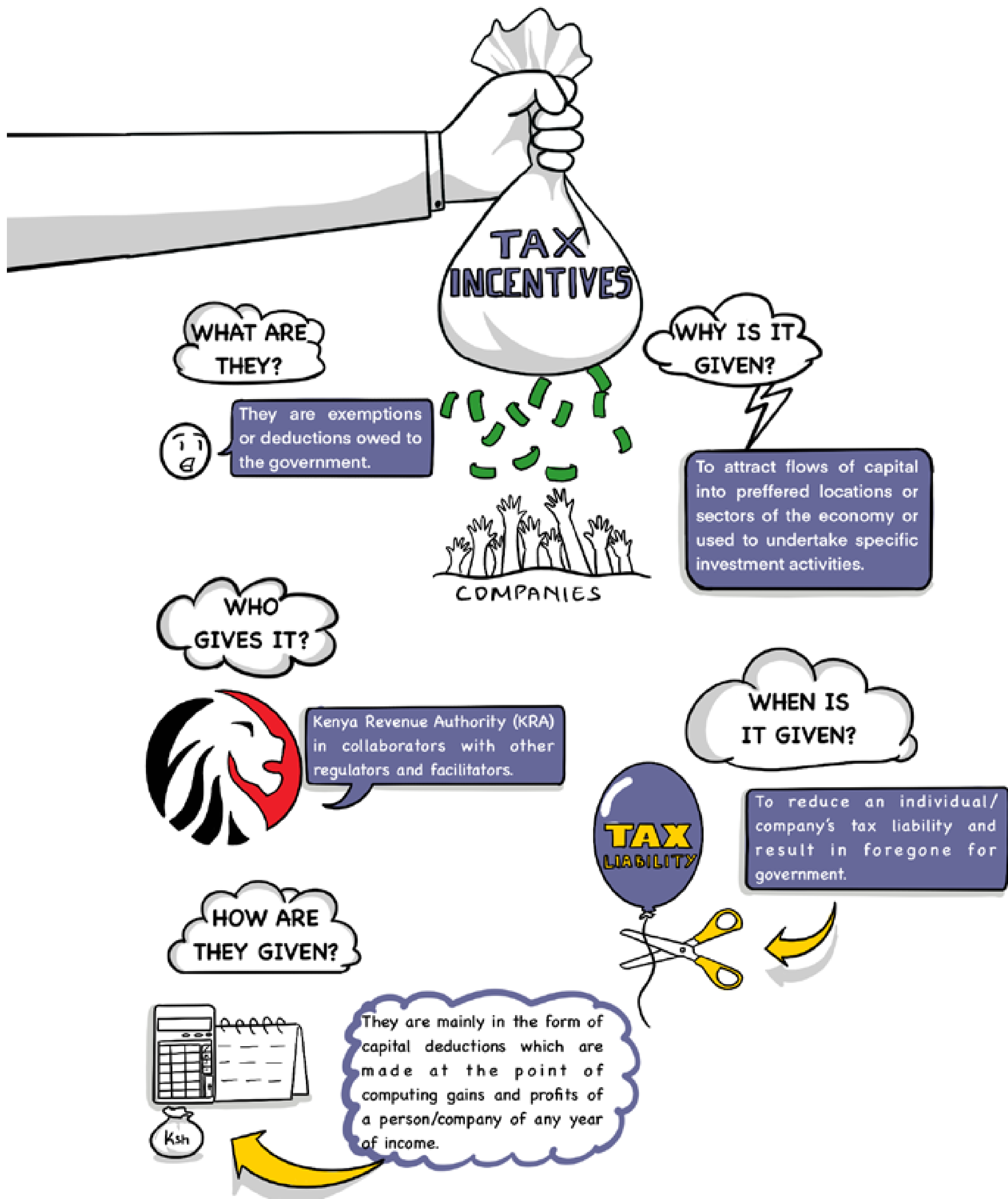
MNCs: Multi-National Corporations

PIT: Personal Income Tax

SEZs: Special Economic Zones

VAT: Value Added Tax

SECTION ONE: INTRODUCTION



1.1. Background and Rationale for the Study

With the support of the Third World Network (TWN), Tax Justice Network Africa (TJNA), the East African Tax Governance Network (EATGN), and Africa Centre for People Institutions and Society (ACEPIS), commissioned research on Kenya's Tax Expenditures Framework and its implications on tax base erosion. The research was premised on the understanding that tax expenditures can be an appropriate tool when used to provide broad-based economic benefits. However, when used too frequently and ineffectively, or for purposes where direct government spending would be more appropriate, they can result in excessive loss of revenue to the detriment of national economic development.

The study set out to assess Kenya's tax expenditures by considering increasing concerns over their implications on the country's revenue base; lack of transparency in administration of tax incentives; and questions over the opportunity cost of tax waivers in Kenya - considering the lurking public debt problem in the country. This to generate credible information on the efficacy and prudence of Kenya's tax expenditures considering the current fiscal situation. This to inform advocacy efforts for a more just, equitable, and progressive tax regime in the country.

1.2. Methodology

Based on reviews of several frameworks on the analysis of tax expenditures, the study focused on the elements of transparency, accountability, efficiency, adequacy, and equity. Due to significant data limitations, the study leveraged on information from the National Treasury report on Kenya's tax expenditures released in 2021 as a key source of study data.[1]

The research utilized a mixed methods approach in data collection which entailed desk research and participatory consultative methods. The desk research entailed exploring existing grey literature such as economic surveys, reports, academic papers and publications from Kenya National Bureau of Statistics (KNBS), the National Treasury, Kenya Revenue Authority (KRA) plus other Ministries, Departments, and Agencies (MDAs) related to tax incentives and their implications on tax base erosion. The consultative approach involved Key Informant Interviews (KII) and a Multi-Stakeholder Consultative Forum convened on March 16, 2022 to gather views from diverse stakeholders on the implications of tax expenditures in Kenya.[2]

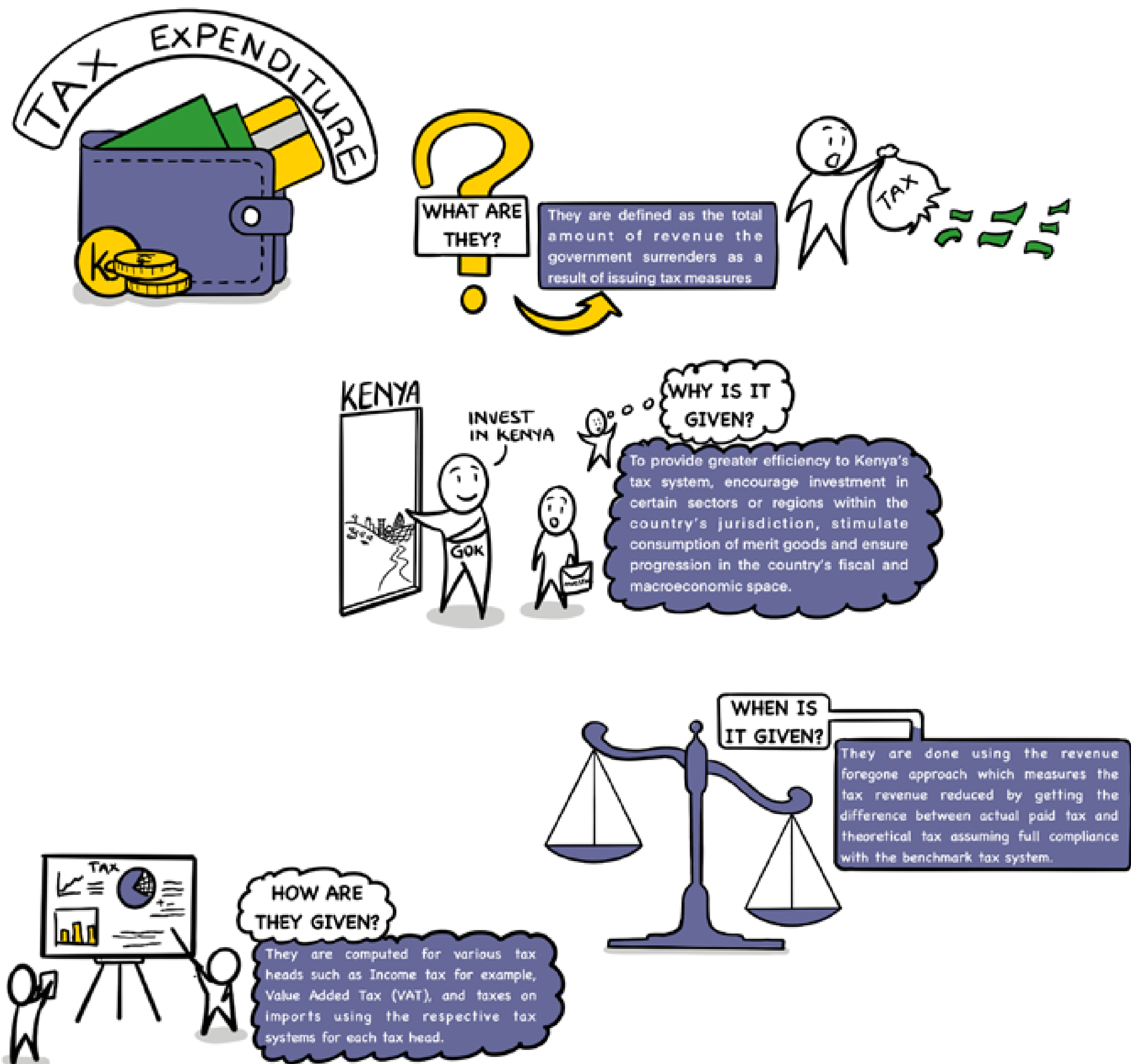
The consultative forum was organized in workshop style congregating 52 participants (20 women and 32 men) drawn from various stakeholder categories including government (Treasury, KRA, and Controller of Budget), civil society, academia, and media. The forum focused on assessing Kenya's framework for tax expenditures and specifically interrogating the 2021 Tax Expenditure Report released by The National Treasury. The forum pursued an economic justice perspective considering transparency, accountability, equity, efficiency, and adequacy guided by a review of several tax expenditure analysis frameworks.

1. GOK (Government of Kenya), *Kenya Tax Expenditure Report 2021*, Ministry of Finance – National Treasury and Planning, https://www.treasury.go.ke/wp-content/uploads/2021/09/2021-Tax-Expenditure-Report.pdf
2. ACEPIS (Africa Centre for People, Institutions and Society) and EATGN (East African Tax and Governance Network), *A Consultative Forum Report on Assessing Kenya's Tax Expenditures and Its Impact on Tax Base Erosion*, March 2022

1.3. Limitations to the Study

The initial aim of the study was to conduct rigorous analysis to determine prudence of the current? Framework of tax expenditures applied by the national treasury. Nonetheless, it encountered substantive data challenges that limited holistic analysis and assessment of the framework for tax expenditures in Kenya. This included lack of access to information on the beneficiaries of various tax incentives and disaggregated data on tax expenditures that are necessary for a rigorous analysis on the efficiency and equity of tax expenditures.

These limitations were offset by use of correlative analysis and utilisation of sector-wide consultations with experts, government agencies, and media accounts. Case studies were also applied in order to utilise examples that could explore and distil emerging issues. The study examined tax expenditures in Kenya by assessing transparency, accountability, and adequacy. But due to data limitation, the study focused its assessment of efficiency and equity on examining tax expenditures in selected sectors, namely: manufacturing, agriculture and construction.



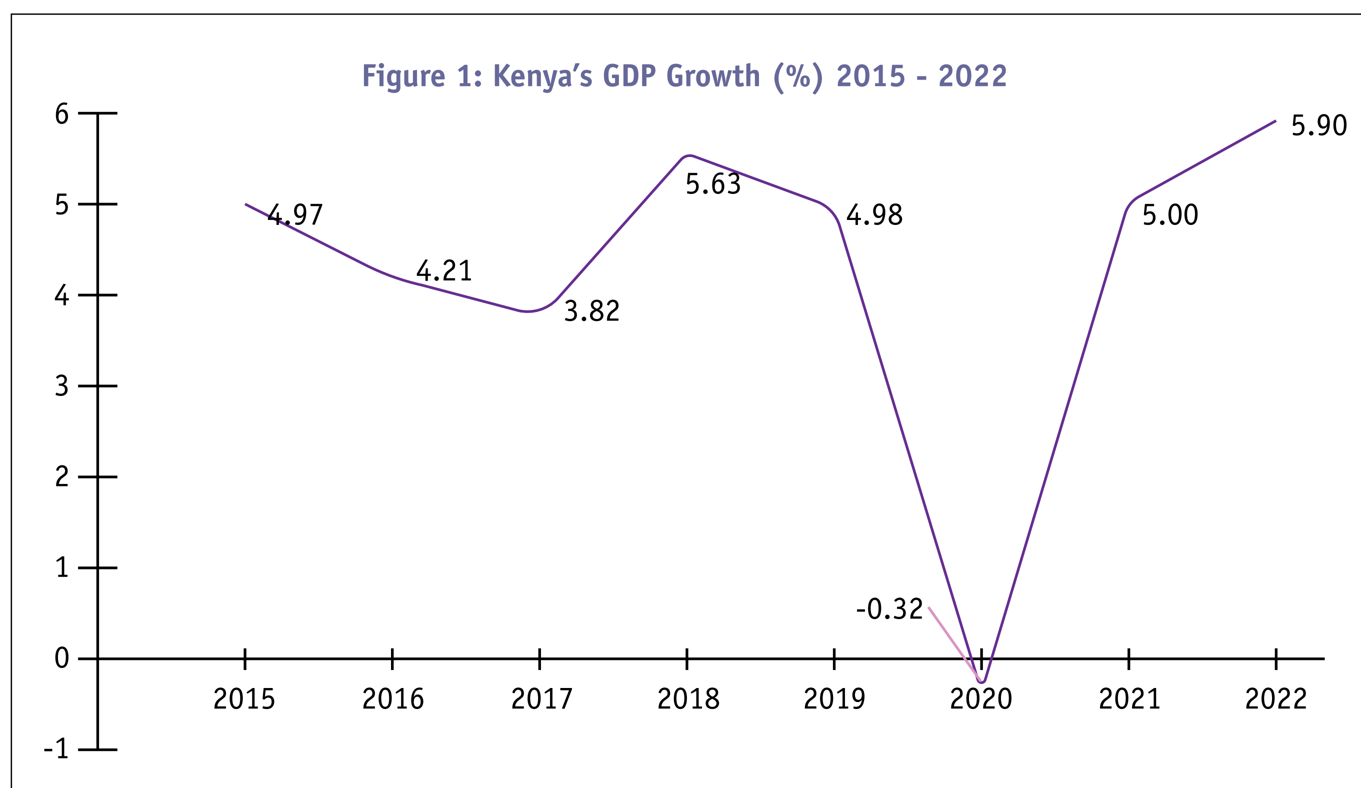
SECTION TWO: THE ECONOMY IN CONTEXT

2.0. Overview of Kenya's Economy

Over the past decade, Kenya has made economic and political reforms that have contributed to economic growth, social development, and political stability. The Constitution of Kenya, 2010 (COK,2010) ushered in a new economic and political governance structure, that introduced a bicameral parliament, devolved county governments, a constitutionally tenured judiciary, and new electoral body. Ongoing public infrastructure projects, strong public or private sector investment, appropriate economic and fiscal policies have supported the continued economic growth.[3]

2.1. Growth Trends

Economic growth between 2015 and 2019 averaging 4.7% was believed to have substantively contributed to reduction of poverty. The growth decline in 2017 is attributed to a prolonged drought that hindered national agricultural output, declining access to credit for private sector (constricting economic activity), and the 2017 election-related uncertainty that reduced private sector investment. A rebounding tourism sector, strong public investment, and relatively low oil prices encouraged growth.[4]



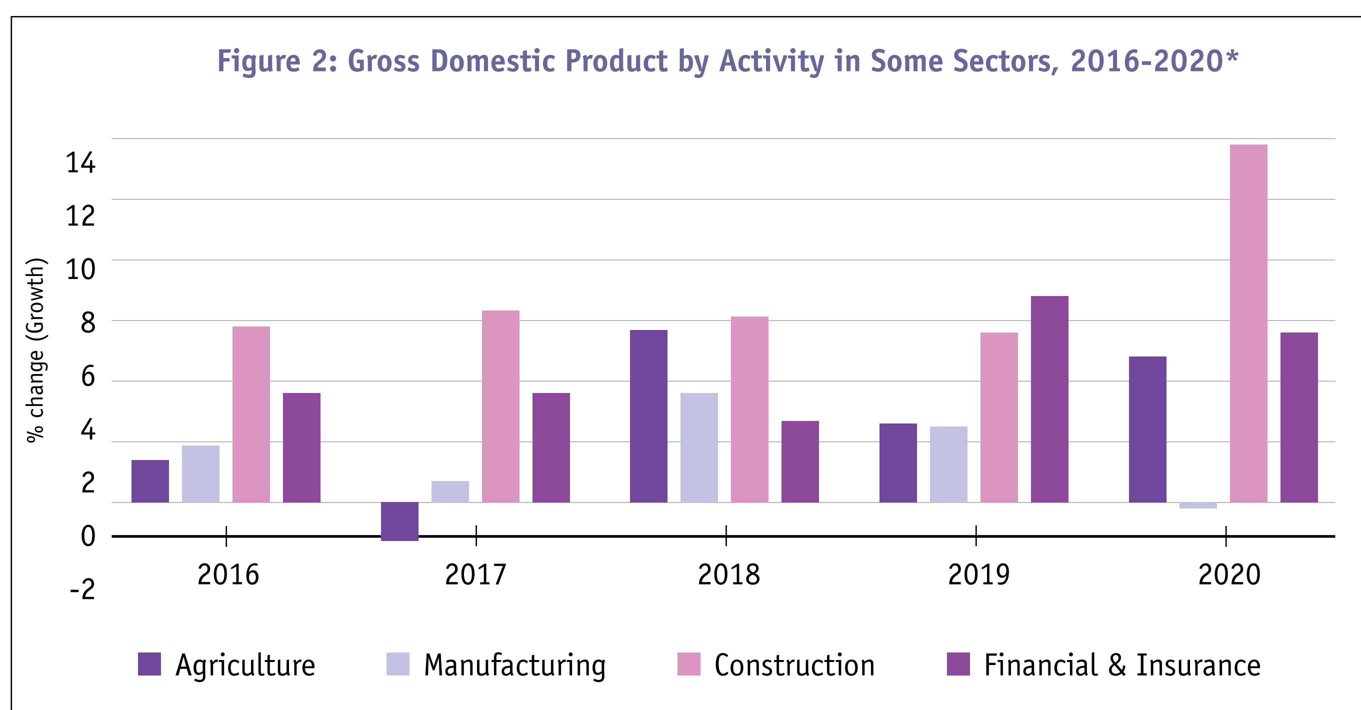
Source: World Bank

3. WB (World Bank), *Kenya Overview,* 03 October 2022 https://www.worldbank.org/en/country/kenya/overview#1
4. WB (World Bank), *Kenya's GDP Growth Slumps in 2017, but can Rebound over the Medium-Term*, 7 December 2017, https://www.worldbank.org/en/news/press-release/2017/12/06/kenyas-gdp-growth-slumps-in-2017-but-can-rebound-over-the-medium-term

The economic rebound in 2018 is credited to the recovery of the agricultural sector, bouncing back of industrial activities steadily after the 2017 general elections, and improved performance of the service sector. The recession in 2020 is a result of the Covid-19 pandemic that impacted economies globally.[5] The ban on international flights hampered international trade and tourism. Containment measures instituted locally by the government such as the curfew and movement restrictions also significantly reduced economic activities.

