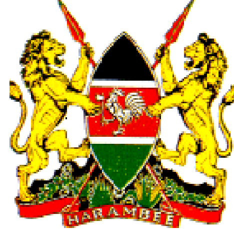

REPUBLIC OF KENYA

THE NATIONAL TREASURY AND PLANNING

2021 TAX EXPENDITURE REPORT

SEPTEMBER 2021

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Executive Summary

Kenya's tax system incorporates preferential tax measures whose goal is to benefit specific categories of taxpayers and achieve targeted policy objectives. These measures are guided by the fact that a government can leverage on its tax system to achieve specific public policy measures.

The 2021 Tax Expenditure Report was prepared as part of the structural benchmarks under the IMF Programme which required the National Treasury to publish the report by 30th September, 2021. Preparation of the report was also informed by the fact that tax expenditure reporting is considered an international best practice meant to foster government budgetary and fiscal transparency. In this regard, this report estimates the national tax expenditure for various tax heads covering the period 2017 – 2020. It also provides necessary information to facilitate monitoring and review of tax expenditure; informs the design of effective tax regimes; and enhances transparency and accessibility of information on national tax expenditure. Being the first publication, the 2021 Tax Expenditure Report will form the baseline for future reports geared towards enhancement of transparency and accessibility of information on national tax expenditure.

The report reveals that total tax expenditure has been on a downward trend over the last four years. In 2020, total tax expenditure amounted to Ksh 318.3 billion (2.96 percent of GDP), a decline from Ksh 437.1 billion (5.15 percent of GDP) in 2017, Ksh 429.3 billion (4.60 percent of GDP) in 2018 and Ksh 350.9 billion (3.42 percent of GDP) in 2019. Out of this, Domestic Value Added Tax accounts for most of the total tax expenditure/ revenue forgone followed by income tax exemptions. Expenditures related to excise taxes account for the least tax expenditure. The total tax expenditure for Kenya is comparable to the 2.9 percent of GDP average for African countries and 4.0 percent of GDP average in the European Union. The amount is higher than Mauritius' which stands at 1.4 percent of GDP, but lower compared to the United States, which is above 7.0 percent of GDP and the United Kingdom, which is above 6.0 percent of GDP. However, it should be noted that comparisons of tax expenditures between countries is always tricky as the Benchmark Tax Systems used as a reference vary substantially.

The reduction in total tax expenditure from 5.15 percent in 2017 to 2.96 percent in 2020 mirrors the Government's efforts to rationalize and harmonize the expenditures in the various tax laws. Domestic VAT exemptions contributed the most to the reduction followed by VAT exemptions on imports. Over the review period, domestic VAT exemptions declined by Ksh 122.3 billion while VAT exemptions on imports declined by about Ksh 7.85 billion. On the other hand,

income tax and excise tax exemptions increased by Ksh 9.8 billion and Ksh 1.6 billion, respectively.

Tax expenditure on domestic VAT (2.2 percent of GDP in 2020) are spread across a range of sectors including Agriculture, Manufacturing and Transport. The bulk of tax expenditures related to corporate income tax are tax allowances and deductions designed to encourage investment in plant and machinery. Personal income tax expenditure in 2020 stood at 0.04% of GDP while tax expenditure related to taxes on imports (Excise tax on imports and VAT on imports) account for 0.21% of GDP in 2020.

To ensure sustainability and value for money from the resources foregone through tax expenditure, the Government will continue to upscale efforts to rationalize and harmonize the tax expenditures with the aim of removing redundant tax expenditures and enhancing those intended to promote investments. In addition, there is need to have an elaborate framework for monitoring and evaluating the impact of tax expenditure in the economy.

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CHAPTER ONE: INTRODUCTION

1.1 Background

The principal role of a tax system is to raise revenue to fund planned Government programmes and projects. These include financing development of public infrastructure and socioeconomic projects, as well as facilitating conducive business environment to support growth of economic activities in the country. A tax system is also used to achieve specific public policy objectives through targeted preferential tax measures such as exemptions, waivers, deductions or reliefs. Tax expenditure is therefore an estimate of the total revenue foregone because of these preferential tax measures.

Like most countries, Kenya's tax system includes preferential tax measures aimed at benefiting specific sectors or categories of taxpayers and to achieve a given policy goal, investment decisions made by households and companies are influenced by tax imposed on various activities or services or goods. These policy objectives could include reducing cost of capital and encouraging investment, supporting development expenditure and easing the cost of living for the vulnerable in society, among others.

While there is no legal requirement to produce tax expenditure report, Articles 201, 210 and 220 of the Constitution of Kenya require maintenance of a public record of tax waivers and adherence to the principles and framework of public finance in Public Finance Management Act, 2012. Additionally, tax expenditure reporting is considered as an international best practice to foster government budgetary and fiscal transparency. In this regard, the Tax Expenditure report will be published annually to enhance transparency and accessibility of information on national tax expenditure.

1.2 Benchmark tax system

Determination of the standard treatment or benchmark is the first step into estimating the value of tax expenditure. This necessitated definition of a baseline against which a tax reducing measure was 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'.

