

# IMPACT OF TAX EXEMPTIONS AND INCENTIVES TO TAX REVENUES IN KENYA

29<sup>th</sup> October 2021

# Outline

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# Comparative Revenue Collection in Mn US \$

Country	2015/16	2016/17	2017/18	2018/19	2019/20
KRA	11,863	13,325	14,020	15,621	15,517
RRA	1,321	1,322	1,452	1,558	1,625
TRA	6,133	6,437	6,837	7,041	7,695
URA	3,403	3,655	4,052	4,522	4,593
OBR	368	385	436	495	544
<b>Total Excluding Kenya</b>	<b>11,225</b>	<b>11,800</b>	<b>12,776</b>	<b>13,617</b>	<b>14,457</b>

# Comparison of tax rates across countries

Countries	VAT	Corporation Tax	PAYE	Import Duty- Motor Vehicle	Excise Duty Imports – Motor Vehicle
Malaysia	10%	24%	30%	30%	105%
Mauritius	15%	15%	15%		100%
South Africa	15%	28%	45%	36%	20%
United Kingdom	20%	19%	45%	22%	
Tanzania	18%	30%	30%	25%	25%
Kenya	16%	30%	30%	25%	20%
Burundi	18%	30%	30%	25%	15%
Rwanda	18%	30%	30%	25%	15%
Uganda	18%	30%	30%	25%	10%
Chile	19%	27%	35.5%	6%	
South Korea	10%	25%	45%	8%	20%
Singapore	7%	17%	22%	7%	20%

# 1. Introduction

- Tax Expenditure (TE) – is a collective term referring to tax revenue foregone through tax deductions, tax exclusions, tax credits, and reduced tax rates for certain activities, industries, or taxpayers.
- Include Tax Incentives, Exemptions, Remissions.
  - ✓ Used to support Government Development Agenda: – Investments, Exports Growth, Output and Employment Creation.
  - ✓ Awarded based on multilateral and bilateral agreements/conventions.
- However, TE are a cost in terms of revenue foregone
- Hence the need for a holistic Fiscal Framework for management of Tax Incentives – Cost Benefit Analysis.

## 2. Impact of Tax Incentives Exemptions & Remissions

- Tax incentives in form of exemptions and remissions are grouped into:
  - investment-related incentives and
  - trade-related (export promotion) incentives.
- The VAT Act of 2013 reduced significantly the exemptions by reducing the number of items that fall under preferential rates in 2013/14.
- However, the gain has been eroded gradually over the past six years.

