



# ANALYSIS OF TAX EXPENDITURES IN KENYA

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**KENYA'S BENCHMARK  
TAX SYSTEM**

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## ABBREVIATIONS

BTS	Benchmarks Tax System
CIT	Corporate Income Tax
GDP	Gross Domestic Product
KNBS	Kenya National Bureau of Statistics
PAYE	Pay As You Earn
PWD	Persons with Disabilities
NT	National Treasury
PIT	Personal Income Tax
OECD	Organization for Economic Co-operation and Development
VAT	Value Added Tax
METR	Marginal Effective Tax Rate
CPER	Comprehensive Public Expenditure Review

## ACKNOWLEDGEMENT

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## EXECUTIVE SUMMARY

Tax systems are set up to primarily collect revenue to finance public goods. However, the tax system could also be used as an alternative policy tool. In the latter case, the government may reduce the taxes payable by entities to meet other social objectives such as cushioning vulnerable groups, encouraging savings or investments, stimulating employment, and protect national investments among others. When this is done, certain provisions of the tax law cease to be revenue collecting provisions, but rather public spending programs disguised in tax language. This is the core for the concept of ‘tax expenditures’. The term “expenditure” emphasizes the fact that foregone revenue, represents government financial assistance to certain groups, that could have been financed by direct budget spending programs.

The report identifies Kenya’s Benchmark tax system, generated through a consensus of what Kenya defines as “Tax Expenditures”, and identifies a list of measures that are regarded as tax expenditures in Kenya based on 2021 Tax Expenditure report. The definition of a benchmark tax system therefore helps in deciding whether identified relief measures constitute a tax expenditure that results in government foregoing revenue, albeit to support other social or public objectives.

The term tax expenditure is defined relative to a benchmark tax system which represents a consistent tax treatment of similar activities or classes of taxpayers and contractual agreement that is not an integral part of the defined benchmark tax system <sup>1</sup>. Accordingly, a tax law provision is considered tax expenditure when it generates a revenue loss and constitutes a deviation from a general tax provision. However, a contrast must be made between specific targeted incentives and the generous tax provisions that are available to all taxpayers regardless of their business undertakings, nationalities, investments and business locations. These generous tax provisions usually do not constitute a tax incentive per se, but are considered an integral part of the general tax structure. For this reason, not all tax concessions are necessarily classified as tax expenditures. Some concessions are viewed as structural features of the tax system and therefore constitute the benchmark. This determination involves an element of judgement in identifying which elements of the tax system are tax expenditures and which ones are not and which ones are part of the benchmark. Therefore the report adopts the National Treasury general concepts to be considered for the definition of the term “tax expenditure”:

That a tax expenditure is a provision which provides preferential tax treatment to one group of taxpayers over another group of taxpayers; and

- i. That a tax expenditure is a provision contained in the tax legislation or agreement that is directly substitutable for a spending programme.

Arising from the above proposition, this reports adopts the following definition for tax expenditure:

***“Any tax law provision and or contractual agreement that is not an integral part of the defined benchmark tax system, and results in preferential treatment of one group of taxpayers over another group; and is directly substitutable for a government spending program”.***

Tax expenditures arise from deviations from the benchmarks as defined; and include specific tax exemptions and waivers, allowances and deductions, reduced tax rates, deferral of tax liabilities and tax credits. This section of the report identifies and summarizes all provisions that deviate from the benchmark regime for each tax type defined above. The relief measures identified may be legislative, regulatory, contractual or exceptional.

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<sup>1</sup> Adopted from 2021 Tax Expenditure Report, The National Treasury tax

**Table 1: List of Tax heads and Tax expenditures**

Tax Head	Tax heads	Different tax incentives/ expenditures under each tax head
Income Tax	Personal Income Tax (PIT)	- Mortgage relief - Insurance relief - Home ownership savings - Exempted income
	Corporate Income Tax (CIT)	- Plant and Machinery Investment deductions - Building Investment deductions - Wear and Tear allowances - Farm works and Agricultural deductions
Value Added Tax (VAT)	Domestic Value Added Tax Expenditure	- The general rate at 16%, - Petroleum products rate at 8% - Zero-rated
Taxes on Imports	Excise Duty	- Excise duty exemption
	Import VAT	- Import VAT exemption

Kenya has tax expenditure programs predominantly aimed to encourage savings, relieve tax burdens on the poor and vulnerable people, induce investment and promoting exports and address externalities, as discussed in chapter 2. Despite, the revenue foregone annually due to these incentives, the benefits derived by the country are however not comprehensively quantified. Often, the fiscal cost of tax incentive policy may outweigh the envisaged benefits; ultimately undermining the much-needed revenue for public spending on infrastructure, public services or/and social safety nets. As a rule of thumb, only those tax incentive programs that can have net benefits, in terms of, the economy and revenue should be granted. This section focuses on the fiscal incidence analysis of tax incentives under income tax (PIT), VAT, and excise duty in Kenya<sup>2</sup>.

Based on the METR analysis, Kenya’s tax system is competitive and, in some instances, subsidizes firms with an average METRs of 11.1 percent that is lower than the maximum CIT rate of 30 percent. The analysis indicates that tax incentives on capital reduced the Marginal Effective Tax Rate (METR) across the selected sectors considered to levels which are lower than the maximum corporate income tax rate. Further there is a significant variations of METRs across the selected. The METRs for the manufacturing sector indicate competitiveness or subsidies extended to the sector and create opportunities to undermine revenue. Agriculture METR is relatively higher than other sectors such as education, though lower than the Corporate CIT rate.

**Policy Implications:** The report findings have created a foundation which can be used to improve fiscal governance of tax expenditures in Kenya: In particular, the following policy recommendations arise:

- i. Government can use the list of tax expenditures to enhance compliance to requirements of Article 210 of the Constitution.
- ii. Whereas government rationalized many tax expenditures in 2020, there is still room for further reform to support revenue collection or compliance to existing legislation. For example, the tax expenditures as they stand today, still contain exemptions which exclude State officers from

<sup>2</sup> The fiscal incidence analysis is referenced on the Kenya 2018 CPER



paying taxes by virtue of the nature of their work. The reform could also target tax expenditures which no longer serve to alleviate existing economic, policy or social challenges and those whose objectives can be met through direct on-budget spending programs; and

- iii. In compliance to the existing legislation, improvements to the budgeting process and enhanced transparency, the list of tax expenditures (as updated) could be used to estimate future annual cost of policy objectives met through tax expenditures as annexure to the budget policy statement.
- iv. Establish an appropriate, evidence-based Tax Expenditure Governance Framework to limit leakages and improve transparency. This phase has supported government establish a Kenya benchmark tax system, established a repository of all tax expenditures, supported quantification of cost and impact of tax expenditures. It is recommended that Government leverage this and complete the fiscal governance by developing tax expenditure fiscal governance arrangements. These may include among others establishing guiding monetary thresholds or ceilings for tax expenditures, clarity on the authorizing environment (i.e. processes and protocols guiding conceptualization, review and approval or retirement of tax expenditures) and Tax Expenditure budgeting.

**Direct taxes on individual incomes are progressive.** 80 percent of the tax incidence falls upon the richest ten percent of the population. The poor are less likely to hold formal sector jobs in Kenya and only earnings generated in the formal sector are likely to be taxed. In addition, personal income tax in Kenya is subject to progressive rates, starting from a ten percent marginal tax rate to 30 percent for higher income groups. At the same time, direct taxes have very limited effects on poverty as the tax burden is concentrated in the upper quintiles and few of these households are pushed below the poverty line. However, direct taxes reduce the Gini index, a measure of inequality with zero indicating perfect equality and one indicating the most extreme form of inequality, by about 2.2 percentage points. Almost a third of all taxpayers are in the top tax bracket.

**The impact of Value Added Tax (VAT) on consumption-based measures of inequality is marginal.** Kenya applies a VAT rate of 16 percent. However, reflecting development priorities, including the intention to make certain goods affordable for the greater majority of low-income households, a number of items are zero-rated or VAT-exempt. The analysis finds that VAT is mildly progressive with respect to consumption (but not with respect to income) but close to being neutral. This suggests that exemptions and zero-rates benefit the poor only marginally. VAT reduces the Gini index by 0.5 percentage points.

**Excise duties on goods and services are largely progressive.** Excise duties on non-alcoholic and alcoholic beverages, tobacco, and airtime account for more than 80 percent of revenues from this tax category. With the exception of excise duty on tobacco products, excise taxes are progressive. However, excise duties account, on average, for only little more than one percent of total household expenditure.

**Public education spending is progressive in absolute terms, but progressivity declines with increasing levels of education.** A disproportionately larger share of children from poor households benefit from public education, in contrast with children of higher income households where the uptake of private primary education is higher. Nonetheless, the net benefits of spending at higher levels of the education system increasingly benefit the better-off. Public technical and teacher education are progressive only in relative terms and public university education is regressive due to low levels of enrollment among the poor.

**Public health spending on outpatient care is progressive.** While Kenya's poor are less likely to seek outpatient care in case of injuries or illness, they are more likely to consult public providers if they do, particularly lower-level facilities such as health centers and dispensaries. This higher uptake among the poor of outpatient care in low-level facilities compensates for lower unit costs at this level relative to government hospitals and lower uptake of outpatient care overall, resulting in a progressive impact of public spending on outpatient care.