Nonetheless, the agricultural sector remained resilient in 2020, helping to limit the contraction in GDP to only 0.3%. A significant economic recovery has been ongoing in 2021 and 2022, with an annual growth of 5% and 5.9% forecasted in respective years. Although tourism has remained under-pressure post-pandemic, there have been increased agricultural harvests, a recovery in the global demand, a resumption in international travel that is to reach full capacity, and a broad-based recouping of the manufacturing sector. These factors are together projected to contribute to improved growth in GDP.

Figure 2: Gross Domestic Product by Activity in Some Sectors, 2016-2020*



Source: KNBS

The agriculture sector registered mixed growth over the past five years. As shown in Figure 2, the sector's performance has mainly been affected by fluctuating weather conditions, pests, and drought which have hampered output. However, productivity worsened in 2017 due to the armyworm invasion. Improved performance in 2018 and 2020 was due to favourable weather conditions which enhanced production of crops and livestock. Nonetheless, the output of some key food crops such as maize was lower than expected partly due to the underperformance of the short rains as well as reduced demand from restaurants and learning institutions that remained closed for the better part of 2020 due to the Covid-19 pandemic.[6]

5. AFDB (African Development Bank) *African Economic Outlook 2021-From Debt Resolution to Growth: The Road Ahead for Africa,* https://www.afdb.org/sites/default/files/documents/publications/afdb21-01_aeo_main_english_complete_0223.pdf
6. KNBS (Kenya National Bureau of Statistics), *Economic Survey 2021,* https://www.knbs.or.ke/wp-content/uploads/2021/09/Economic-Survey-2021.pdf

The manufacturing sector experienced fluctuating growth patterns attributed to varied performance in key subsectors such as food processing and motor vehicle production. Activities in the manufacturing sector declined in 2017 and 2020 mainly due to reduced production of food products, beverages and tobacco, leather and related products. Furthermore, reduction in demand occasioned by the Covid-19 pandemic exacerbated the situation in 2020. The sector's positive growth in 2016, 2018, and 2019 is mainly on account of increased production of agricultural products, motor vehicles, and pharmaceuticals.[7]

Growth has been on an upward trend in the construction sector from 2016 through 2020. This has been occasioned by continued investment in road infrastructure by the government and increased construction activities in the housing subsector. The building and construction sector also experienced a credit growth of 3.4% that further boosted investment and overall growth in the sector.[8]

In 2020, real gross value added for the financial and insurance sector expanded by 5.6% compared to 6.9% growth in 2019. Between 2016 and 2020, Treasury and Central Bank of Kenya (CBK) introduced various accommodative monetary and fiscal policies that cushioned the financial sector from the impacts of Covid-19 pandemic. These included reduction of income tax and value-added tax rates, lowering of turnover rate, reduction of the Central Bank rate, and asking banks to renegotiate loan terms and restructure loans for borrowers facing difficulties.

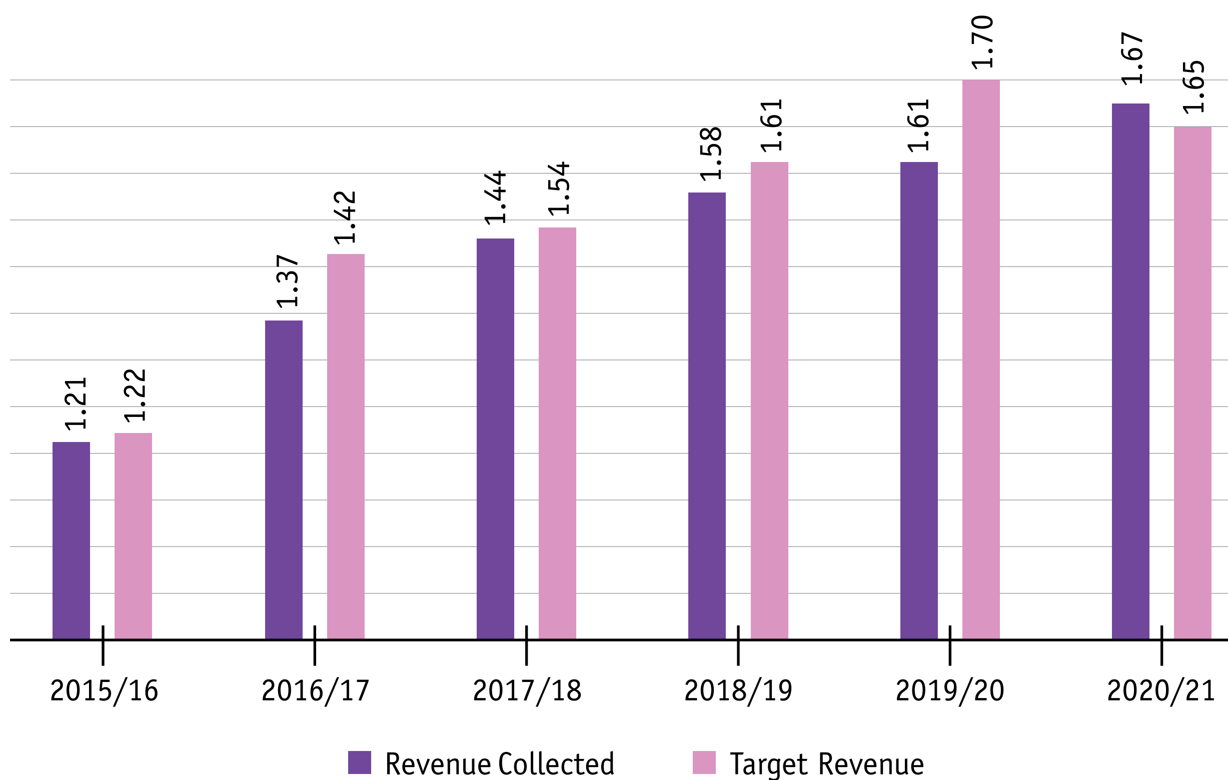
In 2020 and 2021, as a result of job losses occasioned by the pandemic, insurance sector experienced declining investment returns and gross premiums paid. The pension sector also experienced similar reductions in returns on investment and pensions contribution and rising risk scores. Whilst serving to mitigate the adverse socio-economic and financial impact of the Covid-19 pandemic, the measures also came at a cost as the government lost on revenue.[9]

2.2. Trends in Government Revenues

Tax revenues collected by the KRA have been increasing over the years. The revenue collected increased by 38% between FY2015/16 and FY2020/21. Figure 3 illustrates the trends in tax revenues between FY2015/16 and FY2020/21. Despite the sustained increase in revenue collected, the authority has consistently missed set revenue targets outlined in annual Budget Policy Statements (BPS).

However, KRA surpassed its revenue collection target by raising Ksh. 16.81 billion in FY2020/21. The performance was attributed to various factors, including expansion of the tax base as outlined in KRA's 7th corporate plan[10] and increased return from energy, agriculture, and construction sectors.[11] The National Treasury estimates that revenue collection for FY2021/22 will be between Ksh. 1.67 Trillion and Ksh. 1.75 Trillion.

7. *Ibid*
8. *Ibid*
9. CMA (Capital Markets Authority), CBK (Central Bank of Kenya), IRA (Insurance Regulatory Authority) , RBA (Retirement Benefits Authority), and SASRA (Sacco Societies Regulatory Authority), *Kenya Financial Sector Stability Report*, September 2021, https://www.ira.go.ke/images/docs/2021/new/2021/Kenya-Financial-Sector-Stability-Report-20202.pdf
10. KRA (Kenya Revenue Authority), *7th Corporate Plan*, https://www.kra.go.ke/images/documents/7th-Corporate-Plan-FA-Online-version-min.pdf
11. Mwita M., 'KRA surpasses 2020/21 revenue target', *The Star*, 5th July 2021, https://www.the-star.co.ke/business/kenya/2021-07-05-kra-surpasses-202021-revenue-target/

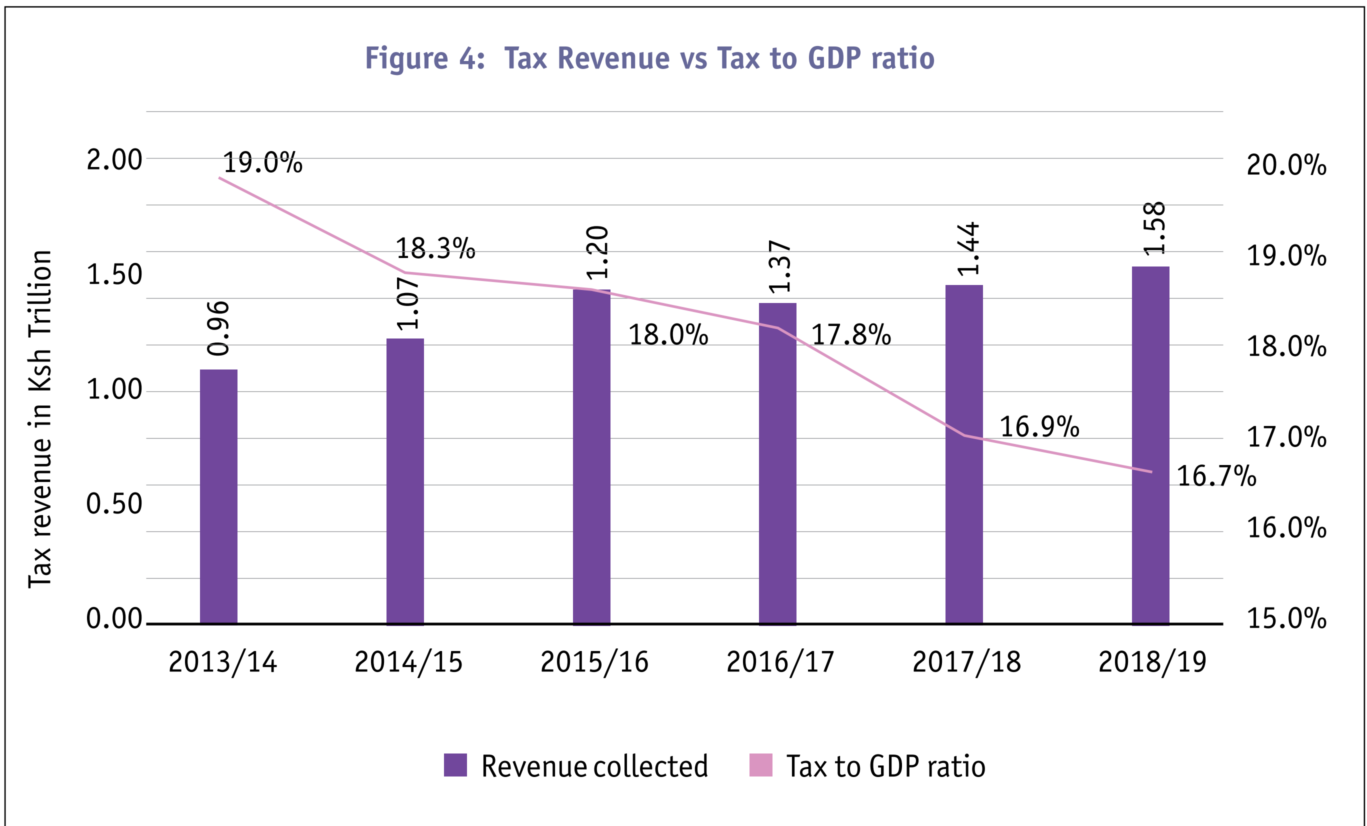


Source: Kenya Revenue Authority

Also, Kenya's tax to GDP ratio has been declining despite the sustained increase in revenue collection, implying that the revenue being collected is not proportional to the overall economic output. According to KRA, the decline in tax to GDP ratio between FY2013/14 and FY2018/19 is attributed to shrinking of the tax base due to a shift in Kenya's economic structure to that which favours non-taxable components of GDP, discretionary policy changes, and sharp increase in tax exemptions or remissions.[12]

The steep decline in FY2017/18 is attributed to underperformance of corporation tax as a result of interest rate capping for banks. The decline in tax to GDP ratio further indicates that for nearly a decade, the government has been missing revenues despite expansion of the economy. There is room for the National Treasury and KRA to seal leakages or explore tax policy reforms to increase revenue collection that can meet the resource demands for country's development objectives espoused in the Vision 2030.

12. KRA (Kenya Revenue Authority), *2018/19 Annual Revenue Performance Report*, https://www.kra.go.ke/images/publications/Revenue-Performance-Report-2018-19.pdf



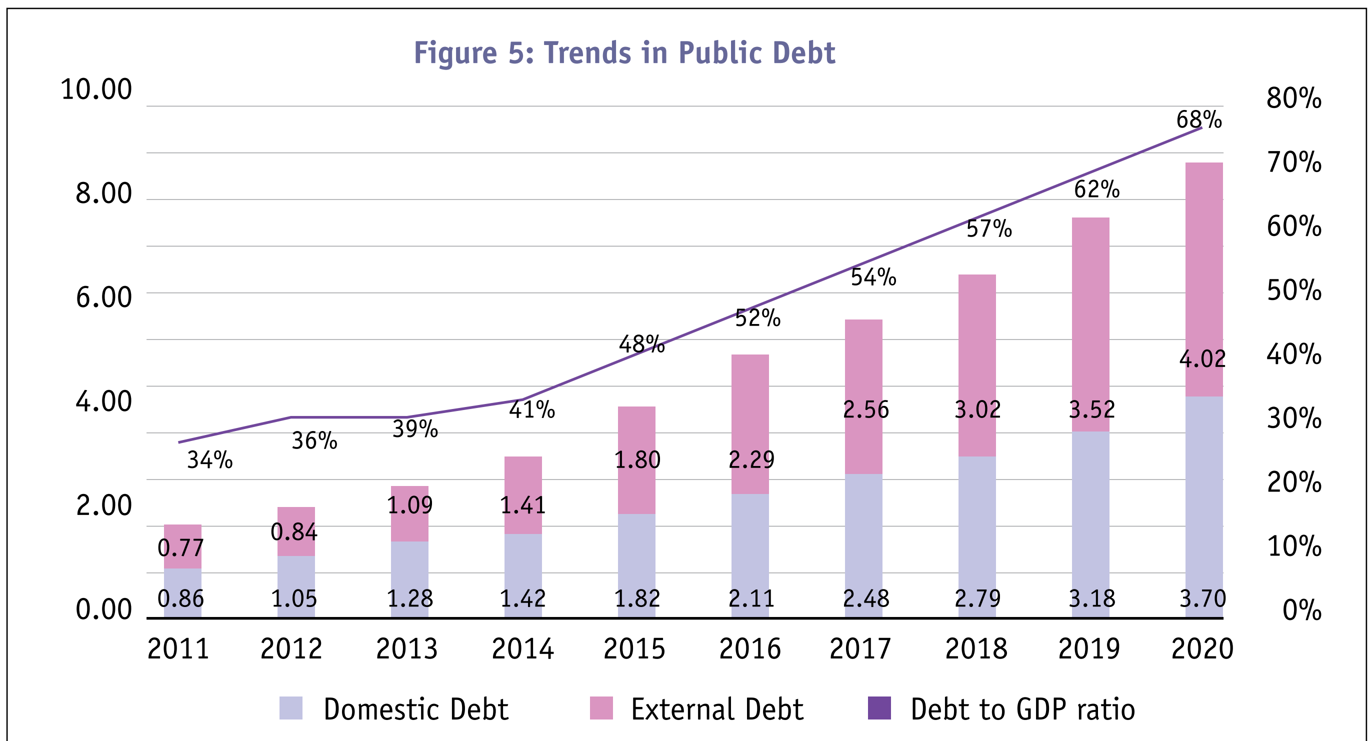
Source: Kenya Revenue Authority

2.3. Public Debt in Kenya

While there has been an increase in tax revenues over the years, revenue collected has been inadequate when compared to public sector expenditures. This has resulted in budget deficits which have been exacerbated by annual increases in recurrent expenditure – salaries and wages, Consolidated Funds Services and the expenses for general maintenance and operations of government. Budget deficits have been largely financed through government borrowing. In addition to obtaining loans to offset the revenue shortfalls, the government has also been borrowing to finance mega development projects, especially infrastructure development.