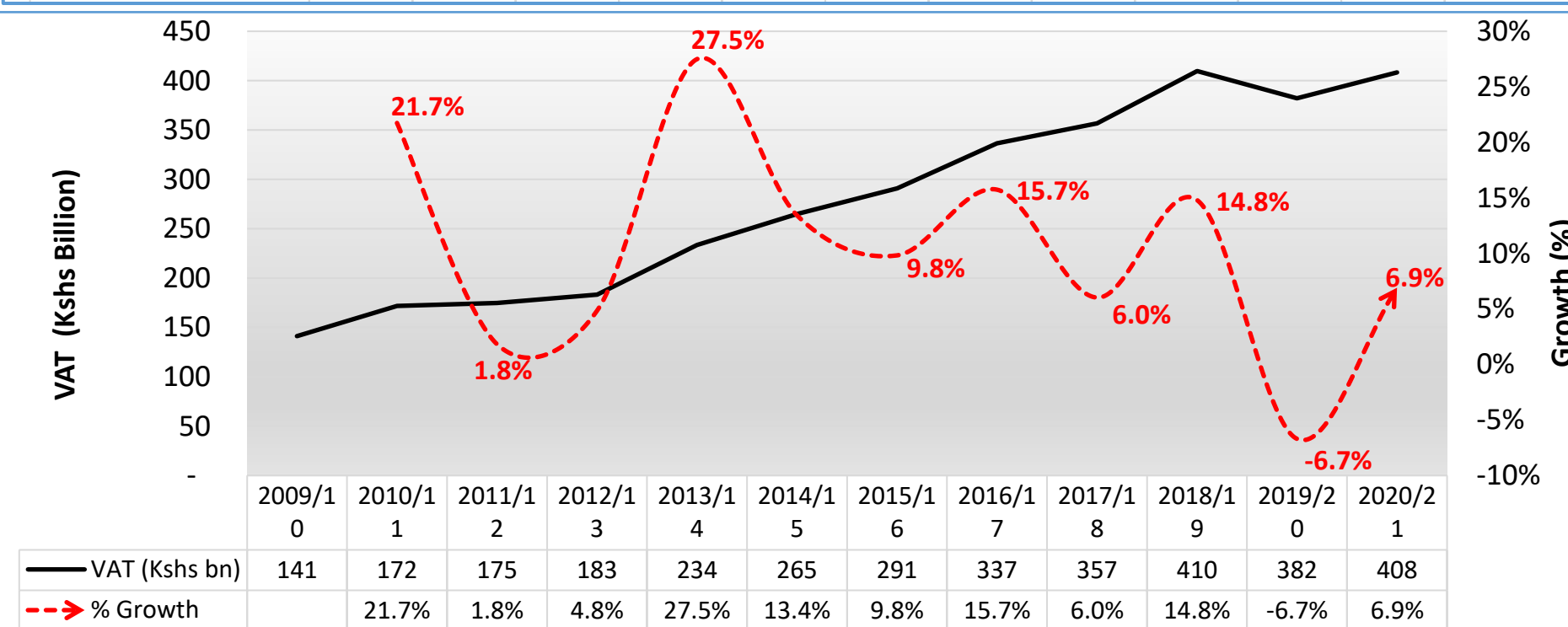
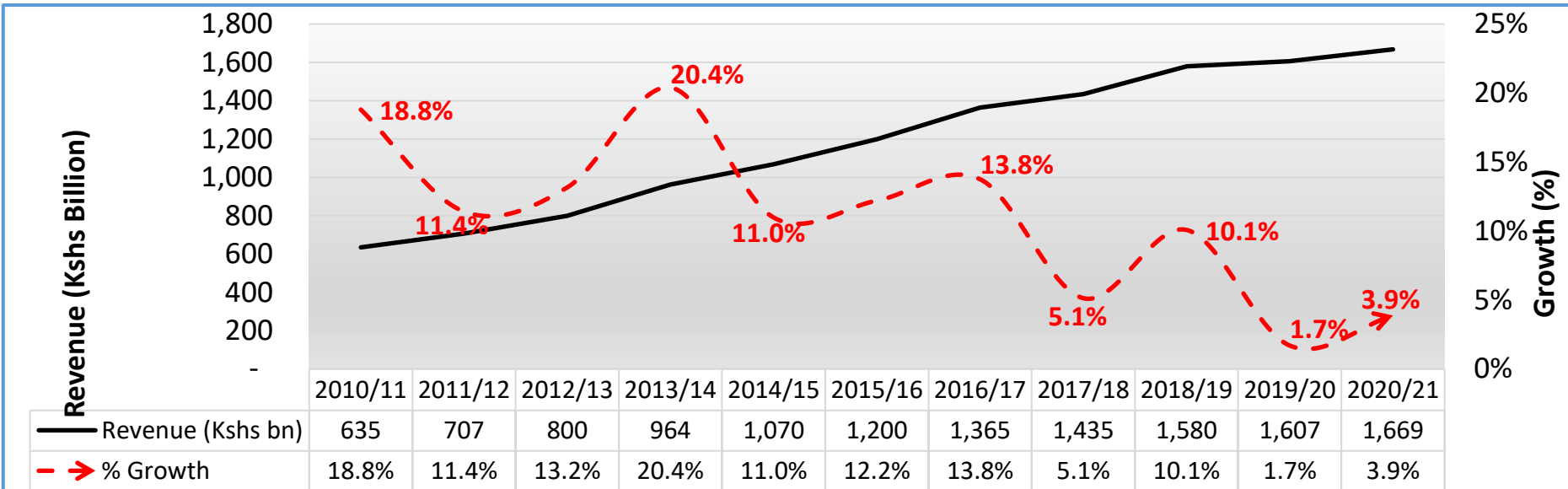
# Exemptions & Remissions ...