**Three potential areas are recommended for further improvement.** First, direct cash transfers should be further expanded in terms of coverage and size. Second, exemptions and zero-rate taxes benefit the poor only marginally. A reevaluation of exemptions and zero rates with an eye to the item-level incidence of VAT across the welfare distribution might boost revenue collection or improve the targeting of exemptions. However, more empirical work is needed in this area and the present analysis should be followed up accordingly. Third, public spending on health could further be shifted away from higher-level health facilities towards lower-level facilities in order to enhance progressivity in primary public health spending.



## CHAPTER 1: INTRODUCTION

### 1.1. Background

Tax systems are set up to primarily collect revenue to finance government expenditure. However, the tax system could also be used as an alternative policy tool by which the government delivers financial support to individuals and companies. In the latter case, this alternative policy intention enables the tax system to be used to achieve public policy objectives through the application of specific measures, such as preferential tax rates, exemptions, deductions, deferrals and tax credits. Some of these measures are intended to cushion vulnerable section of the citizenry from the high cost of living and to encourage or reinforce certain behavior. For instance, to mitigate the adverse effect of COVID-19, the Government of Kenya (GoK) intervened through injection of cash and provision of additional disposable incomes to the people and business by; (i) lowering the Value Added Tax (VAT) rate from 16% to 14%; (ii) reduced tax rates for both corporate and personal income (pay as you earn-PAYE) from 30% to 25% and provided 100% tax relief for persons earning a gross monthly income of up to Ksh 24,000. Moreover, some measures are politically appealing and are often used to achieve other goals and objectives beyond revenue collection, for example encouraging savings, stimulating employment, protecting national industries and encouraging foreign direct investment. When this is done, certain provisions of the tax law cease to be revenue collecting provisions, but rather public spending programs disguised in tax language. This is the core for the concept of *tax expenditures*.

In this regard, the tax system fulfils a similar role to that of public expenditures by adopting measures that deviate from the core function of revenue collection and instead reduces the aggregate tax revenue due from some taxpayers. This trade-off is what is described as *tax expenditures*. In other words, a tax expenditure arises where the tax treatment of an activity or class of taxpayer differs from the standard tax treatment that applies to similar taxpayers or types of activity.

NTA in partnership with Oxfam GB is implementing a project dubbed “*Civil Society Capacity Building for Improved Fiscal Justice in Kenya*”. The overall objective of the project is “*Transparent and accountable revenue generation and public financial management in Nairobi and the National Government of Kenya, for improved social service provision.*” Under this project, the National Taxpayer Association (NTA) commissioned a study on tax expenditures analysis in Kenya complementary to the Kenya’s 2021 tax expenditure report. The study is premised to provide; definition of tax expenditures; identification and cost estimation of major tax expenditures provided by the current tax laws under various tax heads; and finally, evaluation of the social impact through cost and benefit analysis to prompt constructive discourse around policy objectives and rationale for the provisions and therefore enhance budget advocacy work done by civil society.

Tax expenditure 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 (Burman, Toder, Berger, & Rohaly, 2017). Tax incentives a subset of tax expenditures, are commonly geared towards certain economic goals such as attracting and retaining investment and social goals such as cushioning households in low-income segments from the excessive tax burden (Chetty and Hendren, 2013).

A number of features of tax incentives are discernible from prior studies. For instance, whereas the foregone revenue is quantifiable, the gains in employment, social welfare, additional investment, exports, foreign exchange earnings, and economic growth are hardly quantified. Additionally, although the advantages of tax incentives are known, they are not discussed in the literature as extensively as their respective disadvantages. Beginning with the positives, tax incentives may lead to an increase in private sector output (Kosonen, & Harju, 2018), attract foreign direct investment (Klemm, & Van Parys, 2012), and increase real domestic investment, (Nallareddy, Rouen & Serrato, 2018). Conversely, tax incentives counter initiatives

aimed at raising more tax revenue through tax base expansion (Poterba, 2011 and Klemm, 2009). They also violate the optimal tax principles of simplicity, efficiency, transparency, predictability, and equity which exacerbates the cost of tax incentives. Besides, they have the potential to create abusive tax avoidance schemes. Hence, the direct and indirect costs associated with tax incentives seem to overshadow the envisaged economic benefits.

## **1.2. Objectives of the study**

The objective of the tax expenditure study is to inform fiscal policy, as the effectiveness of tax expenditures is rarely the subject of systematic oversight, ex-ante and/or ex-post evaluations. Specifically, the study intends to analyze Kenya's benchmark tax system of tax expenditures and develop a repository on all major tax expenditures under various tax heads (PIT, CIT, VAT, excise duty and VAT on imports). Across these areas, the study will quantify the fiscal, and the social impact of the proposed measures.

The specific objectives are:

- i) Provide an analysis of the tax expenditures in Kenya based on the criteria outlined in the scope of work as outlined in our terms of reference.
- ii) Provide the NTA and its partners with a generally acceptable definition of tax expenditures and compare this with Kenya's classification of tax expenditures.
- iii) Describe the roles and key economic features of tax expenditures as well as how they relate with and affect the budget.
- iv) Compile a list of major tax expenditures provided for by the current tax laws under various tax heads and provide the policy outcomes for each tax expenditure.
- v) The study also outlines how tax expenditures distribute costs and benefits across different segments of taxpayers to identify the impact of the tax expenditures on different groups through an impact analysis based on income/wealth, gender, and minority (special interest) group dimensions to support civil society advocacy for enhanced social justice.
- vi) Provide practical recommendations to civil society actors and government on effective policy options based on the findings of the analysis.

## **1.3. Scope of the Report**

The report presents analysis of the tax expenditure under income tax (PIT & CIT), domestic VAT, excise duty and import VAT for the years 2017 -2020. For each tax head, the report provides a description of the benchmark tax system of the tax expenditure, list of tax expenditures, the roles and key economic features of tax expenditures, cost estimation of tax expenditure, and finally evaluation of cost & benefits of the tax expenditures.

## **1.4. Methodology**

The study utilized both primary qualitative and secondary quantitative data sources. The primary data was obtained from one focused group discussion and four key stakeholder engagements. The secondary data was sourced from Kenya National Bureau of Statistics, publicly accessible data sources, and policy and strategy documents, The National Treasury and the Kenya Revenue Authority. The qualitative data was obtained using structured key informant interviews and focused group discussion. The key target was tax expenditures implementing agencies and key data was collected on the nature of tax expenditures in Kenya; generally acceptable definition of tax expenditures; list of major tax expenditures and their policy outcomes; roles and key economic features of tax expenditures; how tax expenditures distribute costs and benefits across different segments of taxpayers; and proposal of practical recommendations from the respondents on enhancing effectiveness of tax expenditures in the Country while enhancing social justice and service delivery.

## CHAPTER 2: KENYA'S TAX EXPENDITURES

### 2.1. Tax expenditures definition

The Organization for Economic Co-operation and Development (OECD) 2010 publication on tax expenditures defines tax expenditures as “a transfer of public resources achieved by reducing tax obligations with respect to a benchmark tax rather than by direct expenditure”. It is a form of government spending carried out through measures in the tax legislation, regulations and other similar instruments aimed at supporting specific business categories or taxpayer groups, rather than directly through budgeted government expenditures.

Tax expenditure is a collective term referring to tax revenue foregone through tax deductions, tax exclusions, tax waivers, tax credits, tax exemptions and reduced tax rates for certain activities, industries, or taxpayers (Burman, Toder, Berger, & Rohaly, 2017). These different elements indirectly reduce tax liability owed by individuals and businesses. Therefore, tax incentives a subset of tax expenditures, are commonly geared towards certain economic goals such as attracting and retaining investment and social goals such as cushioning households in low-income segments from the excessive tax burden (Chetty and Hendren, 2013).

The term tax expenditure is defined relative to a benchmark tax system which represents a consistent tax treatment of similar activities or classes of taxpayers and contractual agreement that is not an integral part of the defined benchmark tax system<sup>3</sup>. Accordingly, a tax law provision is considered tax expenditure when it generates a revenue loss and constitutes a deviation from a general tax provision. However, a contrast must be made between specific targeted incentives and the generous tax provisions that are available to all taxpayers regardless of their business undertakings, nationalities, investments and business locations. These generous tax provisions usually do not constitute a tax incentive per se, but are considered an integral part of the general tax structure. For this reason, not all tax concessions are necessarily classified as tax expenditures. Some concessions are viewed as structural features of the tax system and therefore constitute the benchmark. This determination involves an element of judgement in identifying which elements of the tax system are tax expenditures and which ones are not and which ones are part of the benchmark.

Therefore the report adopts the National Treasury general concepts to be considered for the definition of the term “tax expenditure”:

- ii. That a tax expenditure is a provision which provides preferential tax treatment to one group of taxpayers over another group of taxpayers; and
- iii. That a tax expenditure is a provision contained in the tax legislation or agreement that is directly substitutable for a spending programme.

Arising from the above proposition, this reports adopts the following definition for tax expenditure:

***“Any tax law provision and or contractual agreement that is not an integral part of the defined benchmark tax system, and results in preferential treatment of one group of taxpayers over another group; and is directly substitutable for a government spending program”.***

The measures that give rise to tax expenditures through a reduction in tax can occur in the following ways;

- i. Exemptions and waivers that involve income or transactions being excluded from the tax base through various headings like exemptions, tax holidays, non-taxable events, among others.

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<sup>3</sup> Adopted from 2021 Tax Expenditure Report, The National Treasury tax

- ii. Allowances and deductions which represent amounts that can be deducted from the tax base before applying the tax rate.
- iii. Credits and offsets which represent amounts that can be deducted from the tax liability, in contrast to deductions, which reduce taxable income. Also included here are refunds which serve to compensate taxpayers financially.
- iv. Rate relief and concessional tax rates which represent lower or reduced tax rates for certain categories of taxpayers or activities than those generally applied.
- v. Tax deferrals that result in postponement or delay in tax payment overtime, without interest or penalties.

