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Tax Incentives and exemption regime in Kenya: Is it working?

Introduction

Governments undertake tax reforms for a number of reasons, some of which include simplification of the tax system; addressing the equity question in the distribution of tax burden; strengthening tax administration and ensuring revenue adequacy. Indeed, the drivers and emphasis on tax reforms will vary from one country to another. Studies[1] show that Kenya's tax reforms are geared towards introduction of new taxes or new rates of existing bases, the need to widen tax bases and reduce exemptions as well as introduce more stringent administrative changes to seal loopholes and appropriate sanction measures.

The outcome of tax reforms is expected to realize the three common objectives of a good tax system. These objectives are; to raise tax revenue for funding government operations without excessive government borrowing, to contribute to equitable distribution of income and to encourage or discourage specific activities. However, implementing tax reforms to meet this ultimate goal of an ideal tax system remains a challenge. Indeed, it has been documented that there has always been heated discussions as to whether, and to what extent, the government can and should use the tax system for policy goals other than raising tax revenue. Raising tax revenue is a key and direct objective of Kenya's tax system, thus striking the appropriate balance in meeting the ever increasing competing needs vis a vis encouraging investment through lower taxes remains to be seen. It is the consideration of the latter that has seen the government of Kenya, like other governments, introduce tax incentives with the belief that taxation is an appropriate policy instrument in attracting investments. This is contrary to alternative school of thought that maintains that policy

In this issue

1. International Bureau of fiscal decentralization

goals, such as stimulation of employment or economic growth, financial incentives among others should be offered through direct expenditure and not through the tax system. In other words, governments should try and maximize efficient tax collection and then utilize these revenues to support and pay for the policy that it favours.

2.0 Understanding tax incentive

The International Bureau of fiscal decentralization defines "tax incentives" as "fiscal measures that are used to attract local or foreign investment capital to certain economic activities or particular areas in a country[2]. The Kenya Revenue Authority (KRA) defines tax incentive as a provision that grants any person or activity favorable conditions that deviate from the normal provisions of the tax legislation. This impacts the person in a positive manner, for that person or activity or any measure that provides for a more favorable tax treatment of certain activities or sectors compared to what is available to the general industry.

Tax incentives may take a number of forms. In the case of Kenya the pertinent tax incentives include, tax holidays, investment allowances and tax credits, accelerated depreciation, special zones, investment subsidies, tax exemptions, reductions in tax rates and indirect tax incentives. When tax incentives are geared towards certain economic goals such as attracting and retaining investment and social goals such as benefiting the poor, there is need to undertake a cost- benefit analysis as briefly mentioned below. This is because it is necessary to make an assessment whether the tax incentive is achieving the goals for which it is granted. The pros and cons of tax incentives are highlighted in table 1.

Table 1: Advantages and disadvantages of tax incentives

Advantages	Disadvantages
• A policy tool to attract increased foreign direct investment through lower tax burdens • Encourage private sector participation in economic and social programs where government plays a key role • To address some form of market failure especially those involving externalities such as investment in research and development, or to promote high technology industries that have a positive externality.	• Tax incentives make the tax system less transparent, less predictable and potential investors are likely to perceive taxation as less stable • Tax differentials can introduce serious economic distortions that reduce efficiency and productivity. • Tax incentives for foreign investors shift the burden of taxation to immobile factors of production like labor. • Tax incentives seen as favoring new producers over existing businesses, but survey show that investors rate them rather low among the factors they decisively consider as influencing business decisions. • The actual revenue cost can be high if the investments would have been viable anyway; the incentives are offset by source-country tax laws; or tax-favored investors take business away from taxable producers. • Abusive tax avoidance schemes, made possible by tax preferences, further erode the revenue base

3.0 The Main Tax incentives available in Kenya

The main tax incentive in Kenya is investment promotion incentive and export promotion incentive. These can be further expounded as follows:

i) Investment Promotion Incentives: These are tax incentives that influence physical and financial capital. These types of incentives can further be sub-divided into incentives of a financial nature (i.e. those affecting financial instruments) and those that stimulate physical investment, which are;

a) Investment Tax Credit and Allowances

Under an investment tax credit, companies in a specific industry generally are allowed to make deductions against their tax liabilities, a fraction of expenditures on new additions to physical or capital stock. It comprises:

- **Investment Deduction Allowance (IDA)**
  Introduced in 1991 to encourage investment in physical capital such as industrial buildings, machinery and equipment. It is claimable on the capital investment once manufacturing

2. Ibid

operations commence. It is currently pegged at 100%, but attracts an additional 50% for investment whose value is Kshs.200 million or more, and is outside the municipalities of Nairobi, Mombasa and Kisumu. The 150% rate was introduced to encourage dispersion of investment outside the central business districts of Nairobi, Mombasa and Kisumu.