- 2013/14 VAT reforms significantly reduced zero-rated and exempt items.
- VAT Act, 2013 reduced the number of exemptions and zero-rated items. However, in 6 years, the numbers increased exponentially:

	Item	2013	2019
1.	Exempt goods	40	104
2.	Exempt Services	18	31
3.	Zero-rated supplies	8	17

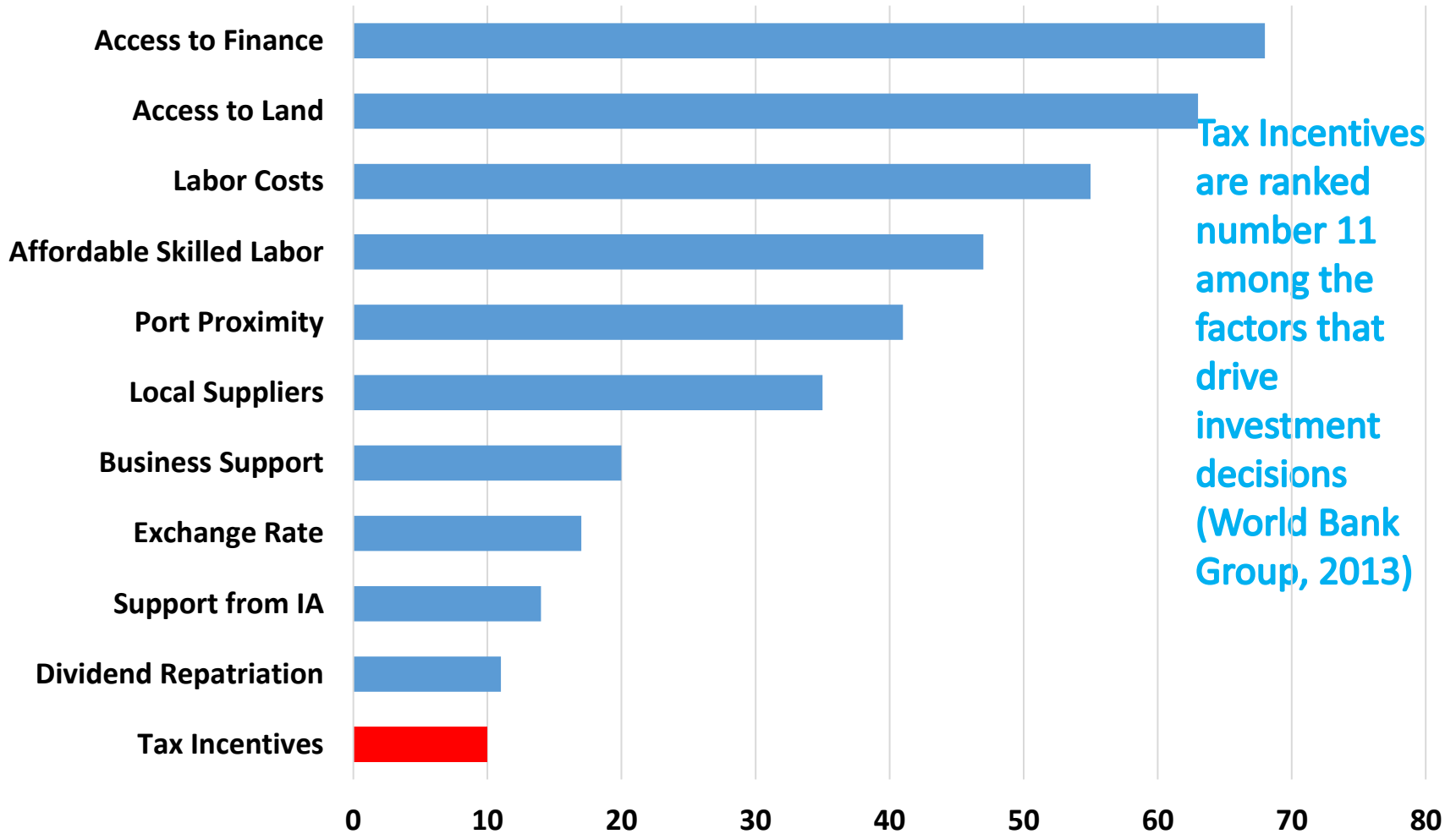
- Kenya Tax Policy Studies undertaken by World Bank in 2017 reported revenue foregone due to VAT exemptions/zero rates and Income Tax exemptions were at 3.13% and 1.9% of GDP, respectively.
- **Income Tax:** In the past, preferential CIT rates and WHT rates for EPZ, SEZ, e.t.c.; enhanced capital allowances e.g. 150% investment deduction; and enhanced expenditure allowances e.g. 130% deduction for electricity reduced the base for CIT revenue.