However, not every item that falls under one of the parameters listed above is necessarily a tax expenditure. The identification of tax expenditures is a complex process, yet it is a prerequisite for measuring their cost or value. Some tax measures have been adopted in order to rationalize the tax system or to reduce tax administration costs, or they ensue from international obligations or obligations arising from regional membership. Accordingly, only those tax measures which divert from the adopted benchmark for the respective type of tax and which are not considered inherent features based on the tax law design and structure, would qualify as tax expenditures. The accurate formulation of the benchmark is a key to the identification of tax expenditures.

## **2.2. Kenya's benchmark tax system (BTS)**

In order to determine whether a tax expenditure exists and to estimate the value of the tax expenditure, it was necessary to determine what the standard benchmark is. This necessitated the definition of a baseline against which a tax reducing measure can be recognized as either part of the 'normal' tax structure or as a departure from the norm and thus a tax expenditure. This baseline is referred to as the benchmark tax system.<sup>4</sup> The identification process premised on the above considerations therefore resulted in the analysis of the tax law provisions into those that form part of a benchmark tax against which deviations arise. Where the inclusion of a measure in the benchmark is questionable, the measure is reported as a tax expenditure.

The main objective in this section is to define the general regime under each tax head based on the legal framework governing each tax type with a view to identify the relief measures that constitute a tax expenditure or a non-tax expenditure, and therefore to be excluded or included in the benchmark, respectively. The key elements of the benchmark tax system include identifying:

- i. The tax base i.e. the activities or transactions subject to the tax;
- ii. The tax rate i.e. the rate of tax that applies to the base;
- iii. The tax unit i.e. the entity liable to pay the tax; and finally,
- iv. The tax period i.e. the period in which tax obligations arise.

The tax system and structure in Kenya distinguishes between direct taxes and indirect taxes. Accordingly, the benchmark tax system as defined in this report is adopted from the National Treasury tax expenditure report.

Direct taxes are imposed or assessed on either the income derived by a person as remuneration for rendering personal services i.e. employment income; or on the income from property as a return on investments i.e.

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<sup>4</sup> The National Treasury definition

property or investment income; or on income from the profits of a business, trade, profession, vocation or adventure in the nature of trade as the rewards from carrying on a business i.e. business income. Conversely, indirect taxes are levied on goods or services before they reach the consumer who ultimately pays the taxes as part of the market price of the goods or services they consume. Table 1 outlines benchmarks that are used to identify and measure tax expenditures under the selected tax heads.

**Table 1: Kenya’s Benchmarks Tax System (BTS)**

Tax head	Benchmark System
Personal Income Tax (PIT)	The benchmark unit of taxation is the individual and benchmark tax rate and structure as it exists in any given time including tax-reliefs offered to taxpayers.
Corporate Income Tax (CIT)	The benchmark unit of taxation is a corporate body. It is described as the statutory standard or general corporate income tax rate in effect at any given time (currently 30% for Kenyan incorporated entities, and 37.5% for non-resident corporate bodies). The benchmark tax rate for capital gains on property and shares is 5%.
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 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.

In broad terms, tax expenditures are concessions that fall outside a tax norm or benchmark. In practice, tax norms are defined differently across countries, making it difficult to make comparisons. It is important to recognize, from the onset, that differences of opinion exist as to the definition of the benchmark tax system, and hence what constitutes a tax expenditure, thus making it difficult to make direct comparisons as the Benchmark Tax Systems used as a reference vary substantially. For instance, the benchmark tax system for domestic VAT standard rate in Rwanda and Uganda is 18% or 0%, with the benchmark unit of taxation is the final consumer of taxable goods and services.

### **2.3. List of Kenya’s tax expenditure**

Tax expenditures arise from deviations from the benchmarks as defined; and include specific tax exemptions and waivers, allowances and deductions, reduced tax rates, deferral of tax liabilities and tax credits. This section of the report identifies and summarizes all provisions that deviate from the benchmark regime for each tax type defined above. The relief measures identified may be legislative, regulatory, contractual or exceptional.

Personal income Tax (PIT) expenditure take the form of reliefs to taxpayers to encourage savings, home ownership and reduce tax burden, among other reasons. These reliefs include; insurance relief, relief related to persons with disability (PWD) and mortgage relief among others. Corporate Income Tax (CIT)

expenditure take the form of deductions such as mining deductions, industrial deductions, farm work deductions, plant and machinery investment deductions, building investment deductions and wear and tear. These deductions are designed to encourage companies to invest in productive fixed assets. The rate of these deductions vary depending on the type of asset.

The Value Added Tax (VAT) Act, 2013 provides legal provisions against which tax expenditure in regard to VAT are affected. These are tax exemptions and zero ratings.

- i. Tax exemption: This involves remission or waiver of a national tax, a fee or a charge. Suppliers of goods that are exempt can neither charge output VAT nor claim input VAT. Thus, no VAT is chargeable on the supply of exempt goods or services.
- ii. Zero rating: This involves total waiver of taxes on goods and services mainly due to their societal importance or are consumed in foreign jurisdictions. Thus, no VAT is payable on the supply (it is charged at 0%). The suppliers of zero-rated goods or services claim input VAT.

Tax expenditure in respect to VAT, therefore, is the revenue foregone due to exemptions, zero-rating of certain goods and services as well as exemptions from payment by certain bodies or persons. Tax expenditures on VAT are issued to relieve tax burdens on the poor and vulnerable people.

Under excise duty, tax expenditures include: exemptions on inputs for manufacture of sanitary towels; exemption on denatured spirits for use in the manufacture of gasohol or as heating fuel is exempt from excise duty; and rate relief/variation for similar goods as provided for in the Section 7 (1, e) and the First Schedule of the Excise Duty Act, 2015. Import VAT tax expenditure arise from exemptions, zero-ratings, and preferential VAT rate of 8 percent on petroleum products. This expenditure takes the form of duties and is meant to address the negative externalities that certain goods and services tend to have.

Kenya's tax expenditures are comparable to those of EAC countries. Between 2017 and 2020, tax expenditures as a percentage of GDP in Kenya averaged 4.0 percent. This is compared to an average of 3.1 percent of GDP in Uganda and 3.2 percent of GDP in Rwanda (Table 2). It is however important to note that comparison of tax expenditures between different countries is difficult as the Benchmark Tax Systems used as a reference vary substantially.

**Table 2: Comparison of Kenya's Tax Expenditure with her peers (% percentage of GDP)**

Year	Kenya	Uganda	Rwanda
2017	5.2%	2.4%	
2018	4.6%	2.6%	2.5%
2019	3.4%	3.7%	3.0%
2020	3.0%	3.6%	3.5%
2021			4.0%

Source: Kenya 2021 Tax expenditure report; Uganda 2020 Tax expenditure report; & Rwanda 2021 Tax expenditure report



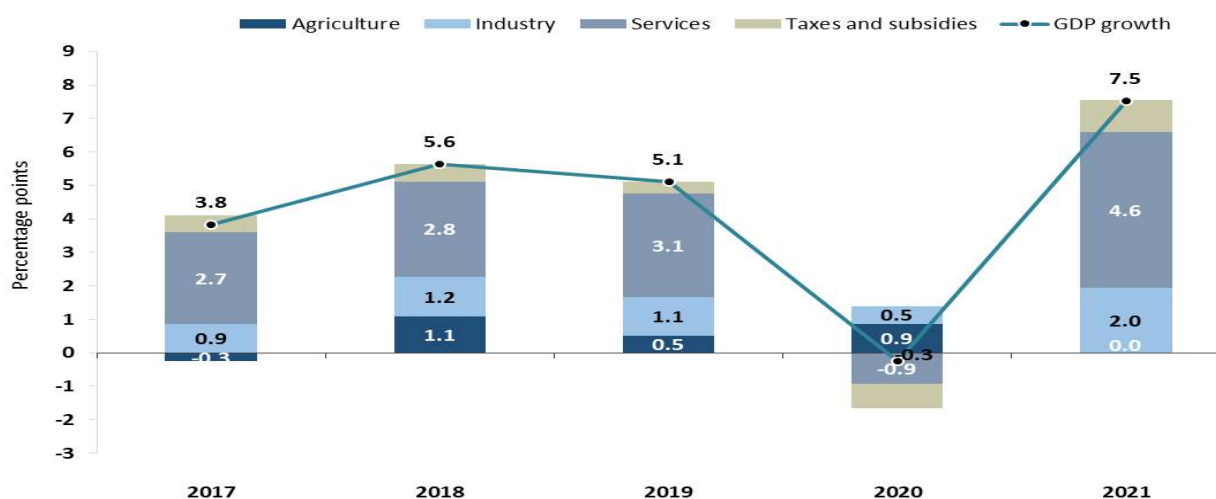
**CHAPTER 3: TREND ANALYSIS OF TAX EXPENDITURE 2017-2020**

**3.1. GDP growth, Revenues and Tax expenditure Trend Analysis**

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 transformed both economic and political governance structure. For instance, the constitution introduced a new legal framework and institutions to ensure transparency and accountability in the management of public finances by providing for public participation in the budget-making process and access to information to key budgetary documents that outlined the government’s spending priorities and the potential resources. In addition, implementation of public infrastructure projects, strong public and private sector investment, and appropriate economic and fiscal policies have supported the economic growth over the study period.