- **Industrial Building Allowances (IBA)**
  Introduced in 1974 with the objective of encouraging investment in buildings used for industrial purposes e.g. in the hotel industry. It is granted on straight-line basis on balance of cost of construction at the rate of 2.5% for manufacturing and 10% for hotels.
- **Mining Deductions Allowance (MDA)**
  Introduced to encourage investors to venture into the mining industry, which is highly capital intensive, and is calculated at a rate of 40% in the first year and 10% for the remaining 6 years on a straight line basis.
- **Farm Works Deductions (FWD)**
  Introduced in 1985 to precipitate capital accumulation and encourage equipment modernization in the agricultural sector, it is computed at the rates of 20% on straight-line basis for 5 years of income.

ii) **Export promotion incentives:** These are tax incentives geared towards encouraging exports with the basic idea being to allow exporters to get access to inputs at world prices. The basic principle underlying export promotion incentives is that exporters should not access inputs at prices above world prices as this will translate to uncompetitive produce. Kenya has therefore introduced various schemes targeting different categories of exporters. The 3 main schemes are the Export Processing Zones (EPZ's), Manufacture under Bond (MuB) and the Tax Remissions Export Office (TREO).

EPZ's are generally set up by government to promote industrial and commercial exports in addition to providing the incentives such as exemptions from certain taxes and regulations. The objective of EPZ is to encourage and generate economic development, foreign direct investments, and economic activities by encouraging foreign investment for the development of zones.

Manufacture under Bond refers to the incentive extended to manufacturers' import plants, equipment, machinery and raw material on a tax free basis, for use exclusively in the manufacture of goods and services. It is meant to encourage manufacturers, both local and foreign to manufacture for export within the country.

Tax remissions export office is a reprieve for manufacturers who produce to export their products. This is achieved by remitting duty and VAT on raw material used in the manufacture of the goods for export. For the purpose of this scheme, the manufacturer includes any process by which a commodity is finally produced. These include assembling, repacking ,bottling, mixing, blending, grinding, cutting, bending, twisting, joining or any other similar activity.

4.0 Institutions benefiting from Tax Incentives in Kenya

i. **Export Zones Processing Authority (EPZA)**
EPZA was established through an Act of Parliament Cap 517 of 1990, Laws of Kenya. Its core mandate is to regulate, facilitate and promote export oriented investments in the Export Processing Zones countrywide. EPZ's are designed to attract export-oriented investments in the zones, thus achieving its economic objectives of job creation, diversification and expansion of exports, increase in productive investments, technology transfer and creation of backward linkages between the zones and the domestic economy. The program has over 40 zones in place with over 70% of EPZ output being exported to the USA under (African Growth and Opportunity Act (AGOA).

EPZ benefit on several tax incentives categorized as follows;

a. ***Fiscal Incentives: generally reduces costs and improves profitability. It includes the following tax incentives;***

- 10-year Corporate Tax holiday and 25% tax rate on profits thereafter (except for commercial activities)
- 10-year Withholding Tax holiday
- Duty and VAT exemption on inputs
- Stamp Duty exemption

b. ***Procedural Incentives: reduces bureaucracy, faster start up. This category includes the following tax incentives;***

- Operation under essentially one license issued by EPZ Authority

- No minimum level of investment
- Rapid project approval (under 30 days approval on application)
- One-stop-shop service by EPZA for set-up, facilitation and aftercare (work permits, labor relations, port, utilities e.t.c)
- On-site customs documentation and inspection

c. ***Physical Incentives: zone infrastructure: lowers investment costs, improves efficiency, security***

- Lease or buy serviced land for construction of customized buildings – Athi-River EPZ offers 1 hectare plots for $5,000 annually plus a service charge or $100,000 for 50 years.
- Set up own EPZ on own/leased land - EPZA physical requirements must be met.
- Lease ready factory shells and start immediate operations - rentals range from $2-$3.5/square feet per year depending on location.

ii. **Export Promotion Council (EPC)**

The Export Promotion Council (EPC) was established in 1992. Its primary objective is to address bottlenecks facing exporters and producers of export goods and services with a view to increasing the performance of the export sector. EPC co-ordinates and harmonises export development and promotion activities in the country, providing leadership to all national export programmes. EPC is the focal point for export development and promotion activities in the country.

iii. **Kenya Investment Authority (Ken Invest)**

Established in 2004 through an Act of Parliament (Investment Promotion Act of 2004) with the main objective of promoting investments in Kenya. It has the responsibility of facilitating the implementation of new investment projects. Further, it is charged with providing after-care services for existing investments, as well as organizing investment promotion activities both locally and internationally. The core functions of the Authority include policy advocacy, investment promotion, investment facilitation, investor tracking and After-Care Services.