# Impact of VAT Exemptions Reduction in 2013/14



# Do Incentives promote Investment?

Importance of Factors in decision to invest in Kenya (%)



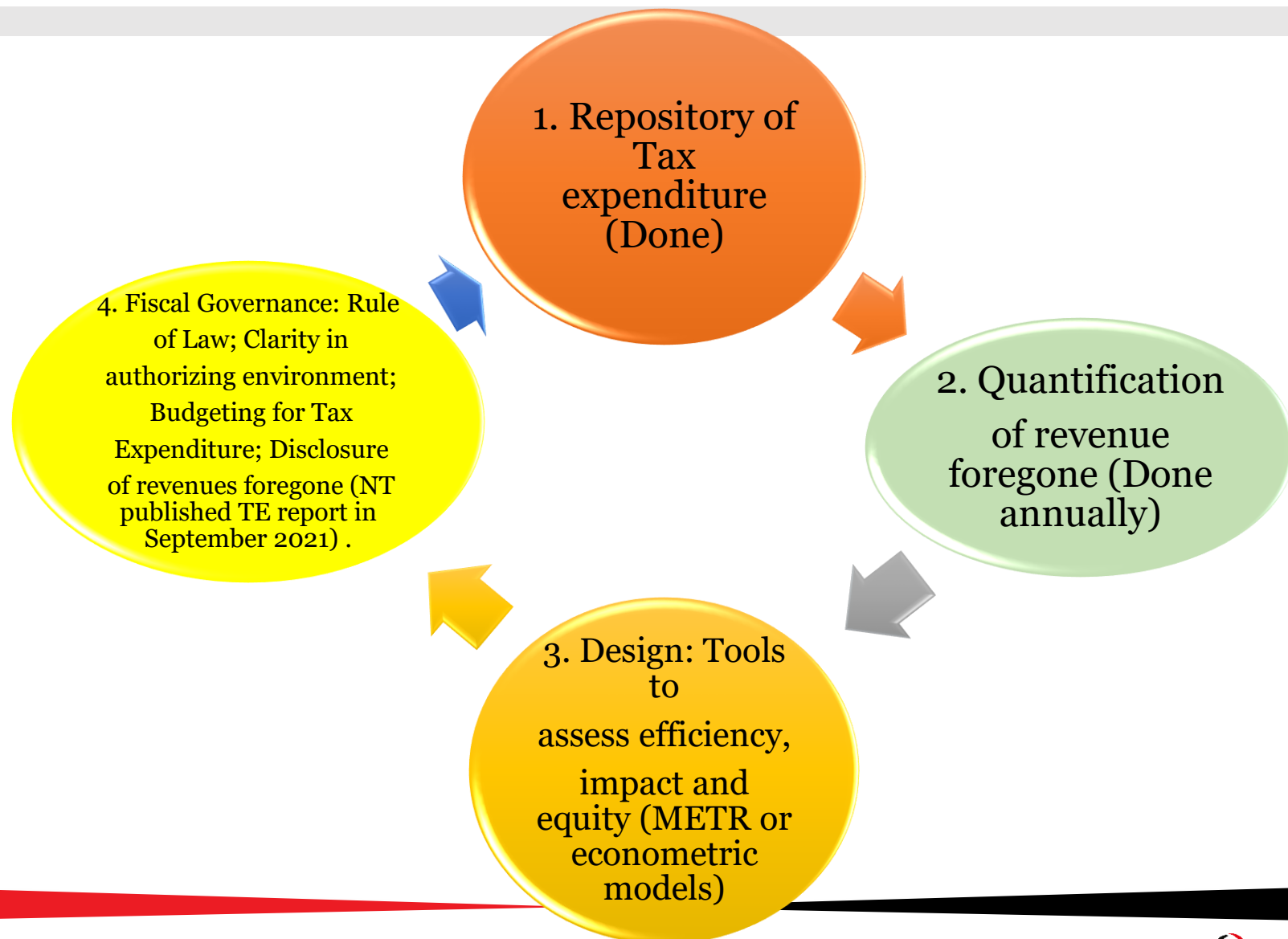
### 3. Fiscal Framework for Tax Incentives