Economic growth in Kenya between 2017 and 2021 remained resilient despite several challenges. The Kenyan economy recorded an average growth rate of 4.4% between 2017 and 2021<sup>5</sup> (Figure 1). Overall growth was volatile, interrupted by a near-stagnant economy in 2020. Economic growth decelerated to a 5-year low estimated at 3.8% in 2017, mainly due to poor rains, slowdown in credit growth to the private sector and election-induced uncertainty. Moreover, Kenya’s economy was severely disrupted by the COVID-19 shock in 2020. After contracting by 0.3% year to year (y/y) in 2020, GDP growth staged a strong recovery, expanding by 7.5% y/y in 2021, supported by rebounds in industry and, especially, services. However, following a strong performance in 2020, the agriculture sector’s output fell by 0.2 percent in 2021 affected by drought conditions in the arid and semi-arid lands. On the expenditure side, improving employment conditions and household incomes against the backdrop of resilient remittances and a strong recovery in services and industry increased household consumption by 6.2% y/y in 2021 against a contraction of 2.5% a year earlier.

**Figure 1: Driver of GDP growth 2017-2021**



Source: Author’s calculation using data from KNBS

<sup>5</sup> KNBS

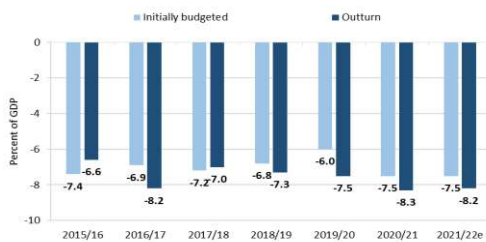


The economic outlook remains highly uncertain and risks to the forecasts were elevated (World Bank, 2022). First, Continuing the momentum on vaccination remains a key factor in the outlook. Although confirmed new cases are currently very low in Kenya, the future course of the pandemic remains uncertain, including the possibility of disruptive future waves of infections from any new variants of the coronavirus. This makes it important to achieve the government’s target of inoculating Kenya’s entire adult population against COVID-19 by end-2022. Second, the war in Ukraine affects the Kenyan economy through, mainly indirect channels and exacerbates uncertainty as to the economic outlook. Though Kenya has limited direct trade and financial links with Russia and Ukraine, the war is expected to impact the Kenyan economy through higher global commodity prices—for example in recent months there has been increase in global oil prices that has led to a spike in domestic inflation rate due to increase in local pump prices—tighter global financial conditions, and slower global growth.

### 3.2. Composition of taxes -Tax structure

The fiscal out-turn data released by the National Treasury (NT) shows a substantial increase in the budget deficit over the study period 2017-2021, calling for stronger measures to return Kenya to a path of fiscal consolidation. Despite a significant reduction in the fiscal deficit from 6.6 percent of GDP in FY2015/16 to about 7.0 percent in FY2017/18, continued downward adjustment was not achieved as the central government deficit expanded to 8.2 percent in FY2021/22 (compared to a target deficit of 7.5 percent of GDP) (Figure 2). This represents 0.7 percentage points (as a share of GDP) above the target primarily due to revenue shortfalls (Figure 3) but also due to expenditure pressures amidst revenue underperformances. This calls for credible adjustment measures by the government to place fiscal accounts back on a prudent trajectory. These include actions to increase revenue and make revenue projections more realistic, strengthening expenditure controls and cash management. Rebound in economic activity and ongoing tax reforms have boosted revenue collection in FY2021/22 as revenue remained on target and performed above the previous year’s outturn. As share of GDP, total revenue stabilized at 17.4 percent in FY2021/22.

**Figure 2: The actual fiscal balance is wider than the target**



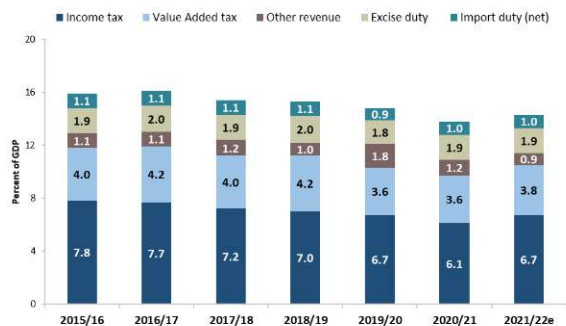
Source: The National Treasury

**Figure 3: Revenue shortfalls have resulted in fiscal slippages**



Source: The National Treasury

**Figure 4: Revenues have declined consistently over the last five years**



Source: The National Treasury

Reversing the downward trend in tax revenue mobilization is critical for creating fiscal space. In recent years there has been a structural decline in tax revenues from 19.2 percent of GDP in FY2013/14 to 16.4 percent of GDP in FY2019/20. This has arisen due to several factors. First, the structure of the economy has changed in favor of non-tax revenue rich sectors such as agriculture — which has expanded as a share of GDP from 27.5 percent in 2014 to 34.2 percent in 2021. For instance, while agriculture accounts for about 34.2 percent of nominal GDP in 2021, its contribution to revenue is just about 2.6 percent. This contrasts with manufacturing that accounted for 7.7 percent of nominal GDP but about 18.2 percent of tax revenue. Second, discretionary changes to the income tax code (corporate and personal) have eroded the tax base through generous depreciation allowances, investment deductions and tax holidays, particularly for export processing zones and special economic zones. Finally, a large informal sector<sup>6</sup> and preference of firms to stay under the radar of the revenue collecting agency.

However, revenue collection in FY2021/22 remained on target and performed above the previous year’s outturn. The strong revenue performance was broad-based, with income tax and VAT increasing the most as tax relief measures introduced at the onset of the COVID-19 pandemic were unwound and tax expenditures were reduced by harmonizing exemptions. Additional tax administration measures such as the Voluntary Tax Disclosure Program<sup>7</sup> also helped to increase revenue collection over the same period.

The decline in income tax accounts for most of the revenue shortfall. In FY2017/18, revenue from income tax<sup>8</sup> was below target by approximately 16.3 percent, representing a decline to 7.2 percent in FY2017/18 from 7.9 percent in FY2013/14. This reflects lower revenue yields from both CIT— CIT is characterized by multiple rates and numerous tax incentives, which erodes the tax base and collected revenues— withholding tax and PIT. In FY 2021/22, this trend was reversed, with a strong revenue performance in income tax as most as tax relief measures introduced at the onset of the COVID-19 pandemic were unwound.

The performance of value added taxes (VAT) and excise duty remains broadly stable, although collections remain below historical trend. VAT has stabilized at around 4.4 percent of GDP over the last five years (2014-2021), which is lower relative to the high of 4.6 percent over 2010-2012 period. The removal of VAT exemptions on petroleum products in the Finance Act, 2018 yielded at least Ksh. 14.4 billion (or 0.16 percent

<sup>6</sup> The informal sector created 753.8 thousand jobs accounting for 81.4 percent of the total jobs created outside of small-scale agriculture and pastoralist activities.

<sup>7</sup> Effective from January 2021, the Voluntary Tax Disclosure Program allows a person to disclose undeclared tax liabilities for the period of 1 July 2015 to 30 June 2020 and obtain full or partial relief of penalties and interest on the tax disclosed under the program (Source: KRA).

<sup>8</sup> Comprises PIT, CIT, withholding tax, turnover tax, lotteries tax, presumptive tax, capital gains tax, and rental income obtained from the fourth quarter of Quarterly Economic Budget Review, various issue.

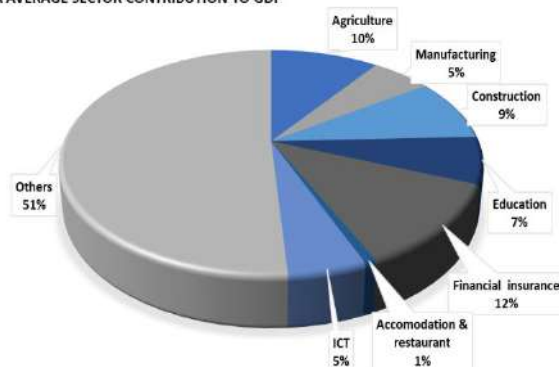
of GDP) in additional revenue, but a review of the entire exemption regime and zero-rating could raise this to about 3.5 percent of GDP in additional revenue. Moreover, tax policy for the digital economy is still evolving, and authorities could review the extent to which VAT from the various business lines could be collected. Excise revenue remained largely unchanged over the study period. Recent tax measures to boost collection from excise revenue (Excise on airtime, data, telephone services, and financial services transactions) are likely to contribute to improved revenue collection but could also lead to unintended disincentives to the growth of the digital economy.

### 3.3. Sectoral driver of tax expenditures

Over the last 5 years (2017-2021), agriculture, financial & insurance activities, and education contributed on average 9.9 percentage point, 12.1 percentage point, and 6.7 percentage point to GDP respectively. While accommodation & restaurant contributed a 1 percentage point to GDP over the review period. The top sectors that provided wage employment include manufacturing, agriculture and education accounted for on average 11.9 percent, 11.7 percent and 20.5 percent, on average respectively over the same horizon (Figure 5). Employment in accommodation & restaurant sector has been on a recovery mode from the drastic decline at the height of the COVID-19 pandemic.