This report follows the legal approach in defining the benchmark tax system. The approach uses the existing tax law as the basis for defining the benchmark and to identify differential and preferential treatment. Only the fundamental structure elements of each tax type were considered part of the benchmark tax system. Therefore, the benchmark tax system has been defined on the basis of the following criteria:

a) The general tax regime as defined in the various tax laws, but with emphasis on the scope, the definition of the taxable base, tax unit, the tax rate(s) and tax period;
b) The national tax policy choices that consider some relief measures as normal, for example, a particular sector of the economy such as health, basic agriculture or education;
c) Some provisions in bilateral agreements, including the tax treatment of projects financed by development partners, which may be considered part of the benchmark, while others may be considered tax expenditure. In principle, these provisions are intended to prevent the double taxation of income. If the rate provided for is that of the ordinary legal regime, there is no deviation from the benchmark tax system. However, if both countries agree on a preferential tax relative to the general regime, the reduction in some tax rates can be identified as a tax expenditure since any bilateral agreement can be renegotiated;
d) Regional agreements and directives that necessitate the evaluation of tax expenditures not just against a national norm but also against a community norm. This is the case in a customs union, where the common external tariff is the norm for customs duties; and
e) International agreements have been considered since exemptions can be decided at the international level. According to the hierarchy of norms, international law takes precedence over regional and national law. These measures have therefore been considered in the tax norms and included in the benchmark tax system.

1.3 Objectives of the report

The overall objective of this Report is to estimate the national tax expenditure. The specific objectives of the report are:

a) Estimate tax expenditure for various tax heads for the period 2017 - 2020;
b) Facilitate monitoring and review of tax expenditures;
c) Provide statistics on tax expenditure; and
d) Enhance transparency and accessibility of information on national tax expenditures.

1.4 Scope of the Report

The report presents analysis of the tax expenditure under domestic Value Added Tax (VAT), Income Tax (Personal Income Tax and Corporate Income Tax), Import duty, Excise duty and Import VAT for the years 2017 -2020. For each

tax head, the report provides a description of the benchmark tax system, list of tax expenditures and estimates on the value of tax expenditure. Tax heads for which no tax expenditure is identified, only description of the benchmark tax system is provided.

CHAPTER TWO: SUMMARY FINDINGS OF TAX EXPENDITURE

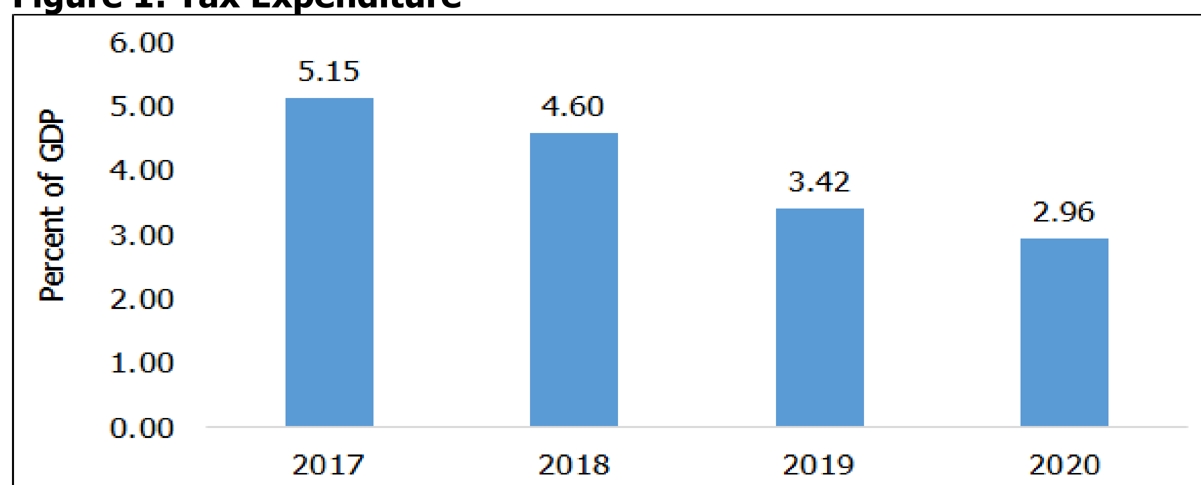
The analysis of tax expenditure on each tax head shows that total tax expenditure has been on a downward trend over the last four years. In 2020, total tax expenditure amounted to Ksh 318.3 billion, a decline from Ksh 437.1 billion in 2017, Ksh 429.3 billion in 2018 and Ksh 350.9 billion in 2019 **(Table 1).**

Table 1: Tax Expenditure

Ksh Million	2017	2018	2019	2020
Personal Income Tax	3,526.3	3,816.2	4,653.6	4,125.2
Corporation Income Tax	47,559.8	77,095.8	61,980.8	56,737.1
Domestic VAT	356,707.0	319,886.4	257,206.3	234,378.4
Excise duty on Imports	3,777.3	4,127.3	4,220.9	5,388.9
VAT on Imports	25,545.6	24,414.9	22,794.6	17,694.8
Total Tax Expenditure	**437,116.0**	**429,340.6**	**350,856.2**	**318,324.4**
Nominal GDP	8,483,396.0	9,340,307.0	10,255,654.0	10,752,992.0
Tax expenditure as % of GDP	**5.15%**	**4.60%**	**3.42%**	**2.96%**

Total tax expenditure as a percent of GDP declined to 2.96 percent in 2020 from 5.15 percent in 2017, 4.60 percent in 2018 and 3.42 percent in 2019 **(Figure 1).**