- **Tax incentives policy** entails reducing or forgoing tax payments for certain economic agents to attract investment, increasing employment, promoting exports or cushioning households in low-income segments from the excessive tax burden.
- The foregone revenue due to tax incentives policy is known as **tax expenditure**
- Tax incentive policy may be cost ineffective especially if the fiscal cost outweighs the envisaged benefits.
- Therefore, the benefits and cost of tax expenditure policy should be quantified and cost effectiveness determined accordingly.
- A **Benchmark system** and a **repository** have been developed to aid in cost benefit analysis of tax incentives policy.
- **Benchmark Tax System (BTS)** is a document defining what is, and what is not a tax expenditure item. This is based on the National Priorities and Laws, and international Conventions/Agreements.
- **Repository** is a list of all tax incentives identified from the tax code.

# Integrated Framework on Fiscal Management of Tax Incentives

- In principle, a good tax system should entail a cost effective tax incentive policy
- The benefits of tax incentives should surpass the forgone tax revenue (cost).
- Often, the fiscal cost of tax incentive policy may outweigh the envisaged benefits; ultimately constraining the much-needed revenue for public spending.
- To track tax policy impact within the fiscal policy sphere, Kenya has adopted an **Integrated Framework on Fiscal Management of Tax Expenditures** approach.
- This approach helps in synchronizing the components of fiscal policy as shown in the next slide.

# A four-step Diagnostic Framework for Tax Incentives



# A four-step Diagnostic Framework for Tax incentives

- 1. Repository of tax expenditure:** The initial step implies identification of all tax expenditures in the tax codes. Deviations from the tax norm (benchmark system) constitutes tax expenditures.
- 2. Estimation:** The foregone tax revenue is obtained once the repository is established.
- 3. Assessment tools:** Entails various efforts to assess cost-benefit of tax expenditure. This is achieved through the use of marginal effective tax rate (METR) and **panel econometric modelling**.
- 4. Fiscal Governance:** An annual update of policy objectives and revenues foregone, in the context of revenue forecasting in support of the annual budget law; and a commitment by the government to monitor and to disclose assessments of revenue foregone regularly (**NT has published TE report**)