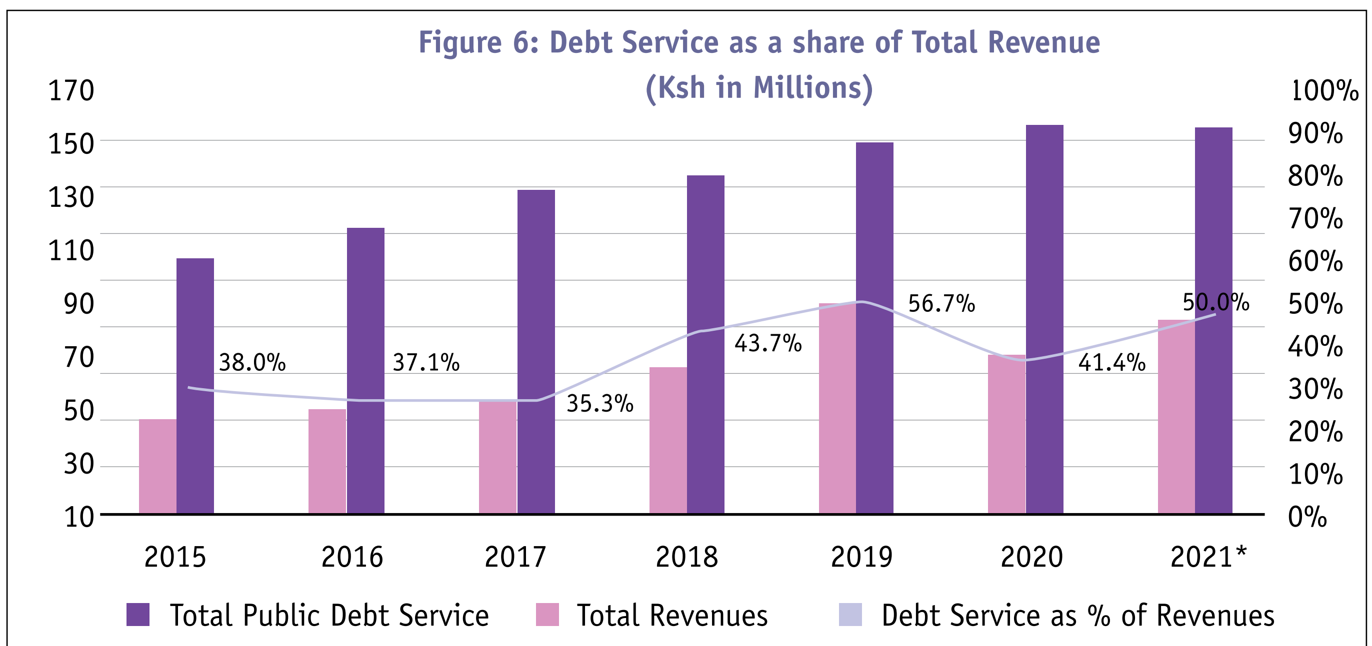
Fiscal deficits are expected to persist due to projected increase in large infrastructure-related expenditure, debt servicing and critical expenditures such as implementation of the economic recovery strategy plus other national election-related expenditures. Borrowing to offset fiscal deficits plus infrastructure-related expenditures has seen Kenya's public debt portfolio and debt repayment obligations exponentially rise over the past decade. The debt portfolio rose from Ksh. 1.4 Trillion in June 2011 to Ksh. 8.2 Trillion in December 2021.[13] Public debt currently makes up 88.9% of the Ksh. 9 trillion debt ceiling established by Parliament. The Parliamentary Budget Office (PBO) forecasts that the debt stock will range between Ksh. 8.6 trillion and Ksh. 8.8 trillion by June 2022, and exceed Ksh. 10 trillion by the end of 2024.[14]

13. CBK (Central Bank of Kenya), *Weekly Bulletin*, 2022, https://www.centralbank.go.ke/uploads/weekly_bulletin/1122846145_Weekly%20CBK%20Bulletin%20March%2018%202022.pdf
14. PBO (Parliamentary Budget Office), *Unpacking of the 2022 Medium Term Debt Management Strategy,* December 2021, http://www.parliament.go.ke/sites/default/files/2021-12/2022%20MTDS%20Unpacking.pdf



Source: The Central Bank of Kenya

A joint debt sustainability analysis conducted in 2020 by the International Monetary Fund (IMF) and World Bank categorized Kenya at a high risk of debt defaulting, with the current debt-to-GPD ratio standing at 68%.[15] Kenya's debt carrying capacity assessment was also revised from strong to medium.[16]



Source: The National Treasury

15. Njoroge P., *Kenya's Public debt Status – Presentation to the Senate Committee on Finance and Budget,* CBK (Central Bank of Kenya), 15 September 2021, https://www.centralbank.go.ke/uploads/presentations/1505218058_Presentation%20to%20the%20Senate%20Committee%20on%20Kenya%27s%20Public%20Debt.pdf
16. IMF (International Monetary Fund), *Kenya Requests for An Extended Arrangement Under the Extended Fund Facility and An Arrangement Under the Extended Credit Facility – Debt Sustainability Analysis,* 19 March 2021, https://www.imf.org/-/media/Files/DSA/external/pubs/ft/dsa/pdf/2021/dsacr2172.ashx

Figure 6 illustrates debt servicing costs as a percentage of total revenues. It is estimated that debt servicing will make up 65% of total revenues collected by the financial year 2023/2024. Debt servicing costs have been increasing over the years as the loans come to mature. This has been exacerbated by weakening of the Kenyan Shilling. The shilling is also expected to depreciate further owing to enhanced demand for imports, relatively weak exports of some agricultural products, slow recovery of the tourism sector, continued servicing of external debt and the uncertainty of international investors owing to the 2022 elections. The increasing recurrent expenditure coupled with increased debt servicing costs point to the need for a more efficient and fair tax strategy to increase revenue collection by KRA.

SECTION THREE: A PRIMER ON TAX INCENTIVES AND EXPENDITURES IN KENYA

3.0. Conceptualising Tax Incentives

Tax incentives are exclusions, exemptions or deductions from taxes owed to government. They are inducements that aim to attract flows of capital into preferred locations or sectors of the economy or used to undertake specific investment activities.[17]

Tax incentives, therefore, reduce an individual or company's tax liability and result in foregone revenue for government. Tax incentives take different forms and can be classified into two; (i) profit-based incentives which minimise taxes on income and (ii) cost-based incentives which reduce the cost of capital. Profit-based incentives include tax exemptions, tax holidays, tax deferrals, tax allowance, special economic zones, and financing incentives while cost-based incentives include investment allowances, tax credits and investment tax credits, capital allowances and depreciation rules.[18] The different types of tax incentives are discussed in the box 1.

Box 1: Typical Tax Incentives

Tax Exemptions are the removal of tax from certain goods or services offered by an organisation. Tax exemptions can be made on Value Added Tax (VAT), Import duty, Excise duty and tariffs.

Tax allowance and Investment allowance is the deduction of a certain fraction of an employee's pay check or of an investment from income tax and taxable profits respectively.

Tax credit and Investment tax credit is a special deduction against total payable tax or corporate income tax otherwise payable earned as a fixed percentage of qualifying income tax or investment expenditures.

Tax Deferrals are when taxpayers delay paying taxes to some point in the future. Some taxes can be deferred indefinitely while others may be taxed at a lower rate in the future.

Tax Holidays are temporary exemption windows where new firms are not required to pay corporate income tax for a specified time with the goal of encouraging investment. Tax holidays can take the form of i) being completely exempt from paying taxes on the firm's profits and ii) reduced tax rates

Special economic zones are geographically limited areas in which investors enjoy tax privileges not granted in other parts of the country.

Financing incentives are the reductions in tax rates applying to fund providers.

Accelerated depreciation is depreciation at a faster schedule than available for the rest of the economy. This can be implemented in different ways, including a higher first year allowance, or increased depreciation rates. Total tax payments in nominal terms over time are unaffected, but their net present value is reduced, and the liquidity of firms is improved.

17. FTC (Financial Transparency Coalition), Norad, APMDD (Asian Peoples' Movement on Debt and Development), Christian Aid and TJNA (Tax Justice Network Africa), *Use and Abuse of Tax Breaks: How Tax Incentives Become Harmful*, 15 January 2020, https://financialtransparency.org/reports/31710/
18. Klum A., Causes, 'Benefits and Risks of Business Tax Incentives', *IMF Working Paper*, Fiscal Affairs Department, January 2009, https://www.imf.org/external/pubs/ft/wp/2009/wp0921.pdf

KRA is the government agency responsible for assessment, collection, and accounting of all revenues in Kenya. It implements the issuance of fiscal (tax) incentives in collaboration with other regulators and facilitators such as the Capital Markets Authority (CMA), Export Processing Zones Authority (EPZA) - for issuance of the EPZ incentives - among others as provided under the Income Tax Act. The legal basis of issuing tax incentives within Kenya's fiscal space is provided for by (i) Section 77 of the Public Finance Management (PFM), 2012 (which outlines the powers of the Cabinet Secretary to waive or vary tax, fees, or charges), (ii) Article 201 of the Constitution of Kenya (which guides all aspects of public finance in the Republic of Kenya (including matters transparency and accountability) and (iii) Article 210 of the Constitution of Kenya (which outlaws carrying or waiving of taxes and licensing fees without legislation).

The preferential tax treatments offered to a select group of taxpayers serve as a fiscal policy tool and intervention within Kenya's macroeconomic framework. They are mainly in the form of capital deductions (such as tax holidays, credits, investment allowances, exemptions, import tariffs/custom duties, deferral of tax liability or preferential tax rates) which are made at the point of computing the gains or profits of a person/ company for any year of income.

These incentives are issued to contribute to the following conditions[19]: (i) the creation of employment for Kenyans, (ii) acquisition of new skills or technology for Kenyans, (iii) contribution to tax revenues or other government revenues, (iv) a transfer of technology to Kenya, (v) an increase in foreign exchange, either through exports or import substitution, (vi) Utilization of domestic raw materials, supplies, and services, (vii) adoption of value addition in the processing of local, natural and agricultural resources, and (viii) utilization, promotion, development and implementation of information and communication technology.

Table 1 identifies tax incentives that exist within Kenya's fiscal and macroeconomic framework.

19. KRA (Kenya Revenue Authority), Website: Investing in Kenya, https://www.kra.go.ke/ngos/incentives-investors-certificate/investing-in-kenya/incentives-investors-certificate

Table 1: Tax Incentives in Kenya[20]

Tax Incentive		Description
Capital Allowances	Wear and Tear allowances	Wear and tear allowances are charged on capital expenditure on machinery and equipment where they are classified into five classes all of which are offered the allowances at different rates.
	Industrial Building Deduction	This is an allowance granted to an investor who incurs capital expenditure on a building used as an industrial building at the rate of 10% of the cost
	Investment Deduction	This is a deduction granted on cost of a building and machinery installed therein as an incentive to encourage investments.
	Farm-works deductions	This deduction is a capital allowance granted to a farmer who incurs capital expenditure on the construction of farm works at the rate of 100% of the cost.
Telecommunication Sector		An investor in the telecoms industry who incurs capital expenditure on telecommunications equipment purchased and used by him in business is entitled to a straight line deduction at the rate of 20% of such cost.
Computer Software		An investor who incurs capital expenditure on the purchase of the right to use a computer software used by him in business is entitled to a straight line deduction at the rate of 20% of such cost.
Special Economic Zones (SEZ)		Capital expenditure on buildings and machinery for use in a SEZ is entitled to investment deduction equal to one hundred percent of the capital expenditure. Corporate taxation at rate of 10% for first 10 years and 15% for the next 10 years.
Export Processing Zones (EPZ) Incentives		A 10-year corporate income tax holiday is available to certain designated enterprises that undertake activities consisting the manufacture of goods for exports only (under the EPZ) and a 25% tax rate for a further 10 years, 100% investment deduction on new investment in EPZ buildings and machinery, and 10-year withholding tax holiday on dividends and other remittances to non-resident parties (except for EPZ commercial license enterprises)
Incentives for Newly Listed Companies		For newly listed companies, there are preferential corporate tax rates dependent on the percentage of listed shares

20. *Ibid*

Tax Incentive	Description
Incentives through Double Tax Agreement (DTA)	Where there is a negotiated DTA between Kenya and any other state, there are usually concessionary tax rates on various categories of payments
Exemptions on VAT	This is granted to Donor Funded projects upon recommendation by National Treasury, Diplomats (DA 1s) upon recommendation by Cabinet Secretary (CS) for Foreign Affairs and privileged persons e.g. the Kenya Defence Forces
Mortgage Relief	Any person who borrows money from a registered financial institution to purchase a home or to improve a home as long as he/she occupies the home, will be entitled to an interest deduction of up to a maximum of Ksh 300,000/= per annum of interest paid to the approved and registered financial institutions
Insurance Relief	Any life insurance cover taken by an individual on self, spouse or child will qualify for relief at a rate of 15% of the premium paid up to up to a maximum of Ksh 60,000/= per year. An education policy with a maturity period of at least 10 years qualifies for relief in the same manner
Home Ownership Savings Plan (Hosp)	An individual will be entitled to relief/deductions on funds deposited under a registered Home Ownership Savings Plan subject to a maximum of Ksh 8,000/= per month or Ksh 96,000/= per year for 10 years. Any interest income earned by a depositor on deposits of up to a maximum of Ksh 3 million shall be exempt from tax
Retirement Benefits Savings	Contributions to a registered retirement benefits scheme is tax deductible to a maximum of Ksh 20000 pm or Ksh 240000 pa. First Ksh 600,000 of lump sum upon withdrawal of benefits and Ksh 25000 monthly pension received from such scheme is tax-free

3.1. Tax Expenditures in Kenya

In Kenya tax expenditures are defined as the total amount of revenue that government foregoes as a result of issuing preferential tax measures (tax incentives).[21] Calculation of tax expenditures in Kenya is done using the revenue forgone approach which measures the amount of tax revenue reduced by getting the difference between the tax actually paid (as a result of the tax expenditure) and the theoretical tax assuming full compliance with the benchmark tax system (BTS).

Kenya's tax expenditures as a percentage of GDP are comparable to those of different African countries. Between 2015 and 2020, tax expenditures as a percentage of GDP in Kenya have averaged 4%. This is compared to an average of 3.2% in Uganda and 5% in South Africa as shown in Table 2. It is however important to note that comparison of tax expenditures between different countries is difficult due to varying benchmark tax systems and contexts.

21. GOK (Government of Kenya), *2021 Tax Expenditure Report,* Ministry of Finance – National Treasury and Planning, September 2021, https://www.treasury.go.ke/wp-content/uploads/2021/09/2021-Tax-Expenditure-Report.pdf

Table 2: Tax Expenditures in Different Countries as a Percentage of GDP

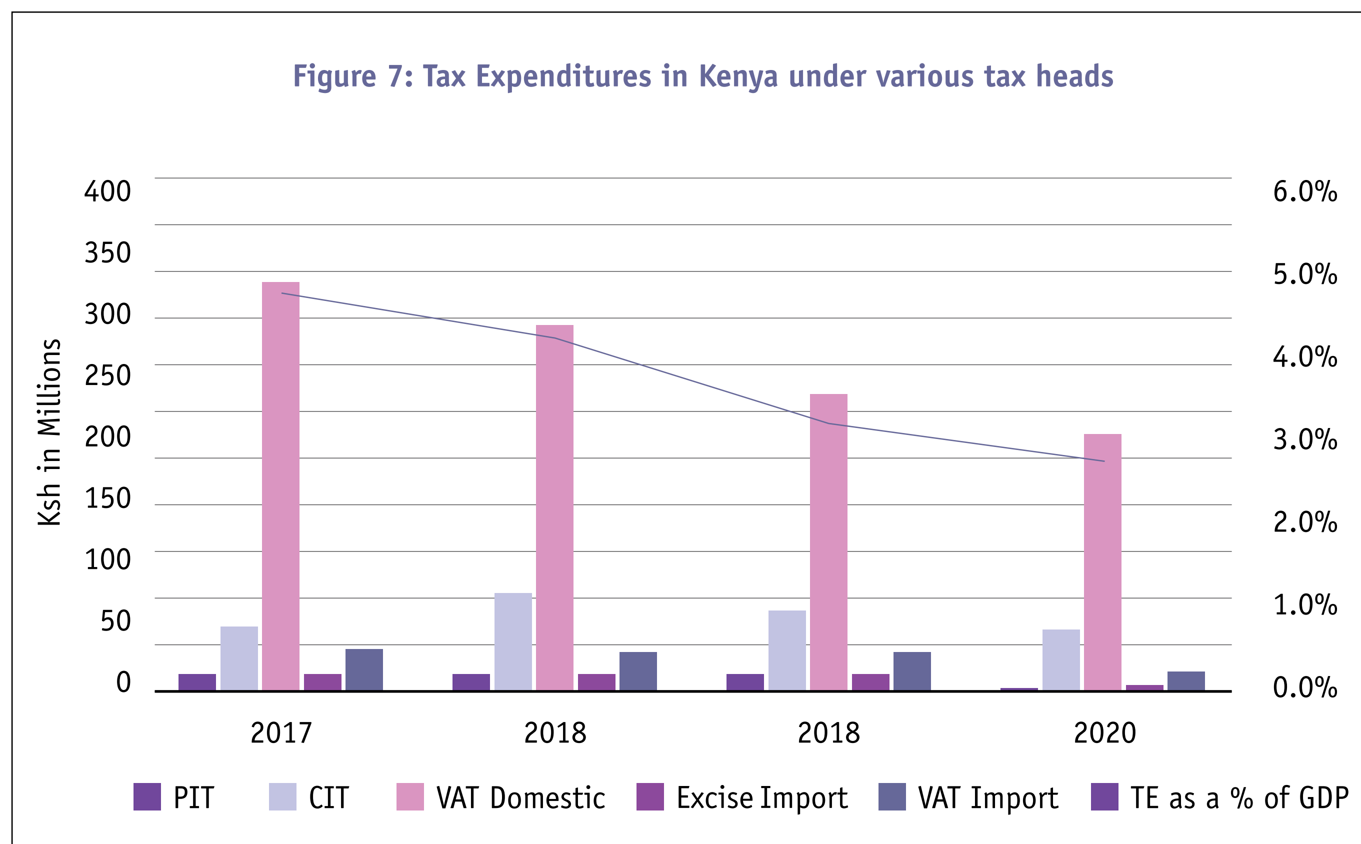
Year	Kenya	Uganda	South Africa
2015	-	-	4.7%
2016	-	2.0%	5.2%
2017	5.2%	2.2%	4.8%
2018	4.6%	3.2%	5.1%
2019	3.4%	3.4%	-
2020	3.0%	5.2%	-

Tax expenditures within Kenya's tax regime are computed for various tax heads such as Personal Income Tax (PIT) and Corporate Income Tax (CIT), Value Added Tax (VAT) and Taxes on Imports (Excise Duty and Import VAT) using the respective benchmark tax systems for each tax head. Table 3 outlines tax expenditures under various tax heads.

Table 3: Different tax heads and their respective tax expenditures

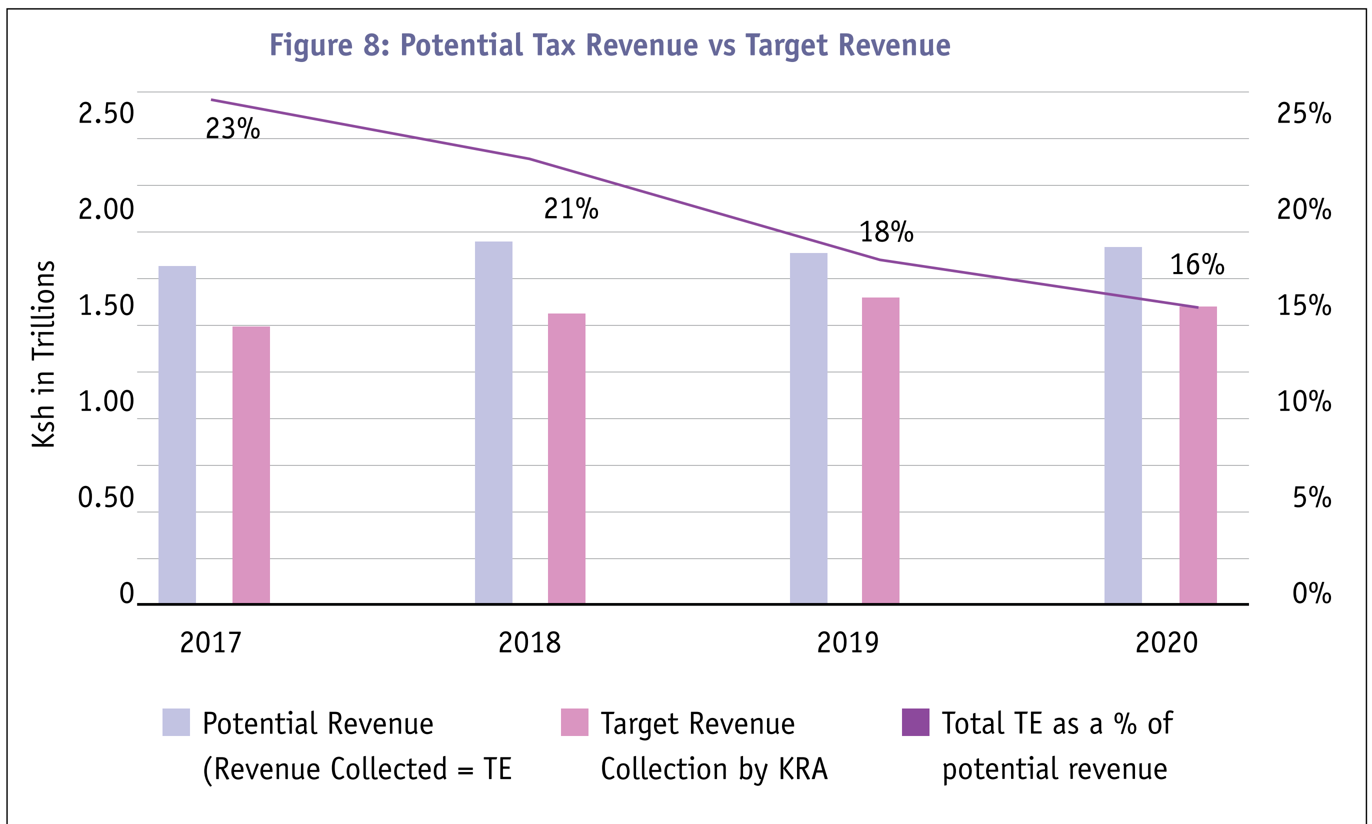
<table>
<tr><th>Tax Head</th><th>Tax Expenditure</th><th>Different Tax Incentives Under Each Tax Head</th></tr>
<tr><td rowspan="2">Income Tax</td><td>Personal Income Tax (PIT)</td><td>• Mortgage relief
• Insurance relief
• Home ownership savings
• Exempted income</td></tr>
<tr><td>Corporate Income Tax (CIT)</td><td>• Plant and Machinery Investment deductions
• Building Investment deductions
• Wear and Tear allowances
• Farm works and Agricultural deductions</td></tr>
<tr><td>Value Added Tax (VAT)</td><td>Domestic VAT Expenditure</td><td>• The general rate at 16%,
• Petroleum products rate at 8%
• Zero-rated</td></tr>
<tr><td rowspan="2">Taxes on Imports</td><td>Excise Duty</td><td>• Excise duty</td></tr>
<tr><td>Import VAT</td><td>• Import VAT</td></tr>
</table>

There has been considerable variability in terms of trends in tax expenditures in Kenya over the past five years. As shown in Figure 7, between 2017 and 2020, tax expenditures with respect to VAT on domestic goods have recorded the largest share of the total tax expenditures averaging Ksh 292.04 billion which represents 3.08% of GDP. These have been followed by tax expenditures on corporate income tax (CIT) which have averaged Ksh 60.8 billion, VAT on imports, Ksh 22.6 billion, Excise imports, Ksh 4.4 billion and PIT expenditures at Ksh 4.03 billion. This paints the impression that the National Treasury has incurred quite a substantive amount of revenue losses attributed to tax expenditures.