Figure 1: Tax Expenditure



Domestic Value Added Tax and income tax exemptions account for most of the total tax expenditure/ revenue forgone. On average, domestic VAT exemptions accounted 75.8 percent of the total tax expenditure followed by income tax exemptions (personal and corporate income tax), which accounted for about 17.2 percent of the total tax expenditure for the four years. Excise taxes account for the least at an average of 1.2 percent **(Table 2).**

Table 2: Tax Expenditure by Tax Head

	2017	2018	2019	2020	Average	2017	2018	2019	2020	Average
	Ksh Million					Share of Total Tax Expenditure (%)				
Personal Income Tax	3,526.3	3,816.2	4,653.6	4,125.2	4,030.3	0.8	0.9	1.3	1.3	1.1
Corporation Income Tax	47,559.8	77,095.8	61,980.8	56,737.1	60,843.4	10.9	18.0	17.7	17.8	16.1
Domestic VAT	356,707.0	319,886.4	257,206.3	234,378.4	292,044.5	81.6	74.5	73.3	73.6	75.8
Excise duty on Imports	3,777.3	4,127.3	4,220.9	5,388.9	4,378.6	0.9	1.0	1.2	1.7	1.2
VAT on Imports	25,545.6	24,414.9	22,794.6	17,694.8	22,612.5	5.8	5.7	6.5	5.6	5.9
Total Tax Expenditure	**437,116.0**	**429,340.6**	**350,856.2**	**318,324.4**	**383,909.3**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**

Domestic VAT expenditure account for the most decline in tax expenditure over the review period followed by expenditure related to VAT on imports. Over the review period, domestic VAT expenditure declined by Ksh 122.3 billion (103.0 percentage change) while expenditure related to VAT on imports declined by about Ksh 7.85 billion (6.6 percentage change). On the other hand, income tax and excise tax exemptions increased by Ksh 9.8 billion and Ksh 1.6 billion, respectively **(Table 3).**

Table 3:Change in Total Tax Expenditure

	Absolute Change btn 2017 and 2020 (Ksh Mn)	Contribution to the Change (%)
Personal Income Tax	598.8	(0.5)
Corporation Income Tax	9,177.2	(7.7)
Domestic VAT	(122,328.6)	103.0
Excise duty on Imports	1,611.6	(1.4)
VAT on Imports	(7,850.8)	6.6
Total Tax Expenditure	**(118,791.7)**	**100.0**

Comparison of Kenya's Tax Expenditure with other Jurisdictions

The total tax expenditure for Kenya is comparable to the 2.9 percent of GDP average for African countries and 4.0 percent of GDP average in the European Union. The amount is higher than Mauritius' which stands at 1.4 percent of GDP, but lower compared to the United States, which is above 7.0 percent of GDP and the United Kingdom, which is above 6.0 percent of GDP. However, it should be noted that comparisons of tax expenditures between countries is always tricky as the Benchmark Tax Systems used as a reference vary substantially.

CHAPTER THREE: INCOME TAX

3.1 Overview

Income tax in Kenya is imposed on different categories or sources of income. Income tax is therefore charged for each year of income, upon all the income of a person whether resident or non-resident, which is accrued in or was derived from Kenya.

The benchmark for income taxation is based on the taxable income of legal persons and individuals who are subject to taxation, regardless of their economic activity or their region of operation. A person's taxable income is the difference between the person's total income and the sum of the taxpayer's total allowable deductions.

The tax base under the Income Tax Act is all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya, wholly or partly. Therefore, under the Kenyan income tax system, categories of income include:

i. Gains or profits from a business, employment or services rendered and a right granted to another person for use or occupation of property;
ii. Dividends or interest;
iii. Income accruing through a digital marketplace;
iv. An amount deemed to be the income of a person under the Act or by rules made under the Act;
v. Any gain as determined under the Act, which accrues to a company or an individual on the transfer of property situated in Kenya;
vi. The net gain derived on the disposal of an interest in a person that derives 20% or more of its value, directly or indirectly, from immovable property in Kenya; and
vii. A natural resource income.

Individuals and corporate bodies are the primary units of income taxation, which is a direct tax. Individuals are taxed on their income through a graduated rate while companies are taxed on a general rate of 30.0 percent for residents and 37.5 percent for non-residents.

3.2 Personal Income Tax (PIT)

Tax is charged for each year of income on all the income of a person, whether resident or non-resident, which accrued in or was derived from Kenya. Tax on personal income is taxed on graduated rate known as Pay As You Earn (PAYE) and is applicable to all persons who are resident in Kenya at the time of employment and to non-resident persons employed by an employer who is resident in Kenya. The PAYE tax base includes wages, casual wages, salary, leave pay, sick pay, payment in lieu of leave, fees, commission, bonus, gratuity, or subsistence, travelling, entertainment or other allowance received in respect of employment or services rendered.

PAYE is progressive because the percentage of income that individuals pay in tax tends to increase with increase in income; and those with higher incomes pay taxes at a higher rate. The personal income tax rate includes a personal relief (tax-free) threshold and a graduated personal income tax rate as shown in **Table 4**. Resident individuals are also subject to withholding income tax at the rate of 3% on contractual fees and 5% on management or professional fees. Non-resident individuals are subject to withholding income tax at the standard statutory rate of 20%.