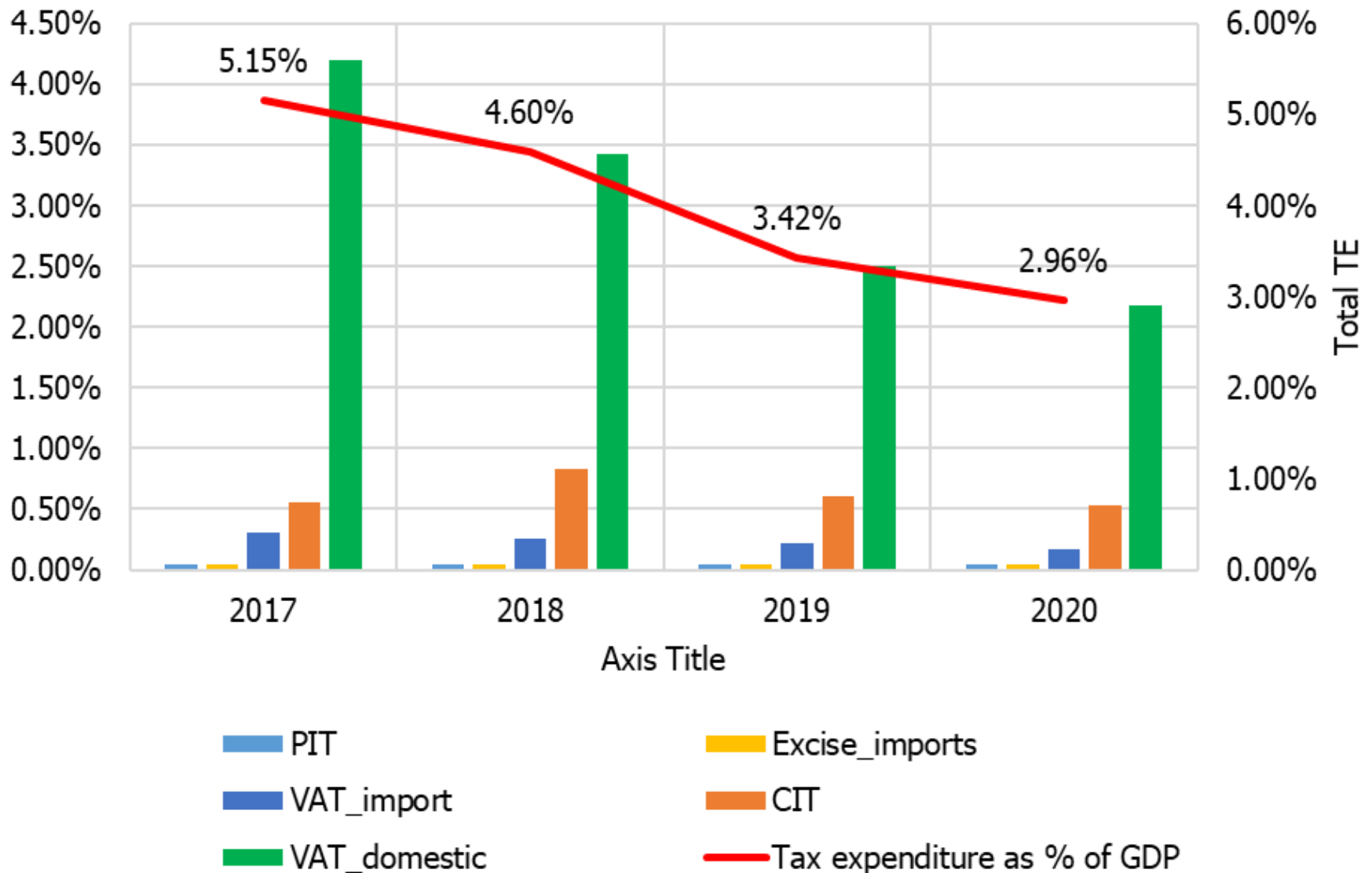
## 4. Tax Expenditure Estimates

- Based on the Benchmark system (Positive approach), the foregone revenue due to tax incentives policy are as follows.