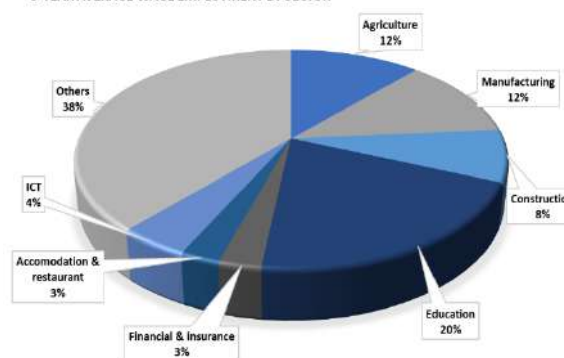
**Figure 5: Sector Contributions to GDP and Employment**

5-YEAR AVERAGE SECTOR CONTRIBUTION TO GDP



Source: Own Calculation based on KNBS data

5-YEAR AVERAGE WAGE EMPLOYMENT BY SECTOR



Source: Own Calculation based on KNBS data

#### a. Taxation of the manufacturing sector

The Sector taxation system is based on the following:

- i. Standard tax rate to all firms except those in the Special Economic Zone (SEZ) who are taxed at 10%.
- ii. Export Processing Zones (EPZ) firms enjoy a ten-year tax holiday.
- iii. Industrial buildings enjoy an investment deduction (100%) and a straight-line Industrial buildings allowance of 10 percent.
- iv. Companies outside Nairobi, Mombasa or Kisumu municipalities, enjoy an investment deduction of 150 percent.
- v. Wear and tear are available at various rates i.e. 37.5, 30, 25 and 12.5 percent.

The June 2020 annual Budget speech announced new tax measures which included reduction in CIT rate to 25 percent and reduction in depreciation and or Investment Deduction rates. Existence of a 10-year tax

holiday for EPZ firms, returns a negative METR for the sector implying substantial subsidies in this area. The report analyses the METR for the manufacturing sector located in Export Processing Zones and found it is negative 98.7 percent or negative 64 percent new regime. All assets return negative METRs implying all assets are subsidized.

The reduced Corporate Income Tax (CIT) rate for firms operating in Special Economic Zones (SEZ) of 10 percent, reduces the METR to about 1.7 percent or 4.9 percent under new regime. Both Industrial buildings and equipment or machinery continue to depict negative METRs implying subsidization of the two categories of assets.

#### **b. Taxation of the agriculture sector**

The Sector taxation system is based on the following:

- i. Standard corporate income tax rate of 30 percent.
- ii. 100 percent tax capital expenditure allowance on 33.3 percent of expenditure farm works subject to depreciation allowance.
- iii. Wear and tear allowances on tractors and combine harvester's 37.5 percent.
- iv. Wear and tear are available at various rates i.e. 25 and 12.5 percent.
- v. City levy permit of 0.3 percent f. Agriculture CESS of 1 percent on turnover

Under the new regime, tax rates were reduced to 25 percent and while initial allowances on farm works was reduced to 50 percent.

Agriculture METR is relatively higher than other sectors such as education, though lower than the CIT rate. The METR for agriculture stands at about 15.54 percent or 19.03 percent when one assumes an agriculture CESS levy of about 1 percent. The METR largely attributable to bigger portions of furniture and fittings, vehicles and 'other' assets is higher than sectors such as tourism (4.2 percent) or education (15.86 percent).

#### **c. Taxation of the education sector**

The education sector contributes about 7 percent to Kenya's GDP and employed more than 20 percent of Kenyans in employment age. It is a service delivery sector which contributes towards human capital for the country.

The Sector taxation system is based on the following:

- i. Standard corporate income tax rate of 30 percent reduced to 25 percent in July 2020.
- ii. Hostel, education and training buildings which receive straight-line industrial buildings allowance of 50 percent but reduced to 10 percent in July 2020.
- iii. Wear and tear are available at various rates i.e. 30, 25 and 12.5 percent.
- iv. City levy permit of 0.3 percent

The METR in the education sector at 15.9 percent or 20.9 post July 2020 is lower than the corporate income tax rate. The METR is driven largely by the 50 percent straight line investment deduction on buildings<sup>9</sup> and a gearing ratio of more than 58 percent. The high investment deduction for buildings (50 percent compared to economic depreciation of 6 percent) supported the sector in achieving an average tax depreciation rate for all assets of 22.5 percent. This rate was higher than the average economic depreciation rate of about 21 percent and imply, conferment of some tax benefits to the sector.

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<sup>9</sup> Buildings in the education sector, comprise 38 percent of the total assets.

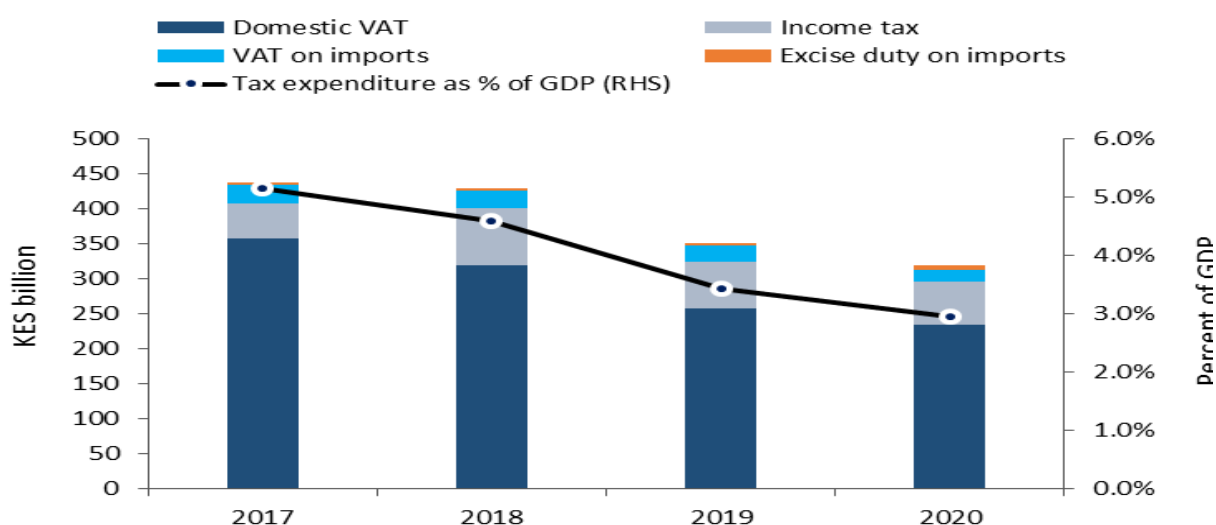
**CHAPTER 4: SOCIAL IMPACT OF TAX EXPENDITURES IN KENYA**

**4.1. Cost estimation of tax expenditures in Kenya**

a. **By Revenue-forgone approach<sup>10</sup>**

Kenya loses Kshs. 100 billion annually due to tax incentives (Curtis, Kambuni, Daniels, Mosioma, Mshana, Ambrose, & Ngowi, 2012). Recent estimates by the National Treasury show that the revenue foregone due to tax incentives has been on a downward trend over the last 4-years from Kshs. 437 bn in 2017, Ksh. 529 bn in 2018, Kshs. 352 bn in 2019, to Kshs. 318 bn in 2020 (Figure 6). These represent 5.2 percent, 4.6 percent, 3.4 percent and 3.0 percent of the GDP for the respective years. VAT and income tax exemptions accounts for most of the revenue lost over the period.

**Figure 6: Tax expenditure by tax head**



Source: The National Treasury

Tax expenditure under VAT is the largest averaging 3.9 percent of GDP. This represents revenue foregone due to exemptions and zero-rating of certain goods and services as well as exemptions from payment by certain bodies or persons. It is estimated at Ksh. 370.4 billion (or 4.2% of GDP) in 2018. Tax expenditure under personal income tax (PIT) is minimal (average 0.1 percent) but largely benefits higher income households. This contains tax forgone due to personal relief, insurance relief, relief related to persons with disability (PWD), and mortgage relief among others. Tax expenditure under custom taxes is in the form of exemptions and zero-rated items under import duty, excise, and VAT on ordinary imports and petroleum imports.

**4.2. Cost-Benefit Analysis on selected tax head’s incentive in Kenya**

Kenya has tax expenditure programs predominantly aimed to encourage savings, relieve tax burdens on the poor & vulnerable people, induce investment & promoting exports and address externalities, as discussed in chapter 2. Despite, the revenue foregone annually due to these incentives, the benefits derived by the

<sup>10</sup> IMF, Tax Expenditure Reporting and Its Use in Fiscal Management: A Guide for Developing Economies, 2019.

country are however not comprehensively quantified. Often, the fiscal cost of tax incentive policy may outweigh the envisaged benefits; ultimately undermining the much-needed revenue for public spending on infrastructure, public services or/and social safety nets. As a rule of thumb, only those tax incentive programs that can have net benefits, in terms of, the economy and revenue should be granted. This section focuses on the fiscal incidence analysis of tax incentives under income tax (PIT), VAT, and excise duty in Kenya<sup>11</sup>.

#### a. Personal income tax cost-benefit analysis

**Personal income is taxed based on a progressive rate structure with six tax brackets.** Income tax in Kenya is imposed *inter alia* on business income, employment income (including benefits), rental income, pensions, and investment income. Personal income tax (PIT) is governed by the Income Tax Act (Kenya Revenue Authority, 2014). Marginal tax rates on income increase progressively from ten percent to 30 percent. In addition, every individual is entitled to an allowance, known in Kenya as ‘personal relief,’ which was KSh13,944 in 2015/16, currently it’s KSh28,800p.a. The personal relief is granted against tax payable. Brackets are periodically adjusted. The present analysis uses the tax brackets as applied in 2015 and 2016 (Table 3).