Table 4: PIT Bands and Rates

Tax Band	Applicable Tax Rate
On the first Ksh 24,000 per month or Ksh 288,000 p.a	10%
On the next Ksh 8,333 per month or Ksh 100,000 p.a	25%
On all income amount in excess of Ksh 32,333 per month or Ksh 388,000 p.a	30%

Pension income is subject to PIT but features different tax specific bands as depicted in **Table 5**.

Table 5: Pension Tax Bands

Bands	Annual Tax Rates
On the first lump sum Ksh 600, 000	Tax free
On the next 400,000	10%
On next 400,000	15%
On next 400,000	20%
On next 400,000	25%
On any amount in excess of Kshs 1,600,000	30%

3.2.1 PIT Benchmark

The benchmark unit of taxation for personal income tax is the individual and the benchmark tax rate and structure is the rate and structure as it exists at any given time, including the tax-free threshold.

3.2.2 PIT Expenditure

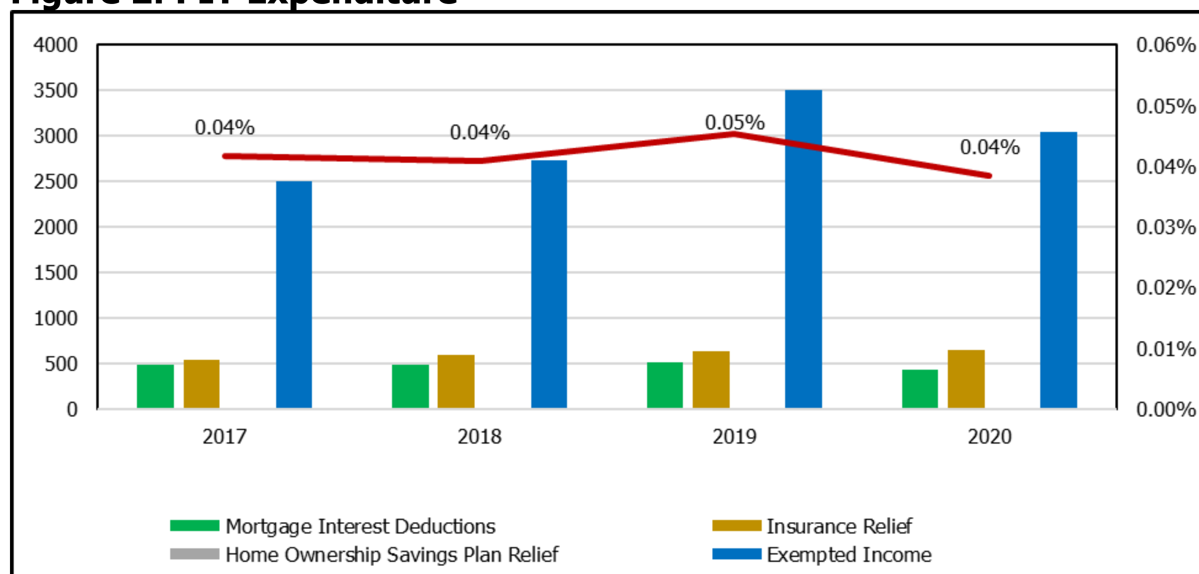
Given the benchmark regime described, the tax expenditures take the form of reliefs to taxpayers to encourage savings, home ownership and reduce tax burden, among other reasons. These reliefs include; insurance relief, relief related to persons with disability (PWD) and mortgage relief among others. The PIT expenditure estimates for the period 2017 to 2020 are shown in **Table 6.**

Table 6: PIT Tax Expenditure Estimates

Ksh Million	2017	2018	2019	2020
Mortgage Interest Deductions	476.87	484.08	510.77	428.10
Insurance Relief	541.82	593.31	631.69	651.44
Home Ownership Savings Plan Relief	3.36	3.38	3.82	4.35
Exempted Income	2,504.29	2,735.41	3,507.35	3,041.28
Total PIT	**3,526.34**	**3,816.17**	**4,653.63**	**4,125.17**
Nominal GDP	8,483,396.00	9,340,307.00	10,255,654.00	10,752,992.00
Total PIT in % of GDP	**0.04%**	**0.04%**	**0.05%**	**0.04%**

Tax expenditure related to personal income tax stood at Ksh 4.1 billion in 2020, an increase from Ksh 3.5 billion in 2017 and Ksh 3.8 billion in 2018. In 2019, the PIT expenditure was Ksh 4.7 billion **(Table 6).** In relation to GDP, PIT expenditure averaged 0.04 percent over the review period **(Figure 2).**

Figure 2: PIT Expenditure



3.3 Corporate Income Tax (CIT)

Corporate Income Tax (CIT) is a form of income tax that is levied on corporate bodies such as Limited companies, Trusts, and Co-operatives, on their annual income. Companies that are based outside Kenya but operate in Kenya or have a branch in Kenya pay Corporation Tax on income accrued within Kenya only.

3.3.1 CIT Benchmark

The benchmark unit of taxation for corporate income tax is the corporate body. Partnerships and trusts are considered fiscally transparent and not separate tax units; therefore, income earned by these entities is taxable in the hands of the individual recipients.