<b>Tax Expenditures Kshs. Million</b>				
	<b>2017</b>	<b>2018</b>	<b>2019</b>	<b>2020</b>
PIT	3,526	3,816	4,654	4,125
CIT	47,560	77,096	61,981	56,737
VAT_domestic	356,707	319,886	257,206	234,378
Excise_imports	3,777	4,127	4,221	5,389
VAT_import	25,546	24,415	22,795	17,695
Total	437,116	429,341	350,856	318,324
Nominal GDP	8,483,396	9,340,307	10,255,654	10,752,992
<b>Tax expenditure as % of GDP</b>	<b>5.15%</b>	<b>4.60%</b>	<b>3.42%</b>	<b>2.96%</b>

Source: National Treasury and Planning, September 2021

# Tax Expenditure Estimates % GDP



# Changes in Tax Expenditure Estimates

- Tax expenditure reduced in the four years under review from a high of 5.15% in 2017, 4.60% in 2018, 3.42% in 2019 to 2.96% in 2020
- The drop was mainly driven by:
  - i.Reduction in the number of items exempted from VAT over the last four years.
  - ii.Decrease of PIT due to decrease in taxable income as a result loss of employment occasioned by Covid-19.
  - iii.The decrease in CIT tax expenditure due to harmonization and reduction of investment deduction rates.
  - iv. Generally, the taxable base declined due to COVID-19 shock resulting in decline in tax expenditure estimates.

## 5. Tax Policy Changes to manage tax exemptions and incentives –Tax Laws Amendment Act, 2020

Description	Effective Date	Revenue Impact Full Year (Kshs. M) Impact
<b>Tax Laws Amendment Act 2020</b>		
<b>CORPORATE INCOME TAX</b>		
Disallow 30% of electricity cost incurred in addition to the normal electricity expense	25th April 2020	2,700
Delete Par. 7 of 1st Schedule of ITA to discontinue exemption of income of ASK from tax	25th April 2020	10
Delete Par. 40 of 1st Schedule of ITA to discontinue exemption of interest earned on contribution paid to Deposit Protection Fund from tax	25th April 2020	5,200
Delete Par. 56 of 1st Schedule of ITA to discontinue exemption of compensating tax accruing to a producer under a power purchase agreement from tax	25th April 2020	2,500
Amend 2nd Schedule of ITA to reduce Investment Deductions Rate from 150% to 100%, and 50% in the year of use and the balance on reducing balance	25th April 2020	14,743
<b>Sub Total CIT</b>		<b>25,153</b>

# Tax Policy Changes to manage tax exemptions and incentives – Tax Laws Amendment Act, 2020 ...

Description	Effective Date	Revenue Impact Full Year (Kshs. M) Impact
VAT		
Delete par 27 of Part I of First Schedule of VAT Act to remove plant and machinery from VAT exemptions	25th April 2020	16,556
Delete par 29 of Part I of First Schedule of VAT Act to remove supplies for construction of power generating plant from VAT exemptions	25th April 2020	29,340
Delete par 30A of Part I of First Schedule of VAT Act to remove supplies for construction of LPG storage facilities from VAT exemptions	25th April 2020	37
Delete par 53 of Part I of First Schedule of VAT Act to remove computer parts from VAT exemptions	25th April 2020	109
Delete par 55 of Part I of First Schedule of VAT Act to remove supplies for construction of industrial works from VAT exemptions	25th April 2020	200
Delete par 97 of Part I of First Schedule of VAT Act to remove supplies of marine fisheries and fish processors from VAT exemptions	25th April 2020	1
Delete par 22 of Part II of First Schedule of VAT Act to remove services provided for construction of industrial parks from VAT exemptions	25th April 2020	50
<b>Sub Total VAT</b>		<b>46,293</b>
<b>Total tax expenditures deleted</b>		<b>71,447</b>