Source: 2021 Tax Expenditure Report

Figure 8 shows the potential additional tax revenue that would be generated by eliminating tax expenditures for each tax type against the target revenue set to be collected by KRA. Tax expenditures as a share of potential tax revenue have averaged 20%, between 2017 and 2021 indicating that annual revenue collection would exceed the tax revenue target by Ksh 0.33 trillion.



Source: The National Treasury

Essentially, tax expenditures are set to provide greater efficiency to Kenya's tax system, encourage investment in certain sectors or regions within the country's jurisdiction, stimulate consumption of merit goods and ensure progressive realisation with the country's fiscal or macroeconomic space. However, a comparison of trends in revenues forgone because of tax expenditures with government revenues dedicated to debt servicing and budget allocations to the county governments is indicative of a competitive nature of costs which brings to the fore questions about the prudence, efficiency, and equity of tax expenditures in the country.

Some economists and development practitioners argue that considering the tight fiscal space that government has had to work with over the past five years, revenues foregone through tax expenditures can be channelled to service debts and significantly increase available resources for county governments. Tax expenditures have averaged Ksh. 383.9 billion (over the past five years), a figure that is almost equivalent to the equitable share of revenue allocated to counties in the financial year 2020/21. That figure is also is slightly close to half the amount dedicated to debt servicing in the financial year 2020/21.

3.2. The Cost of Tax Incentives/Expenditures

Distortions to the economy: Tax incentives are meant to create new investments or expand existing ones. However, as governments seek to attract new investors, incentives discriminate against smaller firms, local businesses and firms in sectors that are not targeted and put them at a financial disadvantage.[22]

22. Sebastian J., *Tax and Non-Tax Incentives and Investments: Evidence and Policy Implications*, 1 September 2013, World Bank, https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2401905

Providing excessive investment incentives to attract new businesses adds more pressure for revenue on the smaller existing investors by increasing their tax burdens and can thus erode the tax base. Distortions to the economy can be through using inefficient incentives designs. Tax incentives are categorised as profit-based and cost-based.

Cost-based incentives are considered to be better because the cost to government revenue of the incentives is linked to an increase in capital investment. Profit-based incentives, which are mostly in the form of tax holidays, lower tax rates and tax exemptions, are discouraged because they mostly attract short-term investments which lack the ability to generate longer-term social benefits. Companies that take advantage of tax holidays can also easily withdraw once the holiday period is over.[23] Distortions to the economy can also happen as a result of poor targeting of tax incentives.

Different sectors of the economy respond to incentives differently. For instance, export-oriented sectors are sensitive to incentives due to their cost-reducing effects while resource-seeking investors such as extractives and market-seeking investors are not as sensitive to tax incentives because the physical characteristics such as availability of natural resources and size of the market are the key considerations. Studies have further shown that for investments that exploit location-specific rents such as natural resources, additional taxes should be imposed rather than tax incentives. This ensures that the location rents benefit the host country in a sustainable way.[24]

Enforcement and compliance costs: Tax incentives require governments to incur administrative costs necessary for constant monitoring to prevent fraudulent use of incentives schemes. Excessive use of tax incentives complicates administration, facilitates evasion, and encourages corruption. Incentives also cost businesses time and money to comply with audit requirements.

Enforcement costs are considered to be the initial grant of the incentive and the costs incurred in monitoring compliance with the qualification requirements and enforcing any recapture provisions upon termination or failure to continue to qualify. The more complex the tax incentive regime, the higher the potential enforcement and compliance costs. Tax incentive schemes that have many beneficiaries are also more difficult to enforce than narrowly targeted regimes.

Social costs of rent-seeking behaviour: Policies and laws that allow for the introduction of tax incentive schemes are enacted by parliament through political decision-making processes. Different policy approaches exist for designing the qualification requirements for tax incentives schemes. Policymakers can therefore choose between approaches that are transparent and objective or those that are discretionary and subjective. Discretionary processes open up spaces for corruption where policymakers act with the inherent interest to either influence the extension of certain incentives whose sunset date (expiration date) has passed or make incentives more generous.

23. *Op.Cit.* FTC, Norad, APMDD, Christian Aid and TJNA
24. Abramovsky L., Bird N., and Tyskerud Y., *Review of corporate tax incentives for investment in low- and middle-income countries,* IFS (Institute for Fiscal Studies) 23 March 2018, https://ifs.org.uk/publications/review-corporate-tax-incentives-investment-low-and-middle-income-countries

Additionally, tax expenditures that are loosely subject to financial discipline/scrutiny are subject to abuse by government officials and legislators either for self-enrichment or to provide benefits to favoured interests. The direct cash value of tax expenditures can also become an open inducement to bribery and corruption. As a result of the direct and often large cash value of tax expenditures to potential recipients, companies and business groups have a strong motivation to lobby for tax incentives by exaggerating the prospective economic or social benefits. Such lobbying often leads to an expansion of tax expenditures and undermines spending efficiency and fiscal accountability.[25]

Resource allocation costs: Successful tax incentives schemes result in increased investment which can correct market failures in different sectors and regions in a country that would otherwise not have happened. Tax incentives may however impact markets differently, especially for developing countries, which do not reflect existing competitive market models. They may cause increases in allocation of resources resulting in disproportionate investment in favoured areas and diversion of resources in sectors or areas not favoured by incentives.[26]

Revenue Costs: Tax incentives result in three types of revenue losses: i) forgone revenue that otherwise would have been collected from activities undertaken, this is commonly referred to as tax expenditures, ii) forgone revenue from projects that would have been undertaken even if the investor did not receive any tax incentives, iii) lost revenue from investors and activities that improperly claim incentives (taxpayers abuse) or shifting income from related taxable firms to firms qualifying for favourable tax treatments (tax planning).[27]

Tax expenditures reduce volumes of revenues that governments collect as taxes as a result of providing special treatment (exemptions of tax) to a certain class of taxpayers.[28] By reducing the net revenues, tax expenditures act as direct expenditures and hence increase the overall budget deficit.

25. *Op.Cit.* KNBS, *Economic Survey 2021*.
26. *Op.Cit.* CMA, CBK, IRA, RBA and SASRA.
27. *Op.Cit.*, KRA, *7th Corporate Plan*.
28. *Op.Cit.*, Mwita M.

Table 4: Benefits and Limitations of Tax Expenditures and Direct Subsidies

	Tax Expenditures	Direct Subsidies
Accessibility for beneficiaries	Simple, due to their automatic nature. Can facilitate a greater range of taxpayer choice.	More complex, requiring selection/ targeting.
Administrative costs	Low for exemption (can use existing tax data) but can be high for the tax system as a whole due to increased complexity.	Medium level, due to necessity of a selection and allocation system.
Possible abuses	Reduced risk of fraud as already tax compliant though there's still room for evasion, avoidance and for rent seeking.	Room for arbitrariness and capture of the allocating body.
Flexibility	Works with permanent laws, thereby generating stability but also inertia.	Works with budgets, evaluations, and regular reallocations.
Transparency and accountability	Their automatic nature is not conducive to control mechanisms or accountability.	Must be approved by the legislature as with all governmental expenditures.
Expenditure control	Expenditure usually determined ex-post, uncertain and unlimited, which can cause fiscal imbalances. Difficult to calculate.	Spending usually programmed, controlled, and limited by budget laws.
Effectiveness	Make use of market allocative knowledge. Incrementality in the targeted action cannot be guaranteed. May finance activity which would have occurred in absence of tax expenditure. (Deadweight).	Risk of displacement of private sector and difficulties in ensuring incrementality.
Equity	Regressive by nature. Only those who pay taxes qualify, and those with greatest income benefit the most.	"Judgement" can provide more equitable access, enhancing targeting on beneficiaries.

Source: Adapted from Villela, et al., (2010)

SECTION FOUR: KENYA'S TAX EXPENDITURES – FOR WHO? AT WHAT COST?

4.0. Context

In establishing the extent to which Kenya's tax expenditures framework has been transparent, accountable, adequate, efficient, and equitable the study reflected on questions such as who makes tax expenditure decisions – based on what law and/or policy guidance and how much scrutiny is possible? It also interrogated Kenya's tax expenditures from the lenses of efficiency – questioning the extent to which tax expenditure serve the purposes for which they are offered – who gets what and at what cost? Lastly, it examined the question of equity considering the balance of benefits of tax expenditures to different segments of the population, local versus international businesses among others.

4.1. Transparency of Tax Expenditures in Kenya

As in other spheres of public finance, transparency is imperative for prudent, just, and inclusive administration of tax expenditures. Essentially, a transparent tax expenditure framework demands that government: i) clearly outlines the laws and policies that govern administration of such tax expenditures, ii) discloses timely and comprehensive data on revenues forgone through tax expenditures, and iii) provides data on beneficiaries of tax expenditures.

Regarding legal and policy frameworks governing tax expenditures - There exists a robust framework of laws and policies/guidelines that demand of Treasury to assure transparency of tax expenditures. In practice however, there is substantive opacity that limits public scrutiny and abets abuse of tax expenditures.

Both Article 210 of the Constitution of Kenya[30] and The PFM, 2012 under Section 77(a)[31] mandate the National Treasury to maintain a public record of tax expenditures together with the reason for waiver and reports on each. Section 82 of the PFM Act, 2012 further requires that reports should be prepared at the end of each financial year.

There are other existing frameworks that provide for the legal provisions against which tax expenditures regarding the different preferential tax measures in Kenya are effected. These are outlined in Table 5. All the laws and regulations governing tax expenditures in Kenya have been made available to the public at no cost. However, the available laws on tax expenditures do not provide instances where the beneficiaries may be considered as to have breached the criteria for benefitting from tax exemptions.

30. KLRC (Kenya Law Reform Commission), *Part 3. Revenue-Raising Powers And The Public Debt - Kenya Law Reform Commission (KLRC)*, Constitution of Kenya, 2010, https://www.klrc.go.ke/index.php/constitution-of-kenya/149-chapter-twelve-publicfinance/part-3-revenue-raising-powers-and-the-public-debt
31. GOK (Government of Kenya), *The Kenya Gazette*, Special Issue CCVII – No.26, 13 March 2015, Nairobi, http://www.parliament.go.ke/sites/default/files/2017-05/Gazette_Notice_Vol._No._CXVII__No._26.pdf

Table 5: Legal Frameworks Governing Kenya's tax Expenditures

Preferential Tax Measure	Legal Framework
Personal Income Tax (PIT)	Income Tax Act, 2012[32]
Corporate Income Tax (CIT)	Income Tax Act, 2012, The Tax Laws Amendment Act, 2020[33],
Value Added Tax (VAT)	VAT Act, 2013[34]
Import Duty	East African Community Customs Management Act (EACCMA), 2004[35] East African Community Management Regulations, 2010[36]
Excise Duty	Excise Duty Act, 2015[37]

Regarding availability of tax expenditures data - Although the law requires Treasury to make regular public disclosures of information on tax expenditures, there has been a constant failure to comply hampering transparency and ability of citizens or non-state actors to scrutinise the framework of tax expenditures in the country. The Access to Information Act, 2016 provides a framework for public entities and private bodies to proactively disclose information that they hold plus to provide information on request in line with the constitutional principles.[38]

Further, the PFM Act requires the Ministry of Finance, National Treasury and Planning to publish records on tax expenditures annually. Despite the existing laws, the ministry has over the years failed to meet the legal requirements of publicly availing the data on an annual basis. The existing data on tax expenditures only covers a period of four years (2017 to 2020), creating a data gap for the previous financial years.

Additionally, the International Budget Partnership (IBP) framework outlines that for tax expenditures to qualify as being transparent, data should be published in a structured, or understandable manner annually and made available to the public as part of the yearly budget process. Despite the recent availability of data, the report is primarily written in tax jargon and fails to provide a detailed description easily understandable to majority of the public. Nonetheless, the National Treasury recently published the first Tax Expenditure Report which documents data on Kenya's tax expenditures for the financial years 2017/18 to 2020/21. Some stakeholders have argued that this was largely because of IMF requirements in 2021 rather than a proactive move to enhance transparency.[39]

32. NCLR (National Council for Law Reporting), 'Income Tax Act', *Laws of Kenya - Chapter 470*, Revised Edition 2012, http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/IncomeTaxAct_Cap470.pdf
33. NCLR (National Council for Law Reporting), 'The Tax Laws Amendment Act 2020', *Kenya Gazette Supplement No.56 (Acts No.2)*, http://kenyalaw.org/kl/fileadmin/pdfdownloads/AmendmentActs/2020/TaxLaws_Amendment_Act_No.2of2020.pdf
34. NCLR (National Council for Law Reporting), *Value Added Tax Act*, No. 35 of 2013, https://www.kra.go.ke/images/publications/ValueAddedTax_ActNo35of2013.pdf
35. EAC (East African Community), *East African Community Customs Management Act (EACCMA) 2004*, Government Printer Nairobi, Revised Edition 2009, http://kenyalaw.org/kl/fileadmin/pdfdownloads/EALA_Legislation/East_African_Community_Customs_Management_Act_2004.pdf
36. EAC (East African Community), *East African Community Management Regulations 2010*, https://www.tra.go.tz/tax%20laws/Customs%20Regulations.pdf
37. NCLR (National Council for Law Reporting), *Excise Duty Act*, No. 23 of 2015, https://www.kra.go.ke/images/publications/Excise_Duty_Act_23_of_2015.pdf
38. NCLR (National Council for Law Reporting), 'The Access to Information Act 2016', *Kenya Gazette* Supplement No.152 (Acts No.31), http://kenyalaw.org/kl/fileadmin/pdfdownloads/Acts/AccesstoInformationActNo31of2016.pdf
39. IMF (International Monetary Fund), *Kenya - Fiscal Transparency Evaluation Update,* Country Report No. 20/2, January 2020, https://www.imf.org/-/media/Files/Publications/CR/2020/English/1KENEA2020001.ashx

This mirrors sentiments from experts:

> *The publication of the tax expenditure report is linked to the International Monetary Fund requirements which requires states to publish tax expenditure reports on a regular basis and link the reports to the budget. Making reports on Tax Expenditures public and more open can work to improve morale of taxpayers.* CSO, Consultative Forum[40]

> *One of the main reasons these tax expenditure reports are being published now is because other external partners have asked that governments publish them as one of the conditions to get resources.* CSO, Consultative Forum[41]

The report outlines benchmarks that are used to identify and measure tax expenditures under PIT, CIT, VAT, Excise Imports and VAT on imports. The benchmarks provided for each tax measure are either in the form of: i) a tax base – the activities or transactions subject to the tax; ii) a tax rate – the rate of tax that applies to the base; iii) a tax unit – the entity liable to pay the tax and iv) a tax period – the period in which the activities or transactions are undertaken. Table 6 outlines the different benchmark systems used to identify and measure each of the tax expenditures provided in Kenya.

Table 6: Benchmark Systems for Tax Expenditures in Kenya

Tax Expenditure	Benchmark System
Personal Income Tax (PIT)	The benchmark unit is described as the individual tax rates and structures paid at a given time. This includes reliefs offered to taxpayers.
Corporate Income Tax (CIT)	The benchmark unit is a corporate body. It is described as the corporate income tax rate that is in effect (30% for Kenyan entities and 37.5% for non-resident entities) and a 5% tax rate for capital gains on property and shares
Value Added Tax (VAT)	The benchmark tax system for domestic VAT is the standard rate of either 16% or 0%. The benchmark unit of taxation is the final consumer of taxable goods and services.
Import Duties	The benchmark rate for import duties are levied at rates of 0%, 10% and 25% depending on product classification. The East African Community Customs Management Act (EACCMA) further provides exemptions which are also considered as a part of the benchmark
Excise Duties	The benchmark excise duty base is the consumption or demand of inelastic goods or services and the consumption of luxury goods while the benchmark unit of taxation is the final consumer of the taxed goods or services. The benchmark excise duty rate is either specific or *ad valorem*.

40. *Op.Cit.*, ACEPIS and EATGN, *Consultative Forum*.
41. *Ibid*.

Regarding availability of data on tax expenditure beneficiaries and their eligibility criteria - There is an acute lack of transparency from the government in terms of availing detailed information on beneficiaries of tax expenditures and their eligibility criteria applied in awarding incentives. This not only limits necessary scrutiny but also hampers rigorous analysis of costs and benefits accrued. The only available data published by Treasury on tax expenditures – the 2021 Tax expenditure report - lacks sufficient detail. The report is thoroughly summarised and only provides information on the amount of revenue foregone by government because of offering the different preferential tax measures.

Additionally, there are challenges in accessing data on the beneficiaries of the tax expenditures, eligibility criteria that different taxpayers need to meet, and actions taken towards companies or entities that fail to meet the conditions based on which incentives are offered – like employment creation among others. Essentially, a prudent tax expenditures framework must allow provisions for publication of data that outlines the number of taxpayers that qualify for different tax expenditures including the fulfilment of eligibility requirements. For instance, tax expenditures, especially the Corporate Income Tax (CIT), require companies to fulfil certain requirements such as offering employment opportunities to residents in the area they set up. Without such information disclosures, it becomes difficult to bring companies that benefit from tax incentives to account. This also prevents effective determination of the costs and benefits of tax expenditures for forward-looking tax expenditure policymaking.