**Table 3: Tax brackets**

Annual taxable income	Marginal tax rate (percent)	Tax bracket as share of GDP per capita in 2016
On first KSh121,968	10	0.86
On next KSh114.912	15	1.59
On next KSh114.912	20	2.32
On next KSh114.912	25	3.05
On taxable income in excess of KSh466,704	30	3.78

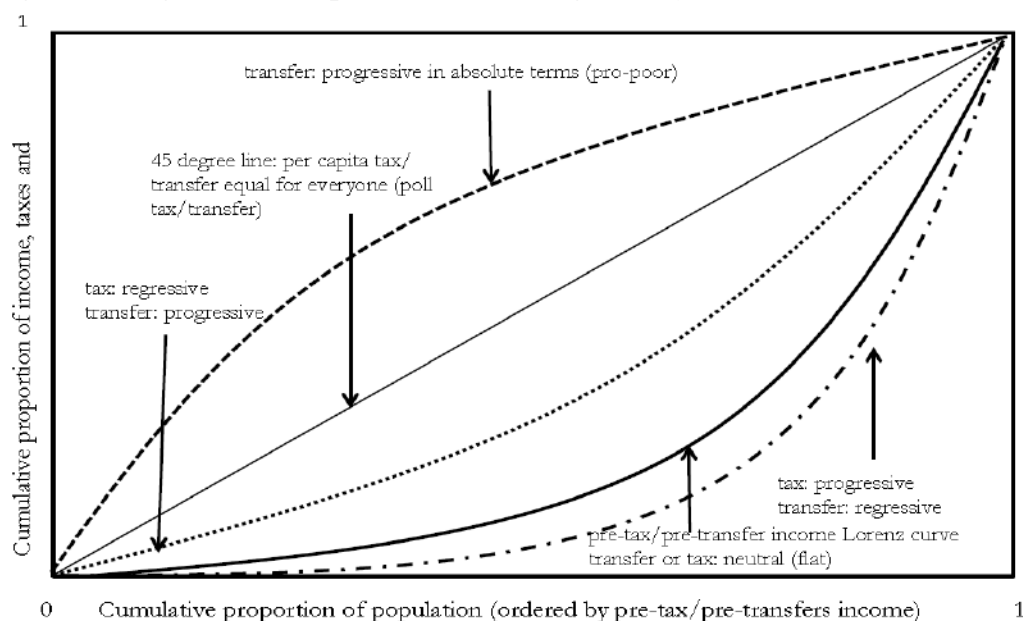
Source: Kenya 2018 CPER report

Higher top tax rates and the resulting increase in structural progressivity imply that the rich pay a relatively larger share of their pre-tax income in taxes. The negative effect on inequality may further be strengthened if the additional revenue is progressively redistributed.

<sup>11</sup> The fiscal incidence analysis is referenced on the Kenya 2018 CPER



**Figure 7: Diagrammatic representation of Progressivity of taxes and transfers.**

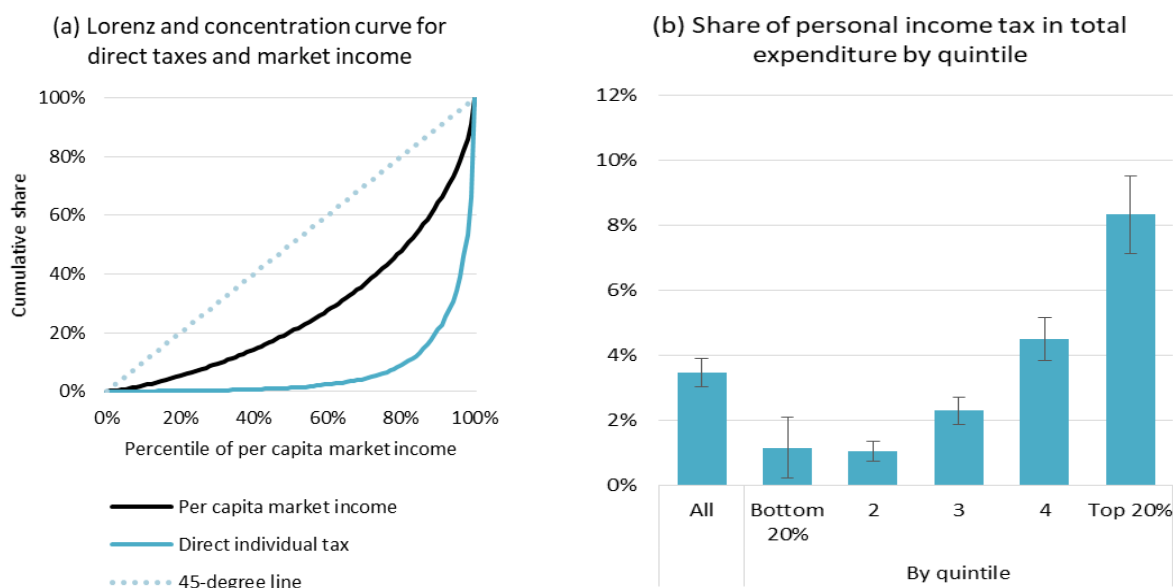


Source: Kenya's 2018 CPER report

**Direct taxes are progressive.** Direct taxes were allocated to individuals in the survey based on the assumptions about formal-sector employment and report of salaries net of taxes and progressivity is assessed based on comparisons between Lorenz and concentration curves (Figure 7). The poorest 40 percent of the population in terms of per capita market income account for 14.3 percent of market income but less than one percent of direct taxes (Figure 8a). In contrast, 80 percent of the incidence is borne by the richest ten percent of the population. On average, direct individual taxes account for only 1.2 percent of total household expenditure among the poorest quintile (Figure 8b). But their share increases to 4.5 percent in the fourth quintile and more than eight percent in the top quintile. This is a result of both limited access to formal-sector jobs among the poor and the progressivity of the tax system (Kenya Comprehensive Public Expenditure Review-KCPER, 2018). Poor workers earn lower salaries and are less likely to hold formal sector jobs, increasing progressivity. Progressivity depends on the tax rate schedule. But since typically only workers in the formal sector pay income tax, progressivity depends also on the distribution of formal sector jobs.



**Figure 8: Lorenz and concentration curves for per capita market income and direct taxes on individual income and share in total expenditure by quintile.**



Source: 2018 CPER report

Source: Kenya’s 2018 CPER report

Note: 95-percent confidence intervals indicated in panel

**b. Value added tax cost-benefit analysis**

**Goods and services in Kenya’s VAT regime are either standard-rated, zero-rated, or exempt.** The standard VAT rate in Kenya is 16 percent. Exclusion from VAT in Kenya appears in two different ways, zero-ratings<sup>12</sup> and exemptions.<sup>13</sup> Of the 460 items for which expenditure was recorded in the survey data, 311 were taxed at 16 percent, 29 were zero-rated, and 120 were exempt. Most exempt goods and services were found in the agricultural sector.<sup>14</sup> The exemption also extends to agricultural inputs such as seeds, fertilizers, and tractors (Kenya CPER, 2018). Two alternative assumptions were made regarding exempt goods in this analysis. Exempt items were either: (i) treated as taxed at the 16-percent rate; or (ii) treated as zero-rated items. While the actual tax rate will typically fall somewhere in-between, it turned out that the distributional implications of these assumptions do not differ substantially. Given that many exempt items in the data pertained to the agricultural sector, in which inputs are often also exempt, it was decided to proceed with the assumption that exempt goods carry no VAT.<sup>15</sup>

**VAT is mildly progressive but close to neutral, regardless of how exempt goods are treated.** The burden of VAT is distributed almost proportionally to market income (Figure 9). For instance, the bottom-40 percent account for between 12.4 and 14.1 percent of the VAT burden, depending on whether exempt items

<sup>12</sup> In this case, a firm selling these items is still allowed to receive credits for taxes paid on its purchases of intermediate and investment goods.

<sup>13</sup> Here, firms selling exempt items are no longer registered tax payer and no credit is allowed for taxes paid on their inputs.

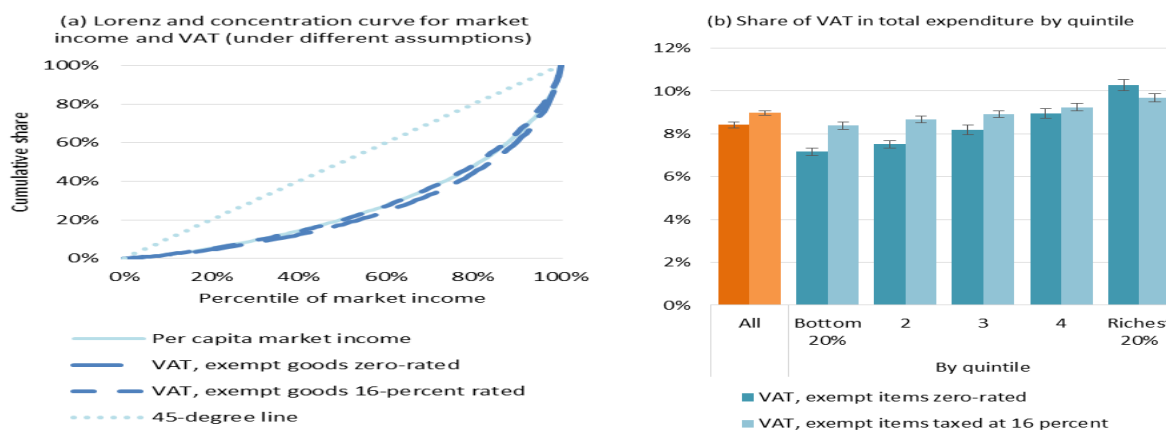
<sup>14</sup> The agriculture sector is largely exempt (VAT ACT 2013)

<sup>15</sup> However, it should be noted that fuel is not exempt. Hence, transport costs do carry embedded VAT.

are treated as zero-rated or taxed at 16 percent, compared to a share in market income of 14.3 percent (Kenya CPER, 2018). The average share of VAT in total household expenditure is 8.4 percent if exempt items are assumed to be zero-rated and 9.0 percent if they are assumed to carry 16 percent VAT (Kenya CPER, 2018). Again, treating exempt goods as zero-rated renders VAT slightly more progressive, but the differences are very small. The expenditure share among the bottom 20 percent increases from 7.2 to 8.4 percent in going from zero-rates to the full 16-percent tax rate and falls from 10.3 to 9.7 among the richest 20 percent. (Kenya CPER, 2018). This may be driven to some extent by the choice of welfare indicator in this analysis, a technical rather than an economic cause. As noted above, many exempt items in Kenya are produced in the agricultural sector, where inputs are also often exempt, therefore it is assumed in the analysis that exempt goods carry no VAT.