The benchmark corporate income tax rate is 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%. The taxation system for corporates includes preferential tax regimes, which are considered as part of the benchmark for this report and will therefore not count as tax expenditure. These specific regimes include:

i. Companies located in Export Processing Zones, for which the corporate income tax rate is 0% for the first ten years and 25 % for the 10 following years.

ii. Companies located in Special Economic Zones (SEZ), for which the corporate income tax rate is 10 % for the first 10 years of operation and 15% thereafter.

iii. Companies locally assembling motor vehicles are subject to a reduced corporate income tax rate of 15% for the first 5 years of operation.

iv. Companies newly listed on any approved securities exchange are subject to a reduced tax rate of 25% for 5 years following the listing. The reduced rate is only applicable to companies listing at least 30% of their issued share capital. If the company lists between 20% and 30% of its issued share capital, the reduced tax rate is 27% for only 3 years. This preferential rate was reduced in 2020.

In addition to these specific regimes, business losses are carried forward indefinitely to allow companies offset the losses with future profits. This in turn reduces future corporate income tax payments.

3.3.2 CIT Expenditure

Given the benchmark tax regime described in section 3.3.1, Corporate Income Tax 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 (**Table 7).**

Table 7: Rates of Investment Deduction

Capital Expenditure Incurred on:	Rate
(a) Buildings	
i) Hotel Buildings	50% in the first year of use
ii) Buildings used for manufacture	
iii)Hospital buildings	
iv)Petroleum or gas storage facilities	
v) Residual value to item (a)(i) to a(iv)	25% per year, on reducing balance
vi)Educational buildings including student hostels	10% per year, on reducing balance
vii) Commercial building	10% per year, on reducing balance
(b)Machinery	
i) Machinery used for manufacture	50% in the first year of use
ii) Hospital equipment	
iii) Ships or aircrafts	
iv)Residual value items (b)(i) to (b)(iii)	25% in the first year of use
v) Motor Vehicle and heavy earth moving equipment	
vi) Computer and peripheral computer hardware and	

software calculators, copiers and duplicating machines	
vii)Furniture and fittings	10% per year, reducing balance
viii) Telecommunications Equipment	10% per year, reducing balance
ix) Filming equipment by a local film producer licensed by the Cabinet Secretary responsible for filming	25% per year on reducing balance
x) Machinery used to undertake operations under a prospecting right	50% in the first year of use and 25% per year, on reducing balance
xi)Machinery used to undertake exploration operations under a mining right	50% in the first year of use and 25% per year on reducing balance
xii) Other machinery	10% per year, reducing balance
(c) Purchase or an acquisition of an indefeasible right to use fibre optic cable by a telecommunication operator	10% per year, on reducing balance
(d) Farm works	50% in the first year of use and 25% per year, on reducing balance

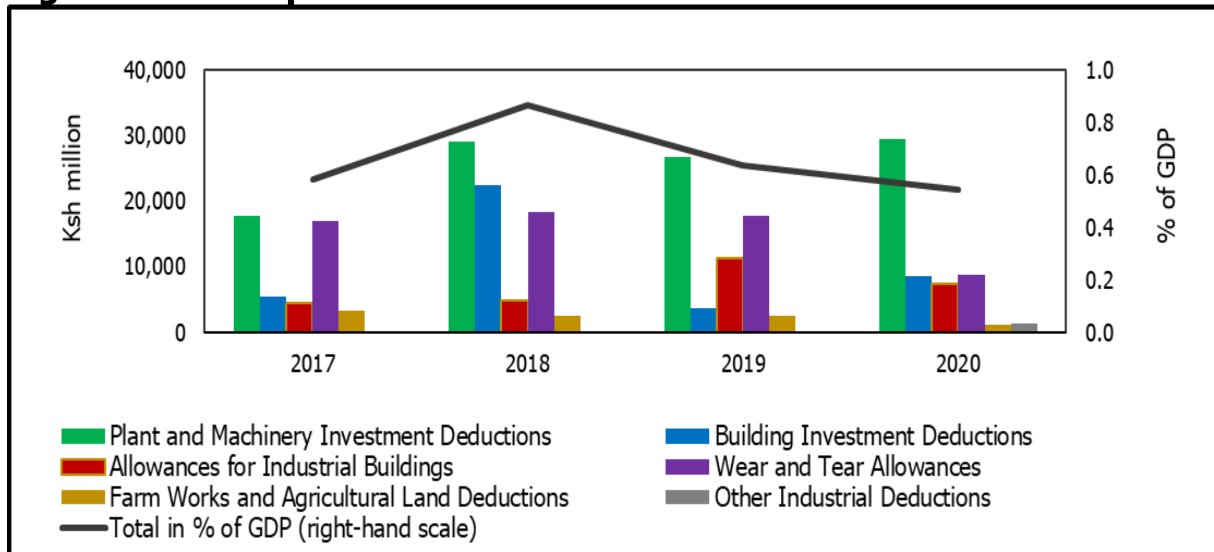
Total CIT expenditure stood at Ksh 56.7 billion in 2020, a decline from Ksh 77.1 billion in 2018 and Ksh 62.0 billion in 2019 **(Table 8).** The decline is attributed to the fact that allowances related to the corporate income tax underwent major reforms in 2020 leading to harmonization and reduction in the amount of wear and tear allowances.