4.2. Accountability of Tax Expenditures in Kenya

For tax expenditures to be administered in a manner that promotes accountability, their structure and administration should ensure that: i) there are explicit goals/objectives, ii) regular periodic assessments are conducted to evaluate their efficiency or effectiveness, and iii) sunset/ expiry dates of the tax expenditures are clearly stated to avoid abuse.

Regarding provision of goals for tax expenditures and metrics for periodical evaluation - While government outlines goals/targeted policy objectives of various preferential tax measures, there appears to be limited effort invested in determining the extent to which objectives of tax expenditures are met. This hampers an understanding of how effective tax expenditures are and the determination of limits upon which to discontinue or adjust certain aspects of tax expenditures.

Notably, for the five major tax expenditure areas – PIT, CIT, VAT, and tax expenditures on imports – the government outlines the policy objectives that include: reducing the cost of capital to encourage investment, supporting development expenditure, and easing the cost of living for the vulnerable in society. Each tax expenditure issued in Kenya is designed to achieve different goals as outlined on Table 7.

Table 7: Desired Goals of Tax Expenditures in Kenya

Tax Expenditure	Desired Goal
PIT Expenditure	This expenditure takes the form of reliefs which are meant to encourage savings, home ownership, and reduce tax burdens. Examples of such reliefs include mortgage relief and insurance relief.
CIT Expenditure	This expenditure takes the form of deductions which are designed to encourage companies to invest in productive fixed assets. Examples include deductions in mining, industrial, farm-works, plant, and machinery investment, building investment plus wear and tear.
VAT Expenditures	Tax expenditures on VAT are issued to relieve tax burdens on the poor and vulnerable people.
Tax Expenditures on Imports	This expenditure takes the form of duties and is meant to address the negative externalities that certain goods or services tend to have.
Import Duties	The benchmark rate for import duties are levied at rates of 0%, 10% and 25% depending on product classification. The EACCMA further provides exemptions which are also considered as a part of the benchmark.
Excise Duties	The benchmark excise duty base is the consumption or demand of inelastic goods or services and the consumption of luxury goods while the benchmark unit of taxation is the final consumer of the taxed goods or services. The benchmark excise duty rate is either specific or *ad valorem*.

However, the National Treasury has failed to conduct and publish rigorous evaluations of the various tax expenditures. There are no publicly available reports of ex-ante or *ex-post* evaluations of tax expenditures. There is limited evidence of periodic assessments by Treasury to evaluate efficiency and effectiveness. As such, it is difficult to understand how government has justified continuation of certain preferential tax measures without information on their performance in terms of meeting set objectives in the past. Existing reviews only entail changing the composition and structure of the tax expenditures but not assessing their effectiveness. As such, it is likely that certain tax expenditure decisions taken by government have gone without sufficient accountability as required by law and could be remitting net revenue losses.

Regarding performance measures for tax expenditures - As it is commonly argued that what gets measured gets done, there appears to be a lack of effective definition of measurement metrics for tax expenditures to facilitate documentation and reporting on their performance. Notably, the PFM Act, 2012 requires the National Treasury to maintain a public record of tax expenditures and reports for each waiver with reasons necessitating them. This however lacks sufficient outline of performance measurement indicators and consistent documentation of expenditure effectives. Essentially, structure and administration of tax expenditures should entail having reporting requirements that should determine whether the tax expenditures are achieving their intended goals.

Also, measuring performance of tax expenditures is only relevant if there are rewards for over performance and consequences for under performance. However, what exists in the Kenyan case appears to be only stated requirements and seems insufficient to assess whether the tax expenditures are attaining the required goals. It also lacks clearly outlined measures to be taken in the case of underperformance or where beneficiaries and sectors exceed expectations. Since only one expenditure report has been developed since the enactment of the PFM Act, it can be concluded that there are no well-defined performance measures on Kenya's tax expenditures. Further, there appears to be insufficient "claw back" mechanisms on expenditures that underperform.

Regarding presence of sunset dates - It is notable that most of the laws governing tax expenditures do not openly state sunset dates and there is currently no publicly available data on sunset/expiry dates for many existing tax expenditures in Kenya. Essentially, sunset/expiry dates provide opportunity for government to evaluate and assess effectiveness of tax expenditures. This further allows government to assess different aspects of the tax expenditure such as its opportunity cost. The laws, and hence the tax expenditures, can be ended or changed through deliberations by legislators and other relevant actors.

Whilst some provisions like incentives for SEZs and EPZs have some element of timelines, a host of other incentives lack clearly stated dates when preferential tax treatments expire. This allows space for abuse and manipulation of incentives, especially to benefit certain entities that have strong connections with high echelons of decision-making in government. Even where sunset/expiry dates appear to exist, there has been the tendency for renewal and/or adjustments of incentives without due process.[42] The net effect is a tax expenditures framework that allows especially multinational companies to come into the country, attract incentives, and repatriate benefits over long periods without significant scrutiny and recourse where they fail to meet set conditions.

4.3. Adequacy of Tax Expenditures

Essentially, tax expenditures should be considered as part of the overall fiscal plan of a country considering that they represent revenues forgone. They technically reduce resources available for policies and programmes that rely on the budget for support. As such, it is important to evaluate the necessity of tax expenditures by comparing them to other competing demands on public spending and assess whether tax expenditures are of higher or lower priority. A rigorous assessment on the adequacy of tax expenditures requires: (i) an evaluation of the fiscal condition of the country and (ii) interrogation of competing resources demands. Through this, it is possible to determine necessity – thus adequacy of tax expenditures.

Regarding the fiscal condition - It is notable that Kenya has grappled with an increasingly constricted fiscal space characterized by low government revenue generation capacity, increasing fiscal deficits, and general slow/stagnated growth. These conditions are indicative of fiscal challenges that do not permit significant allowance for government to incur huge revenue losses as a result of tax expenditures. Economic growth has largely stagnated over the past decade averaging at 4.5% and failing to spur increase in government revenues.[43]

42. Okoth E., 'NIC, CBA bank merger exempted from paying millions in share sale tax', *Business Daily,* 18 August 2019, https://www.businessdailyafrica.com/bd/economy/nic-cba-bank-merger-exempted-from-paying-millions-in-share-sale-tax-2261420
43. ACEPIS (Africa Centre for People, Institutions and Society), *Computations based on World Bank data,* https://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG?locations=KE

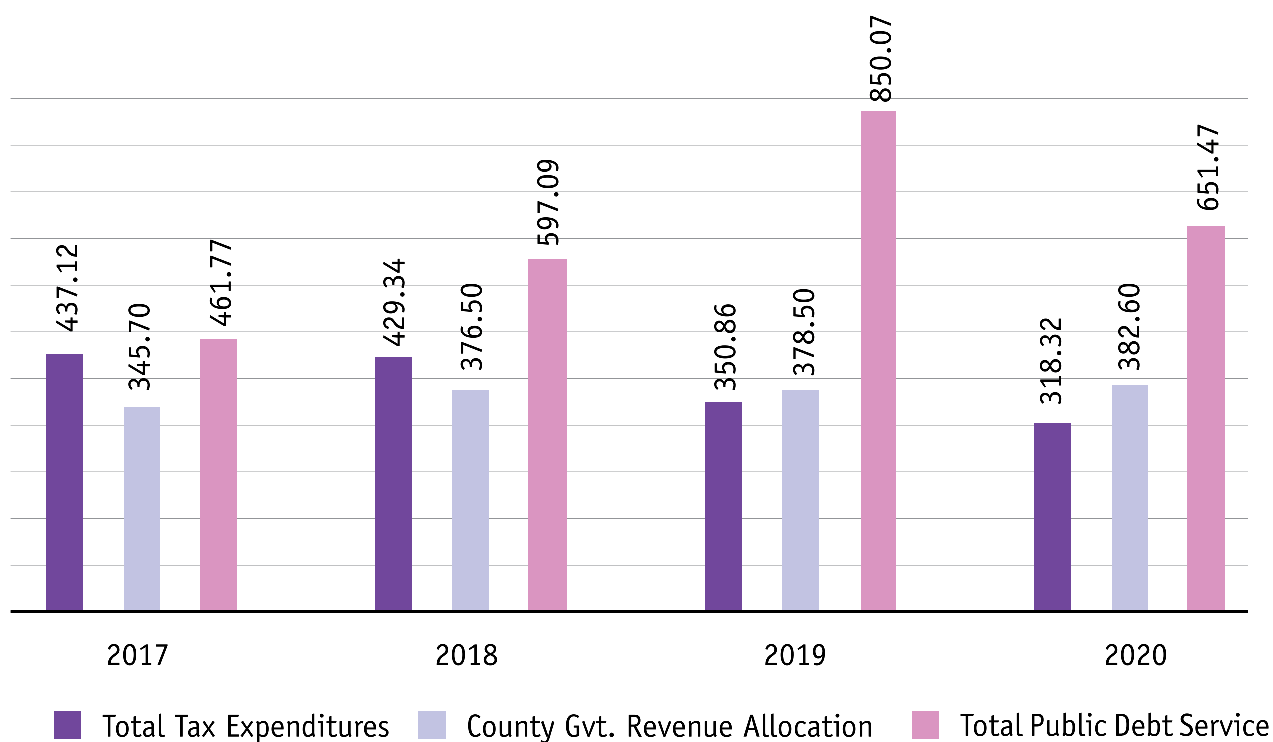
As a result, KRA has been consistently missing revenue targets outlined in the Budget Policy Statements (BPS)(except for FY 2020/21 when it surpassed the set revenue collection target by Ksh. 16.81 billion). Also, the budget has been increasing over the past decade. This is attributed largely to the country's expansionist infrastructure policy. The increase in public expenditure has however not been commensurate to the revenue collections despite tax collection increasing over the years. This has resulted in a surge in the fiscal deficit which is expected to persist due to projections in large infrastructure-related expenditure, debt servicing, and critical expenditures such as the implementation of the economic recovery strategy plus national election-related expenditures.

Borrowing to offset fiscal deficits has seen Kenya's portfolio of public debt increase exponentially over the last ten years, rising from Ksh. 1.4 Trillion in June 2011 to Ksh. 8.2 Trillion in December 2021.[44] Public debt currently makes up 88.9% of the Ksh. 9 trillion debt ceiling established by parliament. The PBO forecasts that the debt stock will range between Ksh. 8.6 trillion and Ksh. 8.8 trillion by June 2022, therefore exceeding Ksh. 10 trillion by the end of 2024.[45] It is estimated that debt servicing will make up 65% of total revenues collected by the financial year 2023/2024. Debt servicing costs have been increasing over the years as loans mature. This has been exacerbated by weakening of the Kenyan Shilling.

Regarding competing resource demands - Over the past five years, Kenya has been juggling competing resource demands for financing public expenditure (especially funding County Governments) and debt servicing. This appears not to square out with tax expenditures incurred by government as they would be considered the least in terms of priority. Whilst the size of the budget has expended, resource demands have outpaced it. Debt servicing, pensions, and personnel emoluments have been prioritized hence denying other public expenditure areas necessary funding. Low government expenditure has limited delivery of essential public goods and services like health, education, or other social amenities such as water, roads, and electricity. This has further been worsened by late disbursements of the equitable share of revenues to counties.

It is argued by some economists that this has limited growth and returned negative back loops in terms of low government revenue generation.[46] This has been exacerbated by the weakening of the Kenyan shilling against the dollar, implying that more of the Kenyan currency is needed to service debt. Nonetheless, the National Treasury continues to implement a tax expenditures policy that has seen the country lose/forego on average Ksh. 383 billion. This compares to Ksh. 382.6 billion which is the equitable share of revenue allocated to counties in the financial year 2020/21 and is slightly close to half the amount dedicated to debt servicing in the financial year 2020/21 which is Ksh. 651 billion as shown in Figure 9. Laws and policies for the management of the country's tax expenditures do exist. However, they remain inadequate as proven by the increasing resource demands and public debt problem. The lack of clear expiry dates and other mechanisms for repealing tax expenditure further worsen the fiscal state of the county.

44. CBK (Central Bank of Kenya), *Recent Monetary and Financial Developments,* Weekly Bulletin, 18 March 2022, https://www.centralbank.go.ke/uploads/weekly_bulletin/1122846145_Weekly%20CBK%20Bulletin%20March%2018%202022.pdf
45. *Op.Cit.,* PBO
46. Kimanthi K., 'Kenya: How Delayed Funding Messed Up Counties', *Daily Nation,* 8 April 2020, https://allafrica.com/stories/202004080473.html



Source: The National Treasury

4.4. Efficiency of Tax Expenditures

Efficiency of tax expenditures considers the extent to which preferential tax treatments lead to such effects as (i) Deadweight, (ii) Displacement, and (iii) Opportunity costs.[47] Deadweight is an economic concept that attempts to capture the amount of activity that would have taken place anyway in the absence of the incentive or scheme. Displacement refers to a situation where some of the benefits associated with the scheme occur at the expense of non-beneficiaries. Lastly, opportunity cost is a fundamental principle of economics that provides all resources (capital, labour, public funds) have a cost reflecting their value in an alternative use and as such, the costs must be considered in evaluation.

Also, based on several international tax expenditure frameworks, efficiency of tax expenditures can be established by answering five fundamental questions: (i) what objective does the tax expenditure aim to achieve? (ii) what market failure is being addressed? (iii) is a tax expenditure the best approach to address the market failure? (iv) what economic impact is the tax expenditure likely to have? Lastly, (v) how much is a specific tax expenditure expected to cost?[48] Efficiency not only highlights the direct cost attributed to foregone revenues, but also taxpayer's costs of complying with the respective eligibility requirements and the government's overall costs of administering tax expenditures to various sectors within Kenya's macroeconomic sector.

47. USGAO (United States Government Accountability Office), *Tax Expenditures: Background and Evaluation, Criteria and Questions,* 29 November 2012, https://www.gao.gov/assets/gao-13-167sp.pdf
48. DOF (Department of Finance), *Report on Tax Expenditures - Incorporating Department of Finance Guidelines for Tax Expenditure Evaluation*, October 2014, https://assets.gov.ie/181244/b0751f6a-d9b0-4bf4-bdcb-68214c7d62a7.pdf

Practically, analysing efficiency of tax expenditures is a demanding, and complicated task.[49] In fact, in many cases, tax jurisdictions, especially in developing countries typically do not conduct rigorous analyses to determine efficiency of tax expenditures at all.[50] Such analyses are largely reliant on data and evaluation reports that document both the cost, which is the revenue loss, and the benefits accrued either social or economic, associated with issuing a tax expenditure.

Such information is normally domiciled in multiple ministries, departments, and agencies of government thus requiring a great deal of cooperation and interagency coordination to conduct. For instance, in Kenya – analysing efficiency of tax expenditures requires data on incentives held by the National Treasury, sector performance data held by KNBS, data on beneficiaries of tax expenditures and revenue losses/forgone held by KRA.

Considering the data asymmetries, already addressed in section 4.1 and 4.2, this study, despite its original ambition, lacks the scope and capacity to conduct a rigorous analysis of efficiency of Kenya's tax expenditures. As such, it attempts some correlative analysis that only scratches the surface on the efficiency in tax expenditures in the country.

Among the intended goals of issuing tax expenditures include the creation of employment and contribution to growth in the different economic sectors.[51] Holding other factors constant, the sectors that benefit from tax expenditures are expected to register significant improvements in performance demonstrated by increased sector growth (contribution to GDP) and increased job creation.

As illustrated in Table 8, a review of the 2021 Tax Expenditures Report reveals that government has foregone substantive amounts of revenue due to tax expenditures in: manufacturing, agriculture, construction, financial and insurance sectors. As such, analysing efficiency focuses on incentives issued to these sectors, plus assesses whether the tax expenditures have contributed to substantive increases in employment creation and economic growth as intended by government.

49. Ross J., *Evaluating Tax Expenditures: A Framework for Civil Society Researchers,* IBP (International Budget Partnership), June 2018, https://internationalbudget.org/publications/evaluating-tax-expenditures-framework-for-civil-society/
50. Kassim, L. and Mansour M., 'Tax expenditures reporting in developing countries: An evaluation', *Revue d'économie du développement*, Volume 26, Issue 2, 2018, pages 113 to 167, https://www.cairn-int.info/article-E_EDD_322_0113--tax-expenditures-reporting-in.html
51. *Op.Cit.,* GOK, 2021 *Tax Expenditure Report.*

Table 8: Various Tax Expenditures indicative of sectors

Expenditures	Sector	2017	2018	2019	2020
PIT Tax Expenditure Estimates, Ksh Million					
Mortgage Interest Deductions	Construction	476.87	484.08	510.77	428.10
Insurance Relief	Finance and Insurance	541.82	593.31	631.69	651.44
Home Ownership Savings Plan Relief	Construction	3.36	3.38	3.82	4.35
Exempted Income		2504.29	2735.41	3507.35	3041.28
Total in % of GDP		**0.04%**	**0.04%**	**0.05%**	**0.04%**
CIT Expenditure Estimates, Ksh Million					
Plant and Machinery Investment Deductions	Manufacturing	17,627.3	28,946.9	26,790.8	29,411.5
Building Investment Deductions	Construction	5,407.5	22,467.3	3,731.5	8,550.9
Allowances for Industrial Buildings	Manufacturing	4,438.9	4,927.6	11,280.7	7,374.6
Wear and Tear Allowances	Manufacturing	16,870.8	18,301.3	17,713.1	8,824.7
Farm Works and Agricultural Land Deductions	Agriculture	3,190.4	2,440.1	2,451.8	1,167.0
Other Industrial Deductions	Manufacturing	24.9	12.6	12.9	1,408.4
Total in % of GDP		**0.6%**	**0.8%**	**0.6%**	**0.5%**
Vat Tax Expenditure Estimates, Ksh Million					
Exempt items		164,070.50	134,622.07	84,224.75	82,913.22
Zero-rated items		192,636.54	185,264.29	172,981.55	151,465.21
Total in % of GDP		**4%**	**3%**	**3%**	**2%**

Expenditures	Sector	2017	2018	2019	2020
VAT Tax Expenditures for Exempt Goods and Services					
Financial and Insurance Activities	Finance and Insurance				23,830
Information and Communication					13,291
Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles					10,788
Manufacturing	Manufacturing				9,245
Agriculture, Forestry and Fishing	Agriculture				6,033
Construction	Construction				4,363
Transportation and Storage					4,347
Water Supply, Waste Management, Sewerage and Remediation Activities					2,368
VAT Tax Expenditures for Zero Rated Goods and Services					
Manufacturing	Manufacturing				48,481
Transportation and Storage					29,588
Agriculture, Forestry and Fishing	Agriculture				28,022
Electricity, Oil, Gas, Steam and Air Conditioning Supply	Manufacturing				17,898
Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles					7,675
Administrative and Support Service Activities					4,512
Mining and Quarrying	Construction				4,160
Information and Communication					3,895

Overview of performance in the selected sectors: The general outlook is that despite significant revenues foregone in the selected sectors, returns in terms of growth, employment creation and other auxiliary benefits like export growth appear not to be commensurate to the tax expenditures incurred. Baring the implications of Covid-19, Table 9 below summarises performance of Kenya's economy in the agricultural, manufacturing, construction, financial and insurance sectors, highlighting different aspects such as tax expenditures under different tax heads, contribution to GDP, growth rate and employment in the year 2020.