**Exemptions could be eliminated or replaced by zero-rates for merit goods without major distributional consequences.** Exemptions do not have a large effect on the relative distribution of welfare because they are both applied to merit goods and other goods that could be considered luxury goods and services, such as air ticketing services supplied by travel agents.

**Figure 9: Lorenz and concentration curves for market income and VAT under different assumptions about exempt items and share in total expenditure by quintile.**



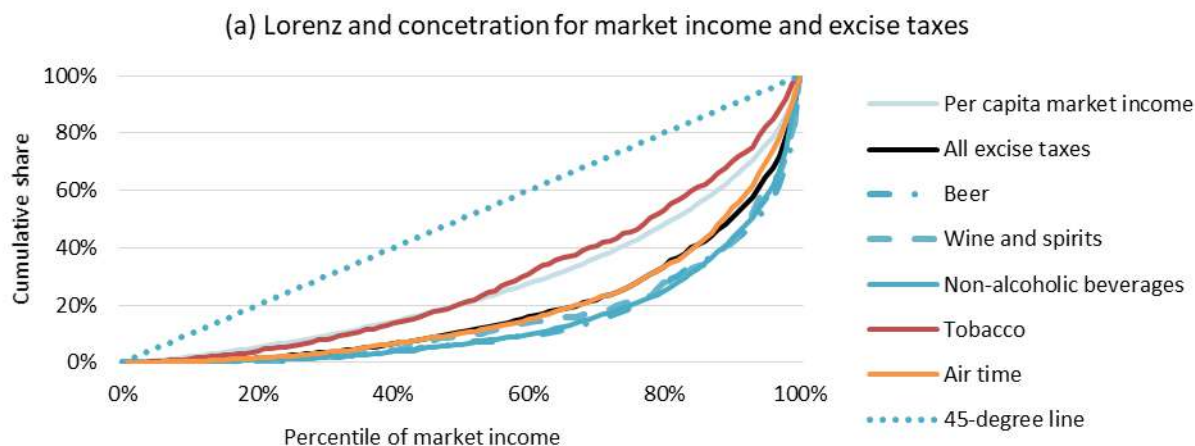
Source: Kenya's 2018 CPER report

Source: Kenya's 2018 CPER report

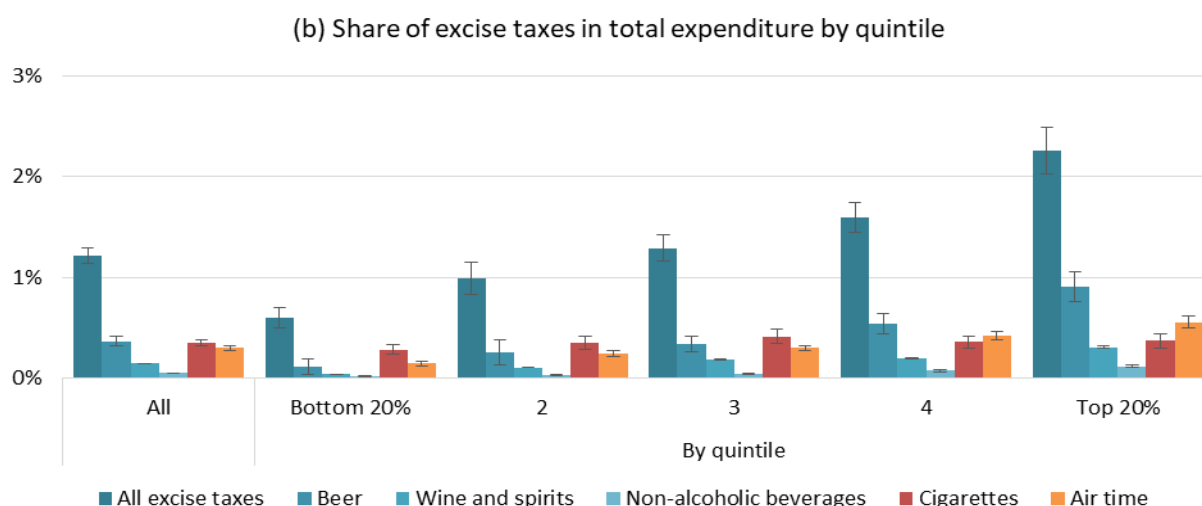
**c. Excise taxes cost-benefit analysis**

The analysis considers excises taxes on beer, wine and spirits, mineral water, soft drinks and juices, cigarettes, and airtime. Beverages and cigarettes are taxed based on quantities whereas consumption of airtime is taxed at ten percent. Excise tax on financial transactions and other commodities (jewelry, cosmetics, and locally assembled vehicles) is not considered. However, the items included in the analysis account for 87 and 82 percent of total revenue from excise tax in 2015 and 2016, respectively (Kenya CPER, 2018).

**Figure 10: Lorenz and concentration curves for market income and excise taxes and share in total expenditure by quintile.**



Source: Kenya’s 2018 CPER report



Source: Kenya’s 2018 CPER report

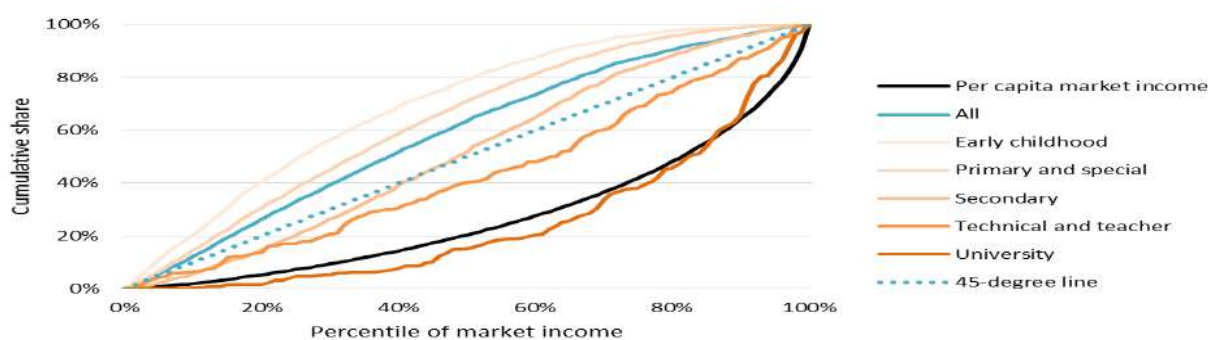
**Excise taxes are progressive except for tobacco products.** The bottom 40 percent, which account for 14.3 percent of market income, account for only 6.6 percent of all excise taxes, rendering the overall tax highly progressive (Figure 10a). This is driven mainly by excise taxes on beer (3.9 percent), wine and spirits (4.4), non-alcoholic beverages (3.9), and air time (6.6) (Kenya CPER, 2018). Excise duty on tobacco is initially mildly progressive but then turns regressive around the median. The bottom ten percent account for only 2.2 percent of per capita market income yet 1.4 percent of tobacco excise tax (Kenya CPER, 2018). However, the concentration curve for tobacco excise duties eventually crosses the Lorenz curve so that the poorest 60 percent already account for 30.7 percent of tobacco excise tax, a larger share than their 27.5 percent in market income (Kenya CPER, 2018). This suggests lower relative spending among the poor and higher relative spending among the middle quintiles. The expenditure shares of excise taxes are small (Figure 10b). Across the entire population, excise tax duty accounts for little more than one percent of total household expenditure. The share rises from 0.6 percent among the poorest quintile to 2.3 percent among the richest 20 percent of the population (Kenya CPER, 2018).

**d. Public Spending on Education and Health cost-benefit analysis**

**Public education spending:** Kenya spends significant public resources on all major levels of the education system. More than 40 percent of total recurrent spending is allocated to primary, more than 30 percent to secondary, and about 15 percent to university education (Kenya CPER, 2018). This results in escalating levels of per student spending: while the average net benefit to public primary school students is around KSh14,600, it is KSh24,500 in secondary, and KSh53,000 in university (Kenya CPER, 2018).

**The combined net benefits of public education expenditure is progressive in absolute terms.** The bottom 40 percent capture 14.3 percent of per capita market income but 51.7 percent of the net benefits of public education spending (Figure 11). This result is driven by early childhood education and primary education spending, of which the poorest 40 percent capture 67.8 and 58.2 percent, respectively (Kenya CPER, 2018). However, public education expenditure in Kenya have become increasingly regressive at higher levels of the education system. While public spending on early childhood education and primary and special education are progressive in absolute terms, spending on secondary public education, technical and teacher education is progressive only in relative terms. Spending on public universities, on the other hand, is regressive, due to low levels of enrollment among the poor (Kenya CPER, 2018).