Table 8: Corporate Income Tax Expenditure

Ksh Million	2017	2018	2019	2020
Plant and Machinery Investment Deductions	17,627.3	28,946.9	26,790.8	29,411.5
Building Investment Deductions	5,407.5	22,467.3	3,731.5	8,550.9
Allowances for Industrial Buildings	4,438.9	4,927.6	11,280.7	7,374.6
Wear and Tear Allowances	16,870.8	18,301.3	17,713.1	8,824.7
Farm Works and Agricultural Land Deductions	3,190.4	2,440.1	2,451.8	1,167.0
Other Industrial Deductions	24.9	12.6	12.9	1,408.4
Total CIT Expenditures	**47,559.8**	**77,095.8**	**61,980.8**	**56,737.1**
Nominal GDP	8,483,396.0	9,340,307.0	10,255,654.0	10,752,992.0
Total in % of GDP	**0.6%**	**0.8%**	**0.6%**	**0.5%**

Corporate tax expenditure as a percent of GDP over the review period remained relatively low and stable. In 2020, the expenditure stood at 0.5 percent of GDP, a slight decline from 0.8 percent in 2018 and 0.6 percent in 2019 **(Figure 3).**

Figure 3: CIT Expenditure



CHAPTER FOUR: VALUE ADDED TAX (VAT)

4.1 Overview

Value Added Tax is a consumption tax levied on the use of taxable products and services supplied or imported in Kenya and collected at designated points in the supply chain. Traders with an annual turnover of Ksh 5 million and above are required to charge VAT. Nonetheless, a person with a turnover less than Ksh 5 million is allowed to register for VAT on voluntary basis.

4.2 VAT Benchmark

There are three types of VAT rates: the general rate at 16.0 percent, petroleum products rate at 8.0 percent and zero rate (0.0 percent). The benchmark tax system for domestic VAT is the standard rate of either 16.0 percent or 0.0 percent. The benchmark unit of taxation is the final consumer of taxable goods and services. However, there are goods and services that are contained in Tax exemption and zero-rating categories in the First and Second Schedules of the VAT Act, 2013 that are considered benchmark but not as tax expenditure (list in **Annex I**).

4.3 VAT Expenditure

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

a) **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.

b) **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. Given this, tax expenditure in relation to domestic VAT amounted to Ksh 234.4 billion (2.2 percent of GDP) in 2020. This was a decline from Ksh 356.7 billion (4.2 percent of GDP) in 2017, Ksh 319.8 billion (3.4 percent of GDP) in 2018 and Ksh 257.2 billion (2.5 percent of GDP) in 2019 (**Table 9).**

Table 9: VAT Expenditure

Ksh Million	2017	2018	2019	2020
Exempt items	164,070.5	134,622.1	84,224.7	82,913.2
Zero-rated items	192,636.5	185,264.3	172,981.5	151,465.2
Total Tax Expenditure	**356,707.0**	**319,886.4**	**257,206.3**	**234,378.4**
Nominal GDP	8,483,396.0	9,340,307.0	10,255,654.0	10,752,992.0
Percent of GDP	**4.2%**	**3.4%**	**2.5%**	**2.2%**

Among the goods and services that were exempt in 2020, exemption on financial and insurance services were the main contributors to total VAT revenue foregone, accounting for 29 percent, followed by Information and communication at 16 percent, Retail Trade at 13 percent, Manufacturing at 11 percent and supplies related to Agriculture, Forestry and Fishing accounting for 7 percent (**Table 10**).

Table 10: VAT Expenditure in Relation to Exempt Goods and Services

Main sectors exempt from VAT	Revenue foregone in 2020 (in Ksh million)	Share of total VAT expenditures related to exempt supplies
Financial and Insurance Activities	23,830	29%
Information and Communication	13,291	16%
Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles	10,788	13%
Manufacturing	9,245	11%
Agriculture, Forestry and Fishing	6,033	7%
Construction	4,363	5%
Trasnportation and Storage	4,347	5%
Water Supply , Waste Management, Sewerage and Remediation Activities	2,368	3%
Total of all VAT exempt supplies	**82,913**	**100%**

Similarly, out of the sectors with zero-rated VAT transactions in 2020, the manufacturing sector contributed the largest share of revenue foregone at 32 percent followed by Transportation and Storage at 20 percent, and Agriculture, Forestry and Fishing at 19 percent. Administrative and Support Service Activities, Mining and Quarrying and Information and communication sectors contributed the least to the total revenue forgone through VAT zero-rating (**Table 11).**

Table 11: VAT Expenditure in Relation to Zero Rated Goods and Services

Main sectors with zero-rated transactions for VAT	Revenue foregone in 2020 (in Ksh million)	Share of total VAT expenditures related to zero-rated supplies
Manufacturing	48,481	32%
Transportation and Storage	29,588	20%
Agriculture, Forestry and Fishing	28,022	19%
Electricity, Oil, Gas, Steam and Air Conditioning Supply	17,898	12%
Wholesale and Retail Trade, Repair of Motor Vehicles and Motorcycles	7,675	5%
Administrative and Support Service Activities	4,512	3%
Mining and Quarrying	4,160	3%
Information and Communication	3,895	3%
Total of all zero-rated supplies for VAT	**151,465**	**100%**

CHAPTER FIVE: TAXES ON IMPORTS

5.1 Overview

Import duty in the East African Community (EAC) is governed by the East African Community Customs Management Act (EACCMA), 2004 and the East African Community Customs Management Regulations, 2010. The primary basis of determination of customs duty liability is the Cost, Insurance and Freight (CIF) value of imported goods. Preferential treatments under customs are normally in form of waivers, exemptions and reduced duty rates, which occasion the deviations from the applicable rates.