The construction sector returned the highest growth rate of 11.8% in 2020 followed by finance and insurance sector at 5.6%. The manufacturing sector had the highest amount of tax expenditures amounting to Ksh 87.14 billion, followed by the agricultural sector with total tax expenditures issued amounting to Ksh 35.22 billion. However, growth in GDP contribution and employment creation appears weak in sectors such as manufacturing and financial services including insurance.

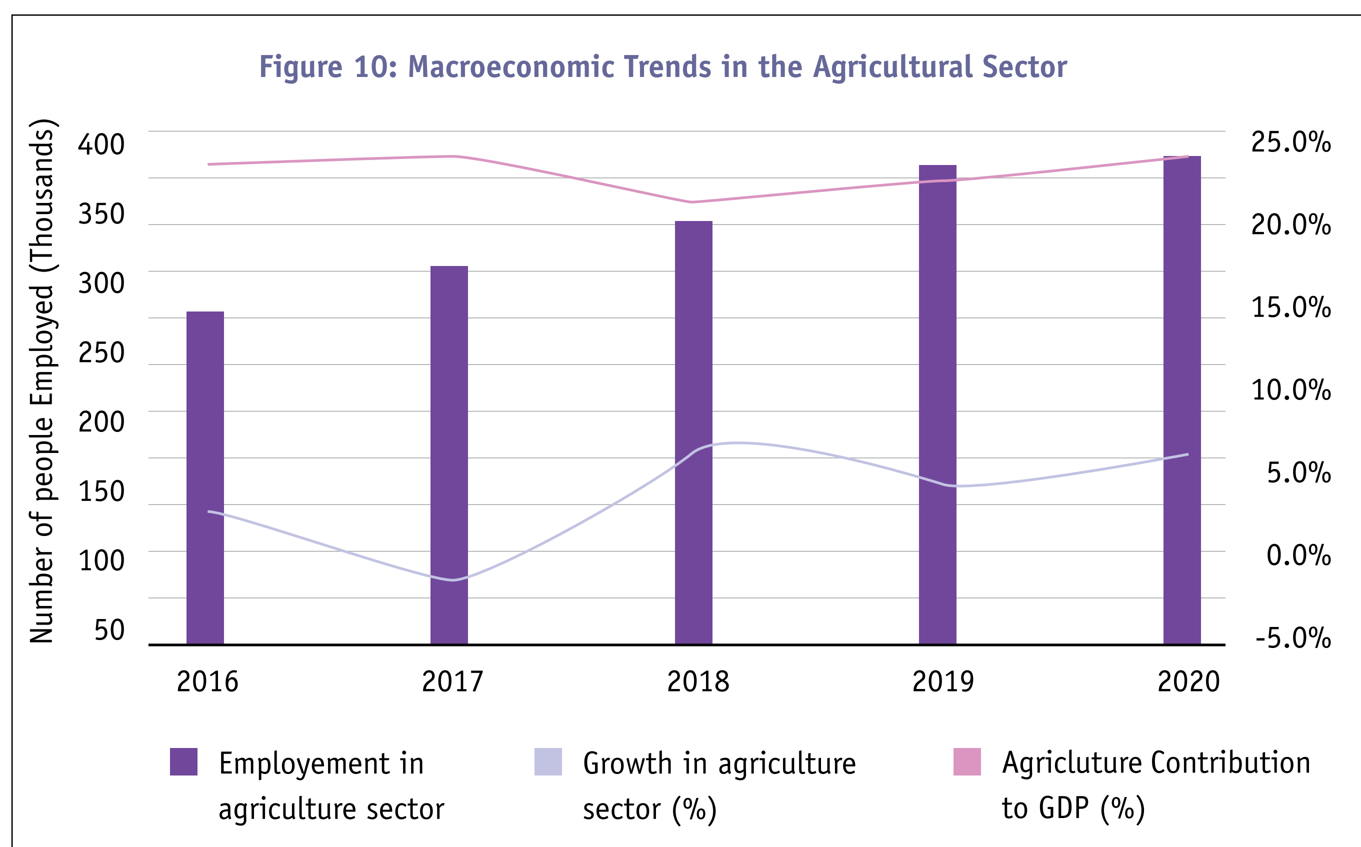
Table 9: Overview of Sectoral Performance

Sectors	Revenue foregone in 2020 (in Ksh billions)			Contribution to GDP in 2020	Growth Rate in 2020	New Wage Employment in the Sector	
	CIT Expenditure	VAT Exempt	VAT Zero Rated			2019	2020
Agriculture	1.17	6.03	28.0	23.0%	4.8%	2000	-16300
Manufacturing	29.41	9.25	48.5	7.6%	- 0.1%	5400	-36400
Construction	15.93	4.36	-	7.0%	11.8%	3100	0
Financial and Insurance	-	23.8	-	6.5%	5.6%	2000	-300

Source: Acepis computations based 2021 Tax Expenditures Report (National Treasury) and Economic Survey (KNBS)

Tax Expenditures in the Agriculture sector: Tax expenditures issued in the agricultural sector in 2020 include: (i) under the corporate income tax expenditures - farm works and agricultural land deductions (which are capital allowances granted to farmers who incur capital expenditure on construction of farm works at the rate of 100% of the cost) worth Ksh. 1.2 billion (ii) under VAT Tax Expenditures for Exempt Goods and Services - Agriculture, Forestry and Fishing worth Ksh. 6 billion, and (iii) under VAT Tax Expenditures for zero-rated Goods and Services - Agriculture, Forestry and Fishing worth Ksh. 28 billion. Between the years 2017 to 2020, farm works and agricultural deductions have been declining from Ksh. 3.2 billion in 2017 to Ksh. 1.2 billion in 2020. Nonetheless, during the period under review, the agricultural sector registered mixed growth results, with the sector's contribution to GDP fluctuating over the years as shown in Figure 10. Additionally, employment in the sector has had a marginal increase between the years 2017 and 2019, before decreasing in 2020 as a result of layoffs stemming from effects from the pandemic.

Baring other factors that impact growth and sector performance, it is deductible that over the period under review, growth in the sector coupled with the increase in employment is considerably low compared to the amount of revenue foregone – through tax expenditures which has averaged Ksh. 2.3 billion over the four years.



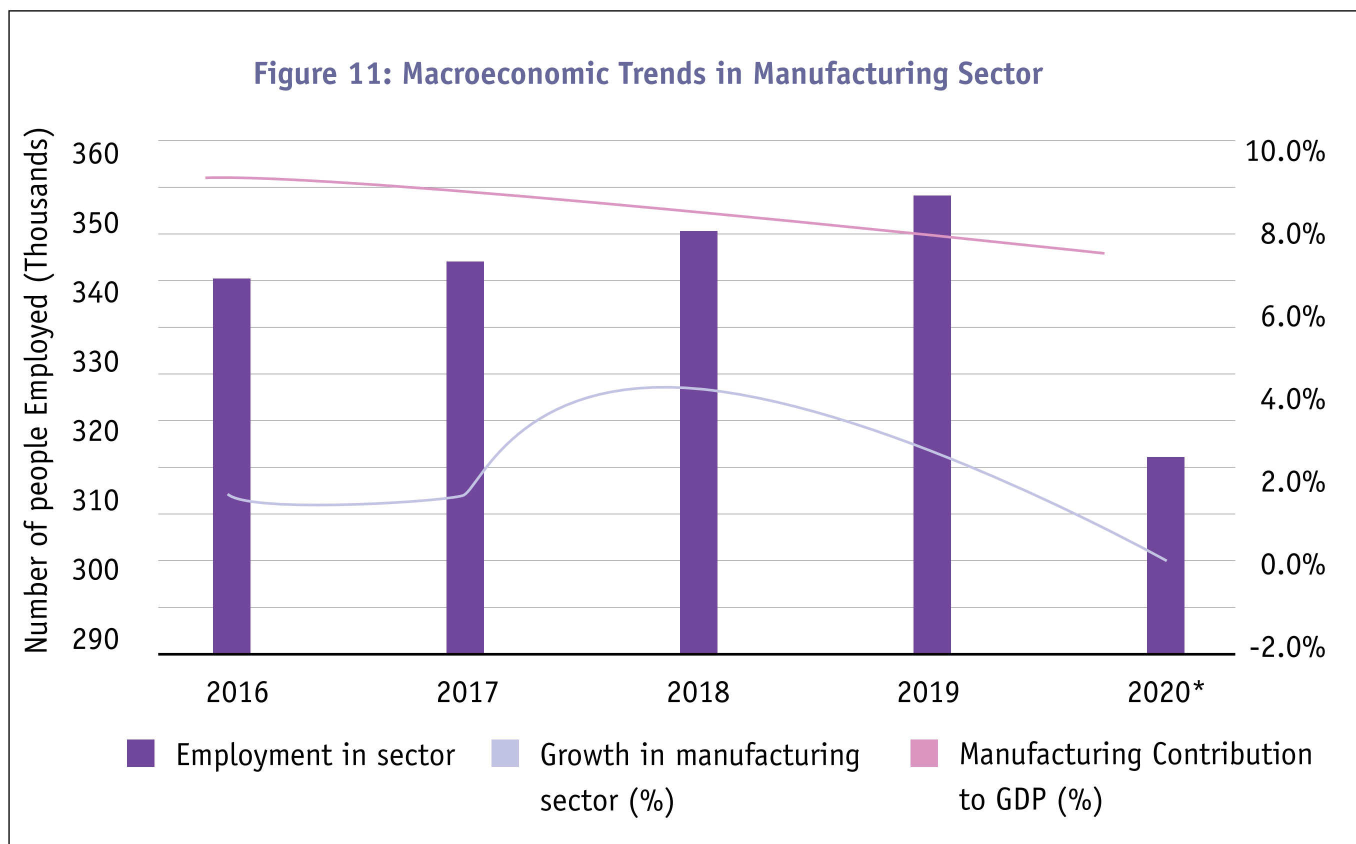
*Source: Economic Survey-KNBS (*Provisional)*

Tax Expenditures in the Manufacturing Sector: The manufacturing sector has been a significant driver of growth and a contributor to economic development in Kenya. This is especially through employment creation, export portfolio growth, and contributions to government revenues through taxation. The sector entails production of a wide range of commodities such as food products, textile, clothing, chemicals among others. Tax expenditures to the manufacturing sector typically include: (i) under CIT expenditures - Plant and Machinery Investment Deductions, Allowances for Industrial Buildings, and Other Industrial Deductions; and manufacturing under both (ii) VAT Tax Expenditures for Exempt Goods and Services and (iii) VAT Tax Expenditures for zero-rated Goods and Services.

These expenditures amounted to Ksh. 38.2 billion, Ksh. 9.2 billion and Ksh 48.5 billion in 2020 respectively. EPZs and SEZs act as enterprises that facilitate production of goods and contribute to growth in the manufacturing sector. Despite these zones enjoying preferential tax treatments, the National Treasury does not consider them as tax expenditures. Incentives to EPZs and SEZs however ought to be considered and accounted for as tax expenditures considering that SEZs and EPZs are believed to account for a significant proportion of revenue losses incurred by government in the manufacturing sector and in the overall tax regime.

It is notable, from the 2021 Treasury Report, that tax expenditures to the manufacturing sector have generally been increasing over the years. In the period between 2017 and 2019, the government spent an average of Ksh. 33.1 billion as tax expenditures. Nonetheless, the manufacturing sector's contribution to Kenya's GDP has been decreasing over the years, declining by 1.7% from 2016 to 2020. Growth in the sector has also been fluctuating over the years. As illustrated in Figure 11, employment creation in the manufacturing sector increased marginally by 2.7%, that is, 9400 new jobs created.

It is thus deducible, baring other factors that impact growth, that the volume of tax expenditures on the sector over the period under review is disproportionate to the growth witnessed and the new jobs created by the sector. It is important, however, to acknowledge that the Covid-19 pandemic had a negative impact on the sector's performance, leading to a decline in growth and significant reduction in employment creation within the sector, especially in 2020. It may be argued that the 9.8% increase in tax expenditures between 2019 to 2020 may be because of the need to cushion the sector from adverse impacts of Covid-19.



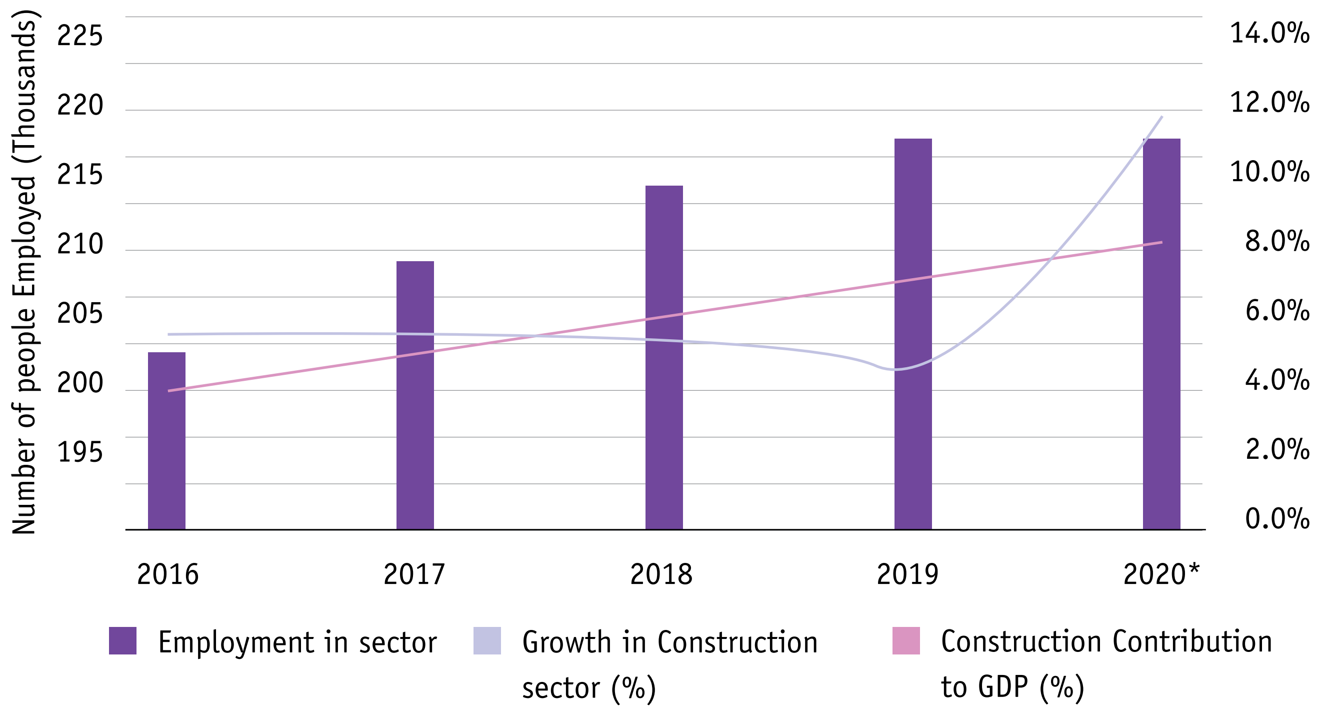
*Source: Economic Survey-KNBS (*Provisional)*

Tax Expenditures in the Construction Sector: Kenya's construction sector is mainly driven by transportation and building. Corporate Income Tax Expenditures in the sector have been in the form of capital allowances, that is, allowances for the construction of industrial buildings. Other forms of tax expenditures related to the sector include: (i) Mortgage Interest Deductions and Home Ownership Savings Plan Relief under the Personal Income Tax Expenditures, (ii) under VAT Tax Expenditures for Exempt Goods and Services – Construction and (iii) under VAT Tax Expenditures for zero-rated Goods and Services – Mining and Quarrying. Over the years under review, tax expenditures to the construction sector have been erratic, with a general increase of about 53% between 2017 and 2020.

The sector's contribution to GDP has also been increasing over the years. Additionally, there has been an increase in the number of people employed in the sector as shown in Figure 12. The government spent an average of Ksh. 52.25 billion between 2017 and 2019 as tax incentives on the construction industry. However, the growth in employment creation represents just about 3.8% - 8100 new jobs created. Generally, the trends in tax expenditures to the sector appear not to mirror trends in employment creation, contribution to GDP and overall growth in the sector.

Moreover, there seems to be a constant trend in the number of jobs created over the years (2017-2019) regardless of the fluctuations witnessed in tax expenditures. Controlling for the effect of other variables, the trends observed hint to the possibility that tax expenditures to the sector and the number of jobs created may be unrelated.

Figure 12: Macroeconomic Trends in Construction Sector



*Source: Economic Survey-KNBS (*Provisional)*

Box 2: Case Study - Assessing Performance of Export Processing Zones

Export processing zones are aimed at attracting export-oriented investment – firms setting up in the designated locations – and as a result increasing the level of employment. Despite the zones having preferential tax treatment, that is, exemption from corporate income tax for the first ten years of establishment and a CIT rate of 25 % for the 10 following years, the KRA does not consider the revenue forgone from the zones as tax expenditures. As such, the tax revenues from the zones forgone by the government remains unclear.

In exploring the performance of EPZs related to the number of jobs created and total value of goods exported, this case study attempts to estimate the potential taxable revenue losses from such zones. It is important to note that due to data limitations (limited access to data on the companies in EPZs, including information on the period of operation since establishment), the study assumes that the companies have not been subjected to CIT between 2011 and 2019.

Estimated Tax Revenues Foregone by KRA

Assuming that all the companies in the EPZs were exempted from CIT between 2011 and 2019, the "estimated profits" shown in Table 10 represent the forgone taxable revenues by the KRA between 2011 and 2019. This translates to the authority foregoing estimated tax revenues of Ksh 20.05 billion between the period.

Table 10: Finance Associated with EPZs

Years	Total sales (Kshs. Billion)	Total Expenditure (Kshs. Billion)[52]	Estimated Profits (Kshs. Billion)	Total Estimated Forgone Tax Revenues (Kshs. Billion)
2011	42.44	36.36	6.08	1.82
2012	44.27	43.07	1.21	0.36
2013	50.29	46.69	3.61	1.08
2014	57.19	50.43	6.76	2.03
2015	64.90	55.24	9.66	2.90
2016	68.57	55.90	12.67	3.80
2017	67.27	58.11	9.16	2.75
2018	77.27	65.07	12.20	3.66
2019	77.19	71.70	5.49	1.65
Total				**20.05**

Source: Export Processing Zones Authority[53,54]

52. Inclusive of imports and expenditure on local purchases, salaries, power, telecommunication, water, and other domestic expenditure.
53. EPZA (Export Processing Zones Authority), *Annual Performance Report 2019*, Export Processing Zones Program, https://epzakenya.com/wp-content/uploads/2020/09/EPZ-Annual-Performance-Report-year-2019.pdf
54. EPZA (Export Processing Zones Authority), *Annual Performance Report 2015*, Export Processing Zones Program, https://epzakenya.com/wp-content/uploads/2020/09/EPZ-Annual-performance-report-year-2015.pdf

Other performance Indicators of EPZ

As shown in Figure 13, there has been an increase in employment in EPZs over the years. However, due to the containment measures necessitated by Covid-19, there was a decline in the number of people employed in 2020. Between 2011 and 2019, some 28,591 jobs were created, an 88% increase in the number of people employed in EPZs. This is against 58 new enterprises being established in the zones during the same period (a 78% increase in the number of enterprises in EPZs).