**Figure 11: Lorenz and concentration curves for per capita market income and the net benefit of public education expenditure by level of the education system.**



Source: Kenya’s 2018 CPER report

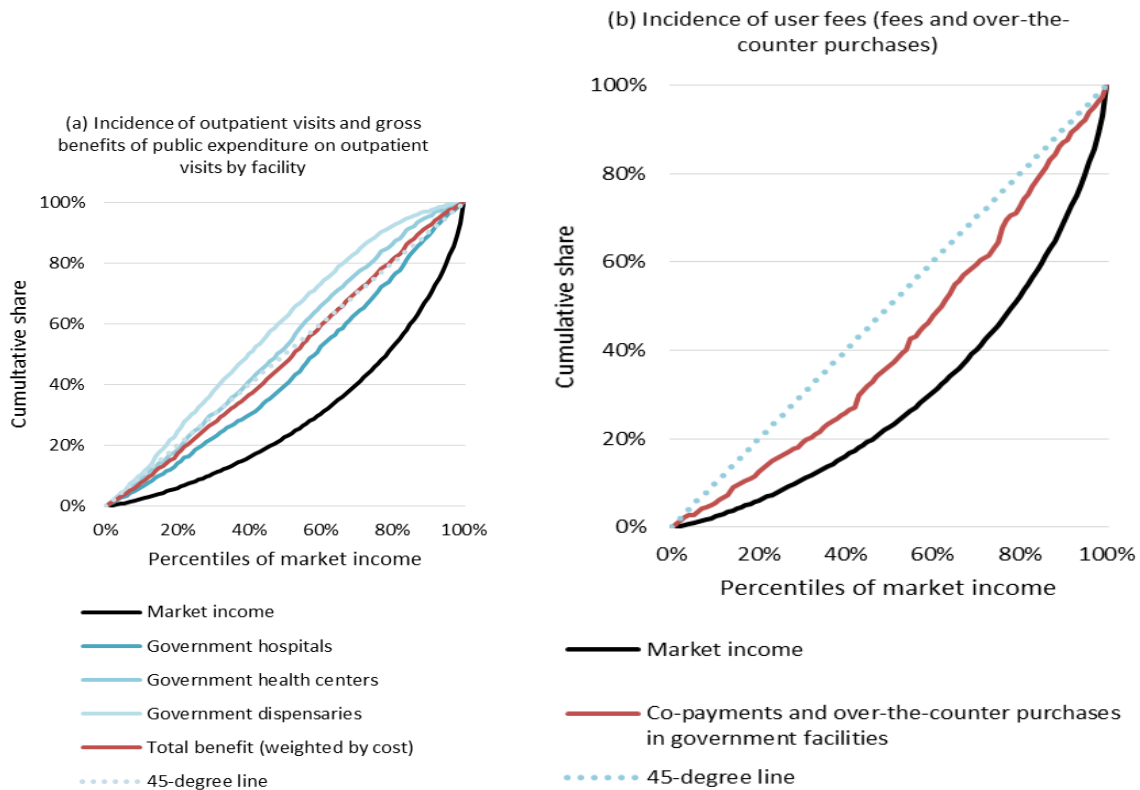
**Public health spending: While the poor are less likely to seek health services in general, they are more likely to consult with public primary health providers.** As in the case of public education spending, there are several factors that determine the incidence of public health spending in Kenya. One is simply the difference in the propensity to seek care. The poor are typically less likely to seek care and this holds for all types of care, curative outpatient visits, inpatient care, and preventive care, and—with the exception of preventive care for children below 15 years—across all age groups (Kenya CPER, 2018). But conditional on uptake, the poor are more likely to consult government-run facilities. This is true for health centers and dispensaries, but not for government hospitals (Kenya CPER, 2018). Reliance on public services is high in rural areas and less so in urban areas. Recent years have seen a shift of public health spending from higher-level facilities to lower-level facilities through the removal of user fees in primary health care facilities as well as for maternal health services.

**Public spending on outpatient care in lower-level facilities is pro-poor.** The overall incidence of public spending on outpatient care is nearly neutral: the bottom 40 percent account for 36.6 percent of the benefits (Figure 12a) (Kenya CPER, 2018). The result follows from a combination of effects. The poor are less likely to consult health providers. But conditional on uptake, they are more likely to consult public primary health facilities, particularly lower-level facilities such as dispensaries and health centers. Consequently, the

bottom 40 percent capture 41.2 and 50.3 percent of the gross benefits associated with health centers and dispensaries but only 30.6 percent of the gross benefits associated with government hospitals (Kenya CPER, 2018). Globally, public spending on outpatient care in health centers and dispensaries is progressive in absolute terms while public spending on outpatient care in government hospitals is still progressive.

**User fees and over-the-counter purchases associated with outpatient care in public facilities are regressive.** The poorest 40 percent have a share of 16.1 percent in market income but account for 25.9 percent of all fees and over-the-counter purchases associated with public outpatient health services (Figure 12b).

**Figure 12: Incidence of outpatient visits, public expenditure on outpatient visits, and user fees by facility.**



Source: Kenya's 2018 CPER report

## CHAPTER 5: SUMMARY FINDINGS AND POLICY RECOMMENDATIONS

### 5.1. Key Findings and emerging issues

The revenue foregone from tax expenditures in Kenya averaged 4.0 percent of GDP over the four years ending 2020. The VAT Tax expenditures are highest at about on average 3.1 percent of GDP followed by CIT tax expenditures at about 0.6 percent of GDP.

Based on the METR analysis, Kenya's tax system is competitive and, in some instances, subsidizes firms with an average METRs of 11.1 percent that is lower than the maximum CIT rate of 30 percent. The analysis indicates that tax incentives on capital reduced the Marginal Effective Tax Rate (METR) across the selected sectors considered to levels which are lower than the maximum corporate income tax rate. Further there is a significant variations of METRs across the selected. The METRs for the manufacturing sector indicate competitiveness or subsidies extended to the sector and create opportunities to undermine revenue. Agriculture METR is relatively higher than other sectors such as education, though lower than the Corporate CIT rate.

**Overall, taxes have mostly an attenuating effect on inequality while their effect on poverty is more mixed.** Direct taxes reduce inequality and are almost exactly off-setting in their effect on poverty. Indirect taxes are progressive and thus reduce inequality. But they increase poverty by definition. Public spending on education is pro-poor. On the VAT front, exempt and zero-rated items within Kenya's VAT regime benefit the poor only marginally. The report finds that the variation in consumption shares of exempt and zero-rated across the welfare distribution is small. A review of the VAT code might help to make VAT more progressive or, while also addressing other concerns about exemptions.

### 5.2. Policy Implications

The report findings have created a foundation which can be used to improve fiscal governance of tax expenditures in Kenya: In particular, the following policy recommendations arise:

- i) Government can consider coming up with a generally acceptable definition of tax expenditures in Kenya.
- ii) Government can use the list of tax expenditures outlined in the report to enhance compliance to requirements of Article 210 of the Constitution;
- iii) Whereas government rationalized many tax expenditures in 2020, there is still room for further reform to support revenue collection or compliance to existing legislation. For example, the tax expenditures as they stand today, still contain exemptions which exclude State officers from paying taxes by virtue of the nature of their work. The reform could also target tax expenditures which no longer serve to alleviate existing economic, policy or social challenges and those whose objectives can be met through direct on-budget spending programs.
- iv) In compliance to the existing legislation, improvements to the budgeting process and enhanced transparency, the list of tax expenditures could be used to estimate future annual cost of policy objectives met through tax expenditures as annexure to the budget policy statement.



- v) Establish an appropriate, evidence-based Tax Expenditure Governance Framework to limit leakages and improve transparency. This phase has supported government establish a Kenya benchmark tax system, established a repository of all tax expenditures, supported quantification of cost and impact of tax expenditures. It is recommended that the Government can leverage in this provision and complete the fiscal governance by developing tax expenditure fiscal governance arrangements. These may include among others establishing guiding monetary thresholds or ceilings for tax expenditures, clarity on the authorizing environment (i.e. processes and protocols guiding conceptualization, review and approval or retirement of tax expenditures) and Tax Expenditure budgeting.
  
- vi) A review of the second and the third schedules of the Income Tax Act with the aim of: Discontinuing issuance of redundant tax incentives to newly registered firms and gradually phasing out of the existing redundant tax incentives.
  
- vii) Develop national guidelines on provisions of tax incentives to guide evaluation and enactments so to ensure that only beneficial incentives are provided for in law.
  
- viii) To improve investment attractiveness of Kenya, consider incentives (tax and non-tax) which are geared towards increasing availability of financing, firm survival and expansion. Further, non-tax initiatives/incentives which increase access to low skilled labor will favor the export promotion strategy.
  
- ix) Arising from the METR analysis, the study proposes the following recommendations: Improve the tax incentive regime by minimizing distortions which favor some sectors or asset categories in preference to others. This is true for sectors which receive lower tax rates, tax holidays and or tax exemptions.
  
- x) Exemptions could be eliminated or replaced by zero-rates for merit goods without major distributional consequences. Exemptions do not have a large effect on the relative distribution of welfare because they are both applied to merit goods and other goods that could be considered luxury goods and services, such as air ticketing services supplied by travel agents. The removal of exemptions would boost tax collection without major impacts at least on the relative distribution of welfare.



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