# Tax Policy Changes to manage tax exemptions and incentives – Finance Act, 2020

Description	Effective date	Amount (Kshss M)	Revenue Impact - Full Year (Kshs M)
<b>CORPORATE INCOME TAX</b>			
Delete Par (v) of section 15 of ITA club subscriptions paid by an employer on behalf of an employee	1st January, 2021	1,392	348
Delete Par (x) of section 15 of ITA expenditure of a capital nature incurred in that year of income, with the prior approval of the Minister, by a person on the construction of a public school, hospital, road or any similar kind of social infrastructure	1st January, 2021	12,000	1,500
Delete Par (u) of section 15 of ITA expenditure of a capital nature incurred in that year of income by a person on rating for the purposes of listing on any securities exchange	1st January, 2021		
Delete Par (s) of section 15 of ITA expenditure of a capital nature incurred in that year of income by a person on legal costs and other incidental expenses relating to the authorisation and issue of shares	1st January, 2021	8	1
Delete Par (ss) of section 15 of ITA expenditure of a capital nature incurred in that year of income by a person, on legal costs and other incidental expenses, for the purposes of listing on any securities exchange	1st January, 2021	7,376	922
Delete Par (h ) of section 15 of ITA entrance fee or annual subscription paid during that year of income to a trade association	1st January, 2021	884	221
<b>Subtotal CIT</b>			<b>2,992</b>
<b>Grand total from Tax Laws Amendment Act 2020 and Finance Act 2020</b>			<b>74,439</b>

# 6. Economic Impact of Tax Incentives: Investment, Exports and firm output – Study by NT/KRA/WB

## Impact on firm investments

Using 119,097 firm-level panel data generated from tax returns for the period 2014 to 2019, it was found:

- ❑ There is no significant difference in investment rates across the various business subtypes (i.e. firms in EPZ, foreign firms, private, public and SEZ).
- ❑ One shilling increase in investment deduction increases the probability of investing by 0.018 percent, which is very small.
- ❑ Deduction in respect of mining, wear & tear, and capital allowance on industrial buildings do not have any effect on the firm investment rate.
- ❑ For each Kshs 2 of total capital deduction expenditure, about Kshs 1 is realized as an investment.
- ❑ A 10% increase in capital expenditure deduction increases firm output by about 1%.

## Impact on Exports

- ❑ A shilling allowed as capital expenditure increases the probability of exporting by 0.48%.

### Cost Benefit Analysis

- ❑ The average annual CIT revenue foregone due to capital expenditure deductions is Kshs. 60,367 million.
- ❑ The cost on average outweighs the benefits of incentives by Kshs. 36,691 million every year.

### Impact on Firm Output

- ❑ a 1 percent increase in capital expenditure is associated with an increase in the firm's value-added by between 0.15% and 0.36%.

# 7. Policy recommendations

- The results imply that export and investment-related tax incentives are either redundant or have a negligible impact on their respective target variables.
- The study, therefore, recommended a review of the second and third schedules of the Income Tax Act with the aim of:
  - i. Discontinuing further issuance of redundant tax incentives to newly registered firms.
  - ii. Gradual phase-out of the existing redundant tax incentives.
  - iii. Developing national guidelines on provisions of tax incentives to guide evaluation and enactments to ensure that only beneficial incentives are provided for in law.
- The National Treasury and Planning is spearheading the development of the **National Tax Policy** which will streamline the provision of Tax Incentives and Exemptions.

## **8. KRA's Efforts to Streamline Tax Exemptions Process**

1. Full automation of all income tax exemptions processes i.e. persons with disabilities, Paragraph 10 of 1<sup>st</sup> Schedule of ITA (charitable institutions), Tax Relief Schemes. Application for the exemptions are lodged on iTax for review and approval and the exemption certificates also issued via iTax.
2. Automation of VAT exemption and zero rating of supplies to privileged persons is ongoing in conjunction with the Ministry of Foreign Affairs. The Ministry's system, IPMIS (Integrated Protocol Management Information System) to be integrated with iTax.
3. Automation of VAT exemption of official aid funded projects is also ongoing in consultation with the National Treasury. The e-Promis (Electronic Project Monitoring Information System) to be integrated with iTax.
4. Field inspections to ensure that the VAT exempted supplies for official aid funded projects are used within the projects. Where any abuse is identified, appropriate action is taken including collection of taxes.
5. Compliance checks and audits for persons (charitable organizations) exempted under Paragraph 10 of the First Schedule to the ITA to confirm that they are carrying out activities for which they are exempted and that their income is not used for any other purposes.
6. Stakeholder engagements with government agencies (National Treasury, Ministries, National Council for PWD's) to streamline exemption processes.

Thank  
you