Excise duty is levied on excisable goods manufactured in Kenya by a licensed manufacturer, excisable services provided in Kenya by a registered person and on excisable imported goods. Rules governing the imposition of excise duty are contained in the Excise Duty Act, 2015. The duty is mostly levied on goods that the Government may want to discourage their use or consumption and luxury goods and services. The First Schedule of the Excise Duty Act, 2015 lists excisable goods and services. The major excisable items include alcoholic products, cigarettes, tobacco, soft drinks, airtimes, financial transactions, and automobiles. Conventionally, the duty is levied to address the negative externalities that some goods/services tend to have. More recently, the tax has been used by governments to meet their revenue requirements especially for items with low price elasticity of demand.

Import VAT is charged on imported goods and services at the place of destination. Imported goods and services are taxed on the same basis and at the same rate as domestic supplies.

5.2 Benchmark system for taxes on imports

Import duties

Import duties are levied at rates of 0 percent, 10 percent and 25 percent depending on product classification in the international harmonized system and based on the tariffs from the East African Community (EAC) Common External Tariff and the level of processing. Some sensitive goods attract import duty at a rate more than 25 percent while goods emanating from EAC member States and other COMESA countries are imported duty free when they meet the rules of origin.

The Fifth Schedule to the East African Community Customs Management Act (EACCMA), 2004 provides for institutions that are exempt from import duty

when they import goods for their official use. It also provides for specific goods that are exempt from import duty. The EACCMA provides for exemption of goods imported for manufacturing under bond, bonded warehousing, inward processing and Export Processing Zones or Free Zones. Goods and services which qualify for import duty exemption include goods and services for direct and exclusive use in Official Aid Funded Projects, duty remission for inputs for production of goods for export and other essential goods such as text and exercise books, support available in Diplomatic privileges, support to other Commonwealth and other Governments and goods listed in the international agreements. These exemptions are considered as part of the benchmark because they are based on ratified regional and international agreements.

Import Excise Duty

The Second Schedule to the Excise Duty Act lists goods and services, which are exempt from excise duty. Majority of the goods listed in this Schedule form part of the Benchmark Tax System.

The Benchmark Tax System (BTS) for Excise duty includes the following;

i. Excisable goods that are bona fide stores for a ship or aircraft, being goods for use or consumption by passengers or crew of the ship or aircraft while on board and while the ship is in international traffic and is such quantities as approved by the Commissioner;
ii. Excisable goods imported into Kenya by a diplomatic or consular mission, or by a diplomat or consul, or a member of the diplomat or consul's family forming part of the diplomat or consul's household in Kenya to the extent provided for under the Privileges and Immunities Act, (Cap.179);
iii. Excisable goods imported into Kenya by a foreign government, international organization, or aid agency to the extent provided for under an international agreement or the Privileges and Immunities Act, 1970.
iv. Excisable goods imported by the Kenya Red Cross or St John Ambulance for official use in the provision of relief services in Kenya.
v. Excisable goods imported by a person changing residence or a returning resident subject to limitations provided for under the Fifth Schedule to the East African Community Management Act.;
vi. Excisable goods imported by, and in the possession of a passenger subject to limitations provided for under the Fifth Schedule to the East African Community Management Act.

vii. One motor vehicle previously owned and used by a deceased person outside Kenya subject to the conditions as the Commissioner may specify;

viii. Excisable goods imported for direct and exclusive use in the implementation of an official Aid-Funded Project, to the extent provided for under the Financing Agreement;

ix. Excisable services supplied in Kenya to a diplomatic or consular mission or to a diplomat or consul, or a member of the diplomat or consul's family forming part of the diplomat or consul's household in Kenya to the extent provided for under the Privileges and Immunities Act (Cap. 179);

x. Excisable services supplied in Kenya to a foreign government, international organization, or aid agency to the extent provided for under an international agreement or the Privileges and Immunities Act (Cap. 179).

The benchmark excise duty tax 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.

Import VAT

Imported goods and services are subject to VAT regardless of the supplier or person supplied; and regardless of whether the goods are for personal use or for business purposes. The application of VAT on imported goods and services is based on the destination principle, which ensures that imports are taxed on the same basis and at the same rate as domestic supplies in the country where consumption takes place.

In the case of tax on the supply of imported taxable goods and services, the tax liability lies with the person receiving the supply as the unit of taxation. The benchmark tax period is the calendar month.

5.3 Tax expenditure related to taxes on imports

Import duties are based on regional agreements which are ratified and harmonized in the EACCMA, 2004 and other international agreements. Therefore, expenditures emanating from these agreements do not constitute tax expenditure for purposes of this report.

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.

Total tax expenditure related to taxes on imports (Excise duty & VAT on imports) declined from Ksh 29.3 billion (0.35 percent of GDP) in 2017 to Ksh 23.1 billion (0.21 percent of GDP) in 2020 **(Table 12).** However, this category accounts for the least share of total tax expenditure.