5.0 Impact of tax Incentive in Kenya

The introduction of tax incentives in Kenya were broadly aimed at promoting investment, Foreign Direct Investment and employment creation. Yet, no cost and benefit analysis study has ever been undertaken to ascertain the net benefit of such programs. A study

Table 2: Estimated Revenue loss over 2003/04-2007/2008 from tax incentives in Kenya (Kshs Million)

Tax Incentive	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	Cumulative Total
(a) Investments Incentives							
Investment Deductions	4,031	14,703	4,323	4,295	11,842	9,477	48,671
Industrial Allowance	481	1,021	539	298	494	325	3,158
Farm works allowance	814	1,130	1,256	609	876	8	4,693
Mining operation deductions (MOD)	203	715	45	70	215	384	1,632
Sub Total	5,529	17,569	6,163	5,272	13,427	10,194	58,154
Revenue forgone as % of Corporate tax collected	**21.00%**	**55.00%**	**15.90%**	**12.20%**	**18.50%**	**16.30%**	**21.10%**
(b) Trade Related Incentives							
EPZ	103	1,712	5,300	6,694	5,804	5,557	25,170
MUB	20	310	937	721	96	137	2,221
TREO	2,979	2,537	3,974	7,951	6,149	9,869	33,459
Sub Total	3,102	4,559	10,211	15,366	12,049	15,563	60,850
Revenue forgone as % of total import duty	**14.10%**	**19.70%**	**47.70%**	**55.10%**	**37.00%**	**43.00%**	**37.30%**
GRAND TOTAL	27,638	43,422	38,058	31,747	39,343	40,581	220,789
GROSS DOMESTIC PRODUCT	1,202,878	1,346,023	1,519,402	1,717,488	1,962,879	2,304,000	
Revenue forgone as % of GDP	1.40%	1.70%	2.10%	1.90%	1.30%	1.80%	

Source: KRA database

Table 3: Estimated FDI flow in Kenya

	1995	1996	1997	1998	1999	2000	2001	2002
KENYA								
FDI inflows (millions of dollars)	33	13	40	42	42	127	50	50
GDP (current, millions of dollars)	9,047	9,257	10,745	11,180	10,542	10,438	11,396	12,333
FDI inflows (as percentage of GDP)	0.36	0.14	0.37	0.38	0.4	1.22	0.44	0.41
UGANDA								
FDI inflows (millions of dollars)	121	121	175	210	222	254	229	275
GDP (current, millions of dollars)	5,619	5,892	6,162	6,535	5,966	5,891	5,675	5,865
FDI inflows (as percentage of GDP)	2.16	2.05	2.84	3.21	3.72	4.32	4.04	4.69
TANZANIA								
FDI inflows (millions of dollars)	150	149	158	172	517	463	327	240
GDP (current, millions of dollars)	5,631	6,463	7,607	8,365	8,635	9,079	9,342	9,414
FDI inflows (as percentage of GDP)	2.66	2.3	2.07	2.06	5.98	5.1	3.5	2.55

Source: UNCTAD data

Table 4: Summary of revenue loss from 2003/04 to 2005/06 from tax incentives (Kshs millions)

Tax Incentive	2003/04	2004/05	2005/06	Cumulative total
Trade Related				
EPZA related	208.00	1,712.00	5,300.00	7,219.00
TREO	2,979.00	2,537.00	3,974.00	9,490.00
MUB	40.00	310,937.00	937.00	1,287.00
Sub Total	3,227.00	315,186.00	10,211.00	17,996.00
Investment incentives				
Investment deduction	4,031.00	14,703.00	4,323.00	23,062.00
Industrial Building allowance	481.00	1,021.00	539.00	2,041.00
Wear and tear	19,007.00	21,294.00	2,184.00	61,985.00
Mining operation deductions	203.00	715.00	45.00	962.00
Farm work deductions	814.00	1,130.00	1,256.00	3,201.00
Sub Total	24,536.00	38,863.00	8,347.00	91,251.00
Grand Total	**27,763.00**	**354,049.00**	**18,558.00**	**109,247.00**

Source: KRA Database

by World Bank Investment Climate Advisory Services in 2009 shows that for many developing countries, tax incentives do not effectively counterbalance unattractive investment climate conditions such as poor infrastructure, macroeconomic instability, security and rule of law, weak governance and small markets.