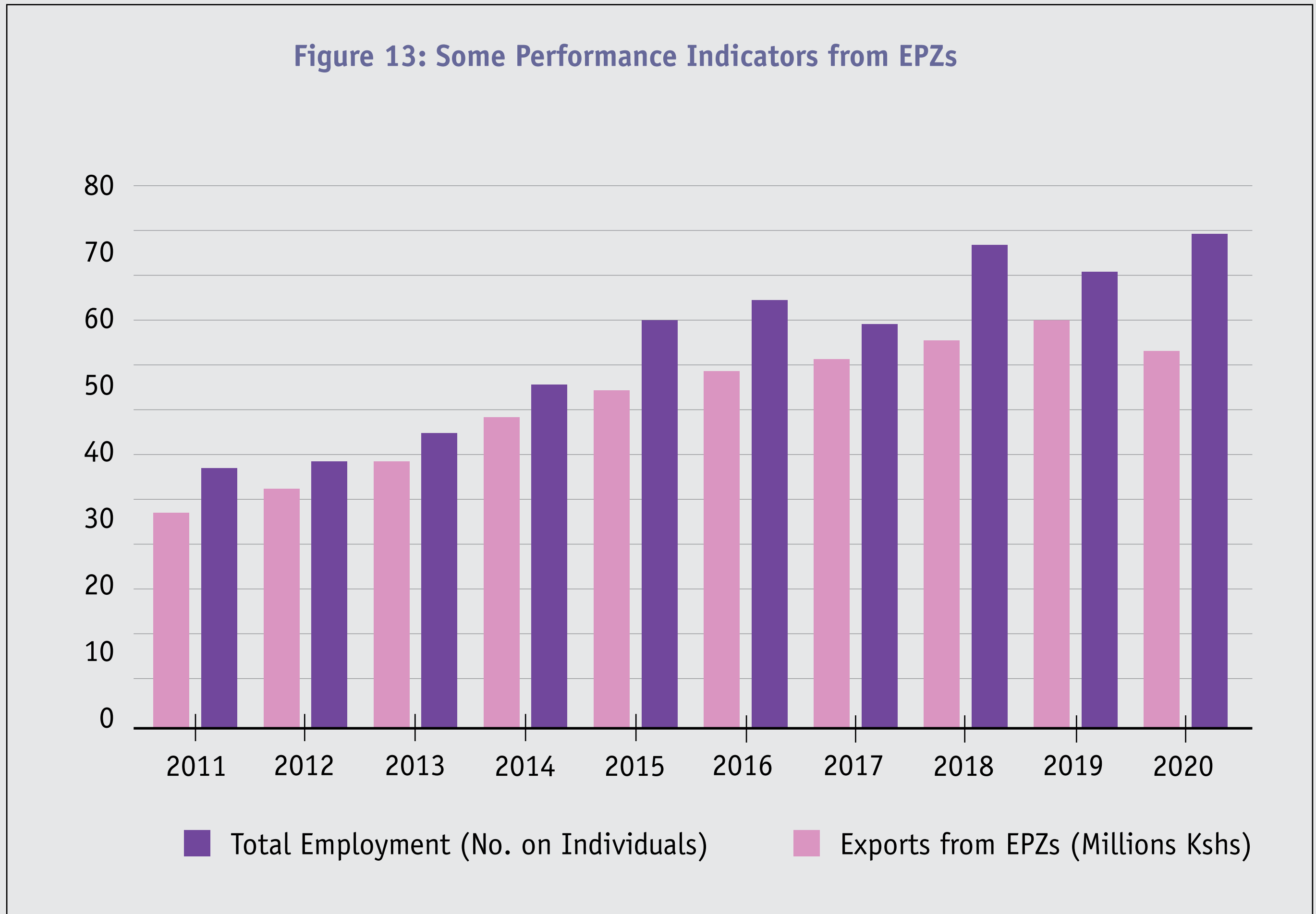
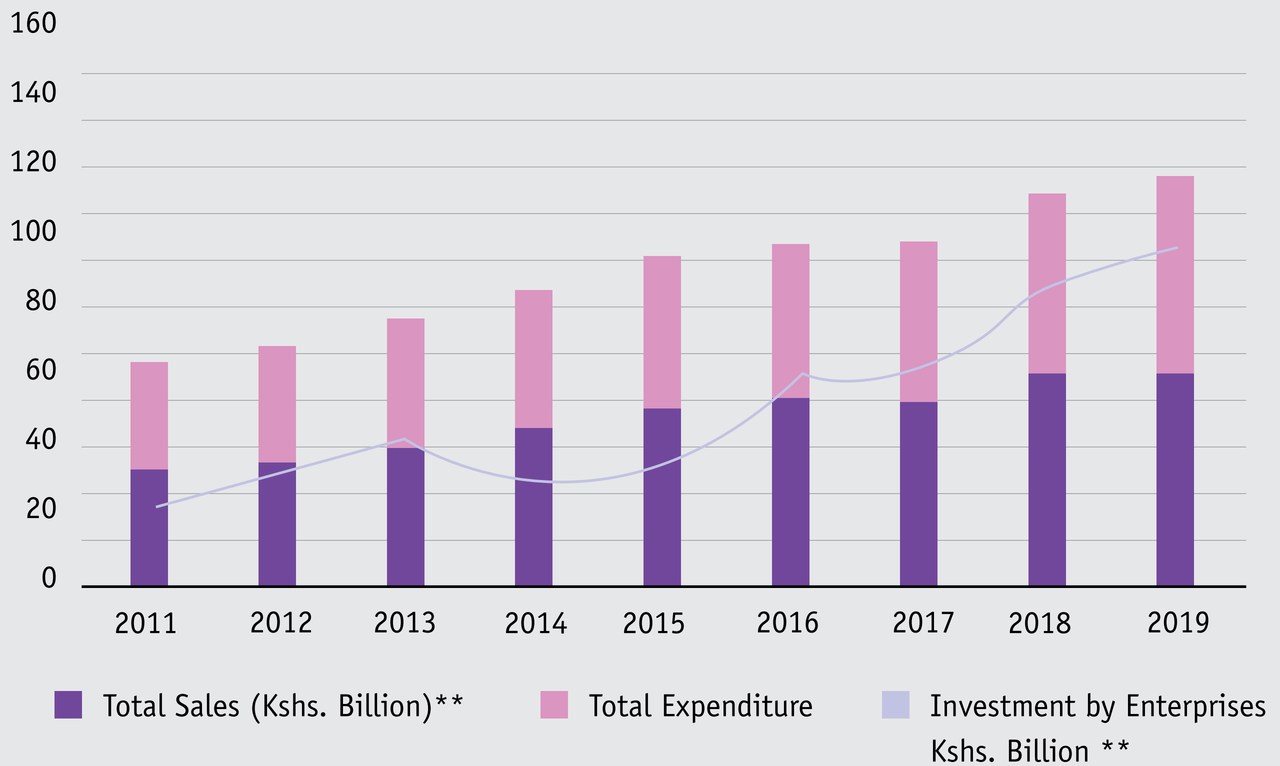


Figure 13: Some Performance Indicators from EPZs

Source: Export Processing Zones Authority; 2021 Economic Survey

The total exports attributed to the zones have also been increasing over the years, although it seems like the volume of exports has been increasing by a fixed margin between 2012 and 2016



Source: Export Processing Zones Authority

As shown in Figure 14, investments by companies operating in EPZs have been increasing over the years. The increase in sales from the zones (local and exports) over the years has been outweighing the increase in expenditures on these zones.

4.5. Equity of Tax Expenditures

Assessing equity of tax expenditures is necessary to determine who benefits from them - whether the preferential tax treatments accrue more economic advantages to the wealthy more than the poor, or whether they make the tax system as a whole more or less equitable. Essentially, provisions that provide a disproportionate share of benefits to lower-income taxpayers make the tax code more equitable, while those that provide disproportionate benefits to high-income taxpayers make it less equitable.[55]

Assessing equity requires data on the incidence of a tax expenditure measured as a percentage of taxpayers' income. In fact, estimating the impacts of investment incentives requires data on identities of specific taxpayers and the tax benefits they receive. These data requirements are generally unattainable especially

55. *Op.Cit.*, Ross J., IBP

for developing countries like Kenya – with governance gaps that manifest in limited transparency and accountability by government, information asymmetries and constrained public participation in public policymaking.

Whereas equity is a key factor in assessing a tax expenditure, the data on the distributional impact is difficult to obtain. As such, in this section we attempt some correlative analysis using case examples of a sector (construction) and an event (Covid-19 pandemic) to illustrate the impact of tax incentives/ expenditures on equity.

The general outlook is that the broad spectrum of incentives and tax expenditures incurred by the government of Kenya seem to benefit higher-income quintiles (middle and high classes) more than those in lower-income groups especially the very poor. A significant proportion of tax expenditures incurred under VAT appear to benefit established businesses – corporations more than small and medium enterprises. In fact, even among corporations, there is the sense that Multi-National Corporations (MNCs) tend to attract more incentives than local business. This is in considering that sectors such as manufacturing, finance, and insurance, and construction appear to benefit more from tax expenditures when compared to agriculture that is the largest employer and a significant contributor to GDP plus overall economic growth.

This mirrors sentiments from experts:

> *The beneficiaries of tax expenditures are high-value investments, and people in the higher class. Granting of tax incentives is also a matter of negotiation. The people who have power to negotiate with government are the wealthy and those that are well connected to power. How does granting tax incentives to certain sectors and high-value earners only help to balance issues of inequality? Reports have shown that in many of developing nations, the sectors benefiting from tax incentives are the mining and manufacturing sectors, while in Kenya it is mainly the Real estate. Houses built primarily target and benefit those that are in the middle and upper classes* – CSO, Consultative Forum[56]

Tax Incentives during COVID-19 Pandemic – Positive implications on equity

Whilst tax incentives are generally frowned upon due to the history of their abuse and opacity, tax expenditures incurred in 2020 during Covid-19 pandemic appear to have substantively contributed to equity – cushioning the vulnerable and allowing the economy wiggle room to bounce back. While it is acknowledged that determining the impact of tax expenditures that are part of indirect taxes (like VAT) is rather complicated and challenging considering data limitations, tax policies play a key role in addressing income inequality.

This is evident in the Kenyan case during the COVID-19 pandemic when the government adopted temporary tax policy measures that aimed to cushion the lower income individuals from economic hardship incurred during the Covid-19 pandemic. These government interventions saw Personal Income Tax (PIT) top rate reduced from 30% to 25%. The government granted a 100% tax relief to individuals earning up to Ksh. 24,000 per month.

56. *Op.Cit.,* ACEPIS and EATGN, *Consultative Forum*.

As illustrated in Table 11, a reduction from 16% to 14% was also implemented on VAT on standard rated items which served to protect the vulnerable from high commodity prices attributed to disruptions in supply chains during the pandemic. Taxes under the different tax heads reduced because of the interventions made by the government. The government incurred revenue losses in 2020 that are related to expenditures aimed at mitigating the effects of the Covid-19 pandemic. Such tax expenditure policies like the ones implemented during the pandemic work to promote equity and provide more robust contributions to economic growth in the long run.

In the Kenyan case, tax expenditures incurred by government on reduction of Pay As You Earn (PAYE) and VAT led to increased disposable income, hence increased consumption (aggregate demand) with a net effect of improved economic growth. Kenya's post-COVID-19 pandemic economic growth is projected to reach 5% which is partly attributable to the tax expenditures incurred by Treasury at the height of the pandemic in 2020.

Table 11: Changes in Tax rates in 2020

Tax Heads	Pre- COVID (2019)	COVID Period (2020)	Decline in Revenues (2020)
Individual Income Tax	30%	25%	9.3%
VAT	16%	14%	7.9%
Corporation Tax	30%	25%	
Rental Income Tax	10%	10%	

Source: Kenya Revenue Authority

Tax Incentives in Real Estate – Negative implications on equity

Tax expenditures incurred in the real estate segment – considered as part of the construction sector in the economy – appear to significantly favour high-income earners and exacerbate income inequalities. This represents a typical example of where tax expenditures exacerbate inequities in the economy and limit growth in the long run.

The real estate market in Kenya is argued to be the most incentivized market as the wealthy have the vantage point of lobbying for incentives that seek to benefit their development projects. There is considerable variability in the types and volumes of incentives that individuals or entities in higher-income categories receive when compared to those received by those in the lower-income segments. There is a tendency of incentives targeting high income earners to have no caps while those targeting low and middle-income earners having a cap at low amounts per annum.[57]

57. Mutava C.N., *Analysis of Tax Incentives and Exemptions in The Finance Acts from 2009 – 2019*, Oxfam, 24 February 2022, https://oi-files-cng-prod.s3.amazonaws.com/kenya.oxfam.org/s3fs-public/file_attachments/Tax%20Incentives%20study%20Report.pdf

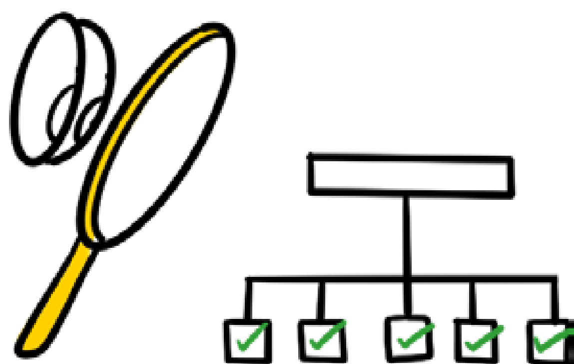
Some of the incentives targeted for high-income earners include a 150% investment deduction on buildings outside of Nairobi, Mombasa, and Kisumu which one requires a minimum capital investment of Ksh. 200 million. The property must be located in a planned developed area or development areas located in middle and upmarket areas. Additionally, developers with at least 400 units benefit from reduced corporate income tax rate. The requirements specified are those that primarily apply to individuals in the higher income quantiles. Developers under the affordable housing scheme benefit from a wide range of incentives with the revenue forgone estimated to be Ksh. 50 billion in 2019.[58] These include reduced corporation tax rate, exemption from import duties, VAT, railway development levy, and import declaration fees on purchase of construction supplies, exemption from stamp duty, and thin capitalisation restrictions. The income predispositions that qualify to benefit from these incentives technically lock out low-income earners from such tax expenditures and furthers established inequities.

The tax incentives that target low and middle-income individuals include a simplified tax regime for landlords of residential property whose income is more than Ksh. 144,000 but less than Ksh. 10 million per annum that was introduced in the Finance Act, 2015. The landlords are also required to pay a simplified tax of 10% on gross turnover. This requirement is however argued to cancel the incentive offered as most landlords rely on debt financing to develop their property. With the real estate market in Kenya being dominated by high-income persons, the target market for the houses developed are also primarily developed for individuals in the higher and middle-income quantiles and as such this continues to widen the income inequality gap.

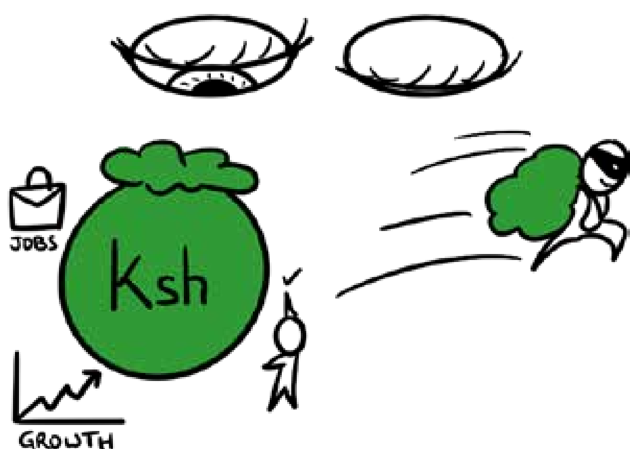
58. KPDA (Kenya Property Development Association), *Annual Report 2019,* https://www.kpda.or.ke/documents/Monthly%20Note/2019%20KPDA%20Annual%20Report.pdf

SECTION FIVE: EMERGING ISSUES

Kenya has a tax expenditure framework which is an important macroeconomic tool that can be exploited to spur economic development. It is also prone to abuse and manipulation by special interests due to inherent opacity, limited accountability, and inadequate citizen participation. The framework identifies a benchmark system that standardizes tax rates across the various tax heads and sets specific targets for performance.



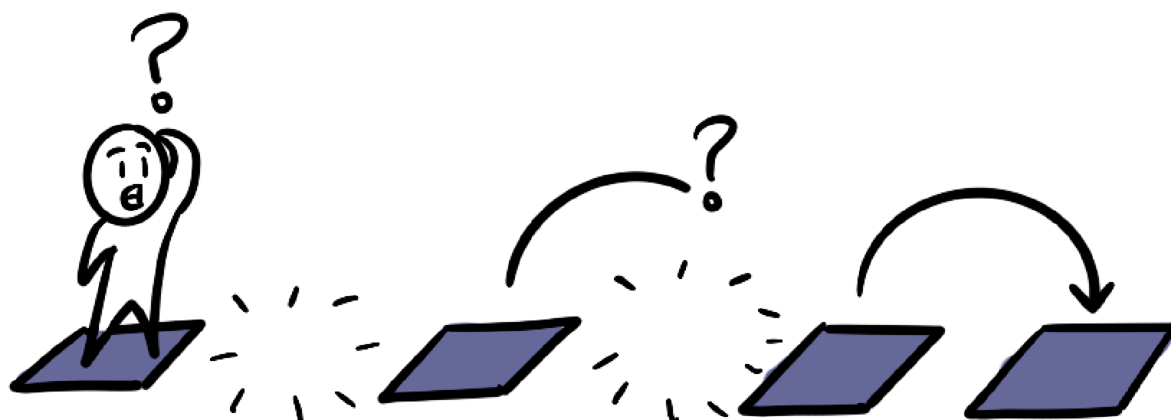
There are existing legal frameworks that house the legal requirements for tax expenditure reporting. These can be relied upon by stakeholders to promote transparency and accountability, equity, plus efficiency. Article 201 of the Constitution of Kenya guides the management of public finances – requiring government to ensure there is accountability and transparency. Article 210 of the Constitution of Kenya castigates the waiving of taxes and licensing fees without proper legislation. Section 77 of the PFM Act requires the National Treasury to publish annual reports indicating tax waivers.