Further, a study by the Kenya Revenue Authority (KRA) estimated that the total amount of revenue loss in Kenya over six years (the period between 2003/04-2008/09) is estimated at Kshs. 220.8 billion as reflected in table 1.0. Of these, investment related incentives and export related incentives accounted for 72.4% 27.6% respectively. On average, this translates to Kshs. 36.8 billion revenue and 1.7% of GDP forgone annually in the six years period under study. Quite notable is that the figure could be slightly higher if all tax incentives were included in the study. On a comparative basis, revenue loss from tax incentives for some countries as percentage of GDP are: 0.4% for Uganda, 3.9% for Tanzania, 4.7% for Rwanda and 1.7% for Malaysia. Table 1.0 below clearly shows the losses associated with Tax incentives in Kenya over a six-year period.

Table 3 shows the level of Foreign Direct Investment as a percentage of GDP. It compares the three East African Countries levels of minus tax holidays for the period of 10 years between1995 and 2005.

Implications of Tax incentives and Revenue Loss

Table 3.0 show a summary of revenues losses resulting from the exemption allowances granted to spur economic growth. The data cover the period 2003/04 to the year 2005/2006, and reflects a total of kshs 109.2 billion in losses averaging ksh. 36.4 billion over a period of three years. The bulk of the losses were related to investment incentives which accounts to 83%, while trade related losses resulted to a 16% loss in revenue.

Policy Options

It is therefore important for the government to evaluate its tax incentives policy, and weigh against the benefits that accrue with the intention of spurring investment in the country. Some of the policies the government should reconsider include but not limited to:

- Focus on improving the investment climate by addressing issues related to security, governance, tax issues, and infrastructure among others as opposed to providing blanket tax holidays as an alternative. Available data indicate that taxes forgone cannot fully compensate the investor for shortcomings associated with poor investment climate.
- Given that tax incentives erode the tax base, the government should consider introducing evidence-based tax incentives, by undertaking research to ascertain empirical outcomes of already existing incentives.. This is hardly the case in Kenya, and tax incentives are introduced through lobbying and in an ad hoc manner.
- Tax incentives in Kenya are rarely reviewed to assess whether they have accomplished the purpose for which they were introduced. There should be continuous review to ensure relevance and effectiveness.
- Tax competition - A dangerous side effect of tax incentives is tax competition, a 'race to the bottom', as countries attempt to entice investment away from their neighbors through lower taxes. As the country is most likely to lose out on this competition, Kenya should be at the forefront of EAC efforts in regional tax harmonization.
- Rationalise the incentive regime: There is growing international consensus that countries are best served with a low stable tax regime with few exemptions. This, as opposed to a complex tax code that emerges from the attempt to provide incentives to tackle shortcomings in the investment climate. Focus should be on ensuring exporters have duty free access to inputs and that all businesses enjoy a low tax rate with no exceptions or exemptions. A similar approach is needed with respect to personal taxation.
- Do away with 150% Investment Deduction Allowance (IDA) to investments outside the municipalities of Mombasa, Nairobi and Kisumu. There is no evidence that investors have invested in rural areas. In addition, there are also challenges in defining what constitutes areas outside these municipalities.
- Do away with tax holidays: Several countries have stopped giving tax holidays and have replaced them with uniform tax regime of low tax rates and highly selective and limited tax incentives. Tax holidays lead to 'tax shopping' with companies exiting as soon as the holiday expires. This has been amply demonstrated in Kenya's EPZ's. In addition, they could simply lead to tax shifting where Double Taxation Treaties (DTA's) exist.

Conclusion

Tax incentives can be costly and are rarely the key determinant to investment. Moreover, while low rates of taxation may promote investment, there is minimal evidence that discriminatory tax incentives are better placed to promote investment than simple, uniform regimes with low to moderate rates of taxation. Indeed, if anything, evidence shows that the latter is preferable and if tax incentives are to be used, accelerated depreciation is likely to be more efficient and have fewer drawbacks than tax holidays.

The Policy question is, whether time is ripe for a review and rationalization of tax incentives and the exemption regime, in light of the amount of revenue forgone. Additionally, as to whether money is well spent, targeted to the right group, and whether there exist transparency around tax incentives/tax expenditure. These are areas that require further analysis.

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