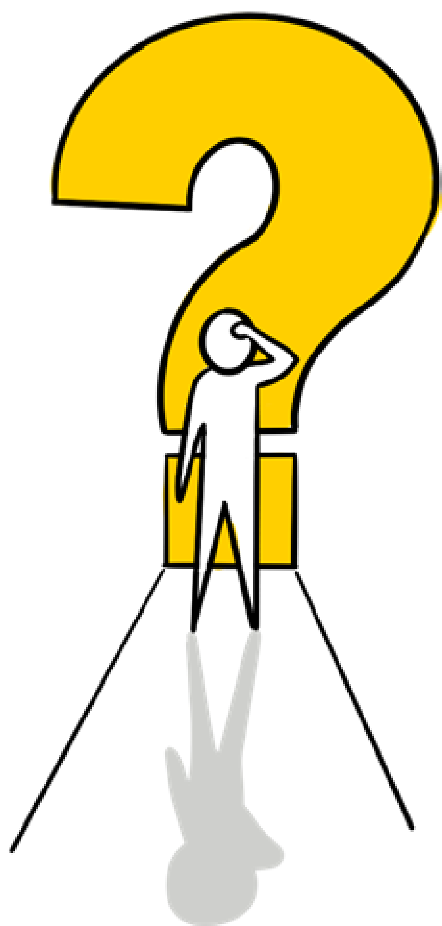
Generalization of the purpose of tax expenditures limits effective scrutiny and monitoring of performance of tax expenditures. This possibly allows deviant entities to abuse and get away with non-performing incentives. Despite the existence of various tax incentives which contribute to loss of tax revenues, there exist general reasons for the issuance of such preferential measures.

Such reasons include: spurring economic growth; increasing investment; and creation of employment. There is limited specification of the desired economic

and social goal for each tax incentive, creating a possibility for exploitation of the measures. Moreover, it is not clear whether specific goals have been attached to the tax expenditures.



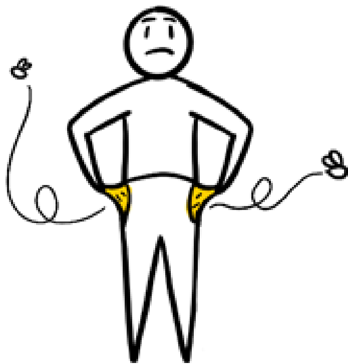
Gaps in existing legal and policy frameworks governing tax expenditures and incentives. Whilst there are laws regarding incentives, these do not address important aspects such as management, eligibility for issuance, and review of the tax incentives. For tax expenditures, the law only requires the revenue authority to provide information on the same but does not specify the details of information to be disclosed. This arbitrariness may impact the level of transparency of the tax expenditure reports.



Clarity on benchmarks and components of tax expenditures. The mechanism by which tax expenditures are calculated is complex. There is lack of clarity concerning certain components of tax expenditures, for example, special economic zones (SEZs) receive preferential tax treatments and ought to be considered as tax expenditures, yet Treasury excludes them from considering them as part of the benchmark.

Competing developmental priorities and resource demands raise questions about the adequacy of tax expenditures incurred by treasury considering the prevailing fiscal situation in the country. Tax incentives, which the government uses as a fiscal policy tool to spur growth within specific economic sectors, also act as a contributor to fiscal loss. Kenya, being a lower-middle-income economy, still needs to issue tax incentives to facilitate growth in various sectors.

However, revenues forgone in the past have been high, indicating the high cost of tax incentives. Over the last four years, 2016 – 2020, current tax incentives have cost government an average amount of Ksh. 383.9 billion which is equivalent to the equitable share of revenue allocated to counties in the financial year 2020/21 and a figure that is slightly close to half the amount dedicated to debt servicing in the financial year.



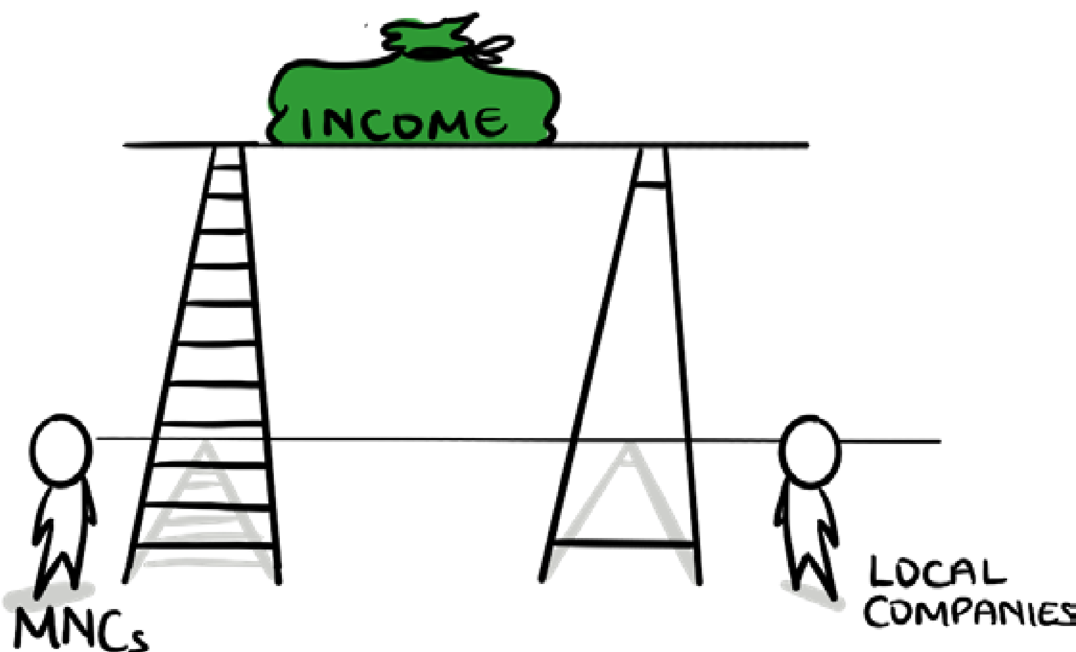
Poor monitoring framework for tax expenditures means that government could be proceeding with inefficient and inequitable tax incentives that require regular reviews to remedy. There exists no clear framework for assessing the performance of tax expenditures against stated/desired goals. This could be attributed to human resource capacity limitations and high monitoring or evaluations costs. It is also unclear whether the tax expenditures are subjected to periodical reviews to determine their relevance and efficacy. As it stands, there is only one Kenya tax expenditures report available for the year 2020/21.

Information asymmetries - limited data regarding tax expenditures in Kenya. Evaluating the costs -, and benefits of tax expenditures remains a challenge because analysis requires data on both the costs incurred and benefits produced by issuing tax incentives. There is difficulty in accessing data on Kenya's tax expenditures. Moreover, existing data on tax expenditures is not disaggregated to capture information on the beneficiaries of various tax incentives thus limiting the analysis of the legitimacy of issuance of tax expenditures.

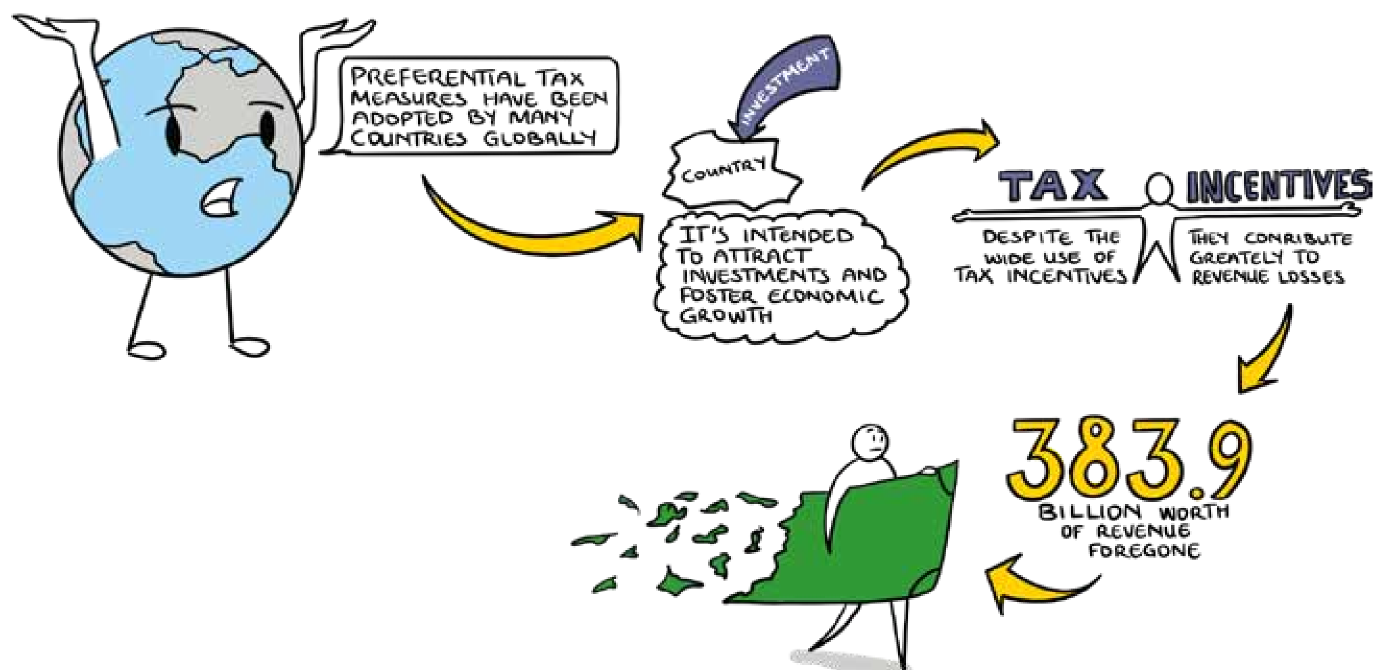
In general, information gaps limit review or analysis of the costs and benefits associated with tax expenditures. Existing data on tax incentive costs is limited to tax expenditures (which is the revenue foregone) with data gaps on enforcement, compliance costs, and resource allocation costs. Additionally, measuring benefits remains challenging in the Kenyan context, and is dependent on different factors which are determined by the returns expected from issuing the tax incentives (which can be revenue returns or non-financial benefits).

There is weak correlation between tax expenditures to sectors and their performance. The trends in performance of certain sectors of the economy such as manufacturing and construction differ from the trends in the level of tax expenditures offered to such sectors with the cost, revenue forgone being higher that the growth of the respective sectors. This is indicative of an inefficient framework of tax expenditures that requires urgent review.

Tax expenditures could be furthering income inequalities that exists between international companies and local companies plus income inequalities between entities in the formal and the informal sector. This is evident in tax expenditure policies benefiting MNCs versus local companies. It is also apparent between large companies and Micro Small and Medium Enterprises (MSMEs). The real estate sector is a sterling example of where tax expenditures could be exacerbating inequalities.



SECTION SIX: CONCLUSION AND RECOMMENDATIONS



6.0. Conclusion

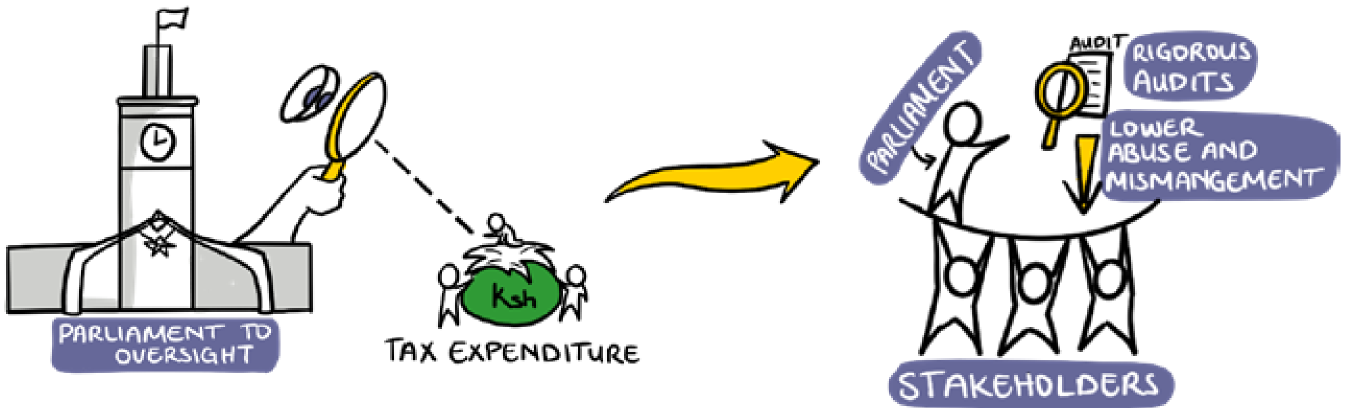
Globally, many countries - both developed and developing - adopt preferential tax measures incorporated in their tax systems, which benefit specific segments/categories of taxpayers, some activities, or are intended to achieve targeted objectives such as attracting investment and fostering economic growth. Government pursues preferential tax treatments on the basis that when effectively leveraged, tax systems can achieve specific public policy objectives, especially developmental ones. Despite the wide use of tax incentives, they are a major contributing factor to revenue losses incurred by government. The government of Kenya has forgone on average Ksh 383.9 billion worth of revenues between 2017 to 2020 as a result of tax expenditures.

In terms of access to information, there is a general limitation in accessing necessary data detailing beneficiaries, benefits (social and economic) accrued from incentives or elaborate costs incurred including administration costs) to conduct rigorous assessment of the costs and benefits of tax expenditures. Nonetheless, the general outlook is that the government of Kenya incurs huge revenue losses attributed to tax expenditures that does not seem to level with the prevailing fiscal situation – characterised by slow growth, fiscal deficits, and a debt repayment burden. Available evidence points to an opaque, unaccountable, less equitable, inefficient, and inequitable framework of tax expenditures that requires review based on rigorous assessment using government data-driven by multi-agency coordination.

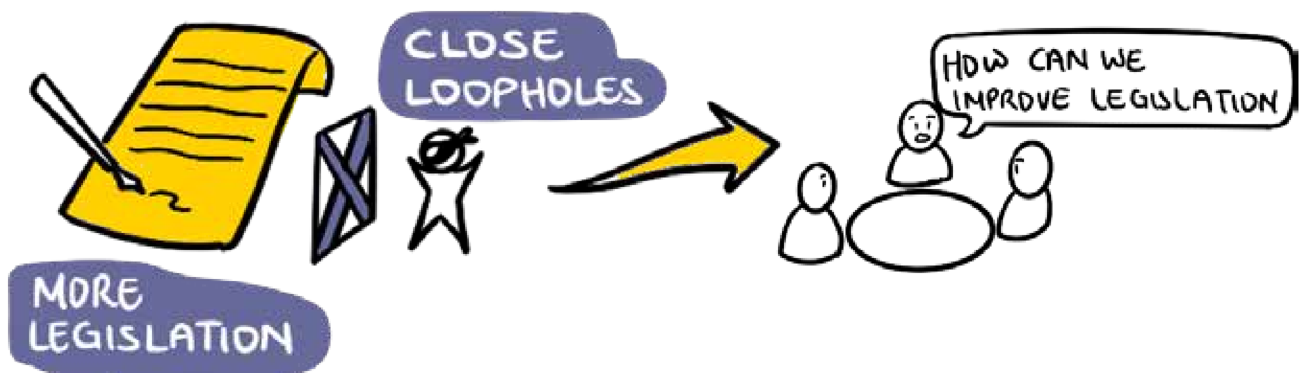
6.1. Recommendations

Moving forward, hereunder are some recommendations that can be pursued by various stakeholders to towards a more just, equitable, and progressive tax expenditures regime in Kenya:

1. Parliament retains the overall mandate of oversight that needs to be utilised in scrutiny of tax expenditures. Stakeholders can work to increase capacity and buy-in from parliament to increase their involvement in rigorous audit and evaluation of tax expenditures to minimise their abuse and mismanagement.

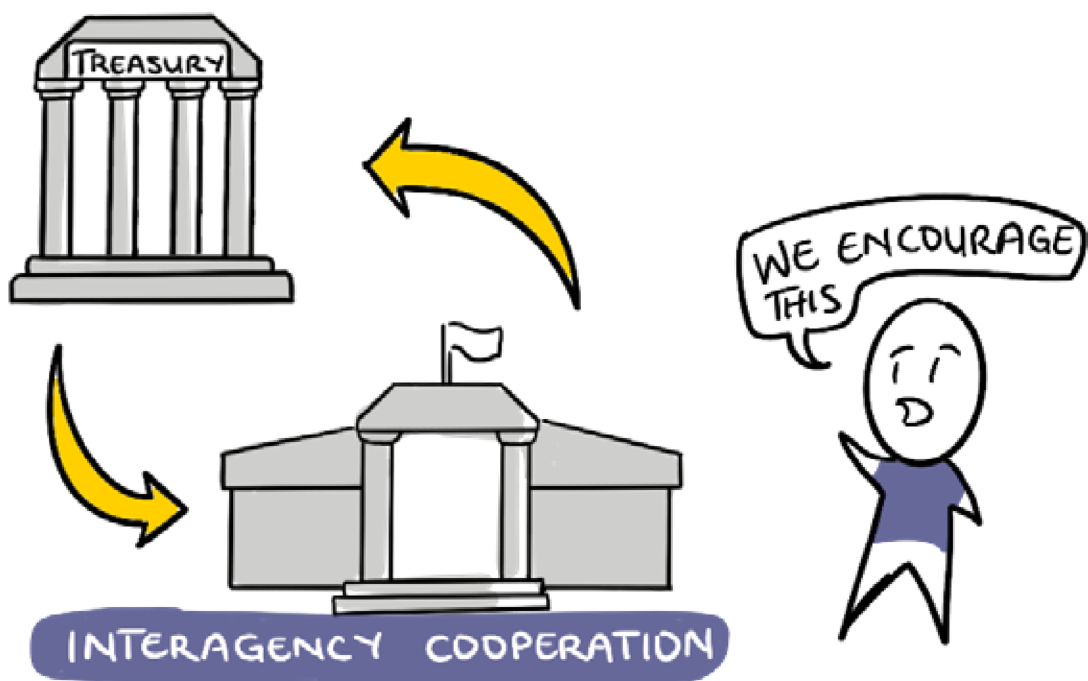


2. More legislation is needed on tax expenditures to ensure the loopholes in issuance of tax incentives and tax expenditure reporting are sealed. Improvements are necessary in existing legislation to provide better guidance on reporting of tax expenditures (including contents of the reports).



3. Owing to the substantive amount of revenue forgone from issuing tax expenditures, there is an urgent need for stakeholders (National Treasury and KRA) to publish comprehensive tax expenditure reports on an annual basis as required by the PFM Act 2012.

4. The national treasury should consider reviewing existing tax incentives to ensure they address specific policy objectives. This can help address overlapping benefits i.e., different tax incentives having similar goals.

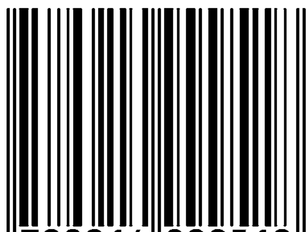


5. There is need for interagency cooperation to improve availability of credible data for evaluating costs and benefits of tax expenditures. Stakeholders can encourage KRA, Treasury and KNBS to pursue interagency collaboration to allow access to such information.

6. Owing to the costs associated with tax expenditures, there is an urgent need for robust explorative analysis of the country's tax expenditure framework. This must involve rigorous monitoring and analysis of the implications of tax expenditures for the tax base plus overall fiscal space.

7. Civil society can play a stronger role in monitoring tax expenditures – especially in evidence generation (through studies) plus advocacy for a more transparent and equitable framework. This includes advocating for more public participation in the planning phase of tax incentives.

8. As tax expenditures cover different facets of the economy and involves different actors, there should be a collaboration between the responsible stakeholders to ensure effective monitoring and reporting, especially on the benefits associated with tax expenditures.



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