Table 12: Tax Expenditure Related to Taxes on Imports

Ksh Million	**2017**	**2018**	**2019**	**2020**
Excise duty on Imports	3,777.27	4,127.34	4,220.87	5,388.90
VAT on Imports	25,545.60	24,414.90	22,794.60	17,694.80
Total Tax Expenditure	**29,322.87**	**28,542.24**	**27,015.47**	**23,083.70**
Nominal GDP	8,483,396.00	9,340,307.00	10,255,654.00	10,752,992.00
Percent of GDP	**0.35%**	**0.31%**	**0.26%**	**0.21%**

CHAPTER SIX: CONCLUSION AND POLICY RECOMMENDATION

6.1 Conclusion

Total tax expenditure has been on a declining trend over the last four years. In 2020, the total tax expenditure amounted to Ksh 318.3 billion (2.96 percent of GDP), a decline from Ksh 437.1 billion (5.15 percent of GDP) in 2017, Ksh 429.3 billion (4.60 percent of GDP) in 2018 and Ksh 350.9 billion (3.42 percent of GDP) in 2019. The decline was mainly driven by the decline in tax expenditure related to domestic VAT, occasioned by a review of the VAT Act geared towards raising revenue. It is noted that the reduction in the number of items exempted from VAT accounts for the most reduction in tax expenditure over the last four years.

Tax Expenditure estimates for VAT on imports have been decreasing steadily over the review period. Specifically, the tax expenditure declined from Ksh 25.5 billion in 2017, Ksh24.4 billion in 2018, Ksh 22.8 billion in 2019 to Ksh 17.7 in 2020. The tax expenditure on excise duty on imports varies across the period under review from Ksh 3.8 billion in 2017, Ksh 4.1 billion in 2018, Ksh 4.2 billion in 2019 and Ksh 5.4 billion in 2020.

On Personal Income Tax, the report shows that the tax expenditure increased from Ksh 3.5 billion in 2017, Ksh 3.8 billion in 2018 and Ksh. 4.7 billion in 2019 and thereafter decreased to Ksh 4.1 billion in 2020. The decrease of PIT from Ksh 4.7 billion in 2019 to Ksh4.1 billion in 2020 was due to decrease in taxable income as a result loss of employment occasioned by Covid-19.

In regard to Corporate Income Tax, tax expenditure increased from Ksh 47.6 billion in 2017 to Ksh 77.1 billion in 2018 and thereafter decreased to Ksh 62 billion in 2019 and further to Ksh 56.7 billion in 2020.The decrease in CIT tax expenditure for the years 2019 and 2020 was due to harmonization and reduction in the amount of wear and tear allowances.

The tax expenditure estimates for Kenya are comparable to the 2.9 percent of GDP average for African countries and 4.0 percent of GDP average in the European Union. The amount is lower compared to the United States, which is above 7.0 percent of GDP and the United Kingdom, which is above 6.0 percent of GDP. However, this comparison should not be relied on since the Benchmark Tax Systems used as a reference vary substantially across countries.

6.2 Policy Recommendation

To ensure sustainability and value for money from the resources foregone through tax expenditure, the Government will continue to upscale efforts

rationalize and harmonize the tax expenditures with the aim of removing redundant tax expenditures and enhancing those intended to promote investments. In addition, there is need to have an elaborate framework for monitoring and evaluating the impact of tax expenditure in the economy.

APPENDICES

Annex I: List of goods and services contained in tax exemption and zero-rating categories in the First and Second Schedules of the VAT Act, 2013 that are considered benchmark but not as tax expenditure

Domestic supply of listed agricultural inputs, including fertilizers;

1. Domestic supply of unprocessed agricultural products;
2. Specified financial & insurance services;
3. Education services as defined;
4. Agricultural, animal husbandry and horticultural services.
5. Sale, renting, leasing, hiring, letting of land or residential premises as defined;
6. Medical, veterinary, dental, ambulance and nursing services;
7. Listed medical materials, articles and equipment, including articles of apparel, clothing accessories and equipment specially designed for safety or protective purposes for use in registered hospitals and clinics or by County government or local authorities in firefighting;
8. Personal protective equipment, including facemasks, for use by medical personnel in registered hospitals and clinics, or by members of the public in the case of a pandemic or a notifiable infectious disease;
9. Materials, articles, equipment and motor vehicles specially designed for the sole use by disabled and physically handicapped persons;
10. Materials, articles and equipment (excluding motor vehicles) intended for educational, scientific or cultural advancement of the disabled;
11. Medicaments;
12. Mosquito nets;
13. Burial and cremation services;
14. Community, social and welfare services provided by National Government, County Government or any political subdivision, charitable organizations;
15. Services rendered by educational, political, religious, welfare and other philanthropic associations to their members;
16. Entertainment services conducted by educational institutions as part of learning; sports, games or cultural performances conducted under the auspices of the responsible Ministry;
17. Accommodation and restaurant services operated by approved educational training institutions and medical institutions for the use of the staff, students and patients of that institution;
18. Canteens and cafeterias operated by an employer for the benefit of his employees;

19. Betting, gaming and lotteries services;
20. Hiring, leasing and chartering of aircrafts, aeroplanes, and space crafts, excluding helicopters;
21. Supply of domestic passenger transportation services by road, rail and water, except where the means of conveyance is hired or chartered;
22. Materials, waste, residues and by-products, whether or not in the form of pellets, and preparations of a kind used in animal feeding;
23. Postal services provided through the supply of postage stamps, including rental of post boxes or mailbags and any subsidiary services thereto.
24. Transfer of a business as a going concern by a registered person to another registered person.
25. Goods imported by passengers arriving from places outside Kenya, subject to specified limitations and conditions.
26. Taxable goods for emergency relief purposes for use in specific areas and within a specified period, supplied to or imported by the Government or its approved agent, a nongovernmental organization or a relief agency authorized by the Cabinet Secretary responsible for disaster management.
27. Hearing aids, excluding parts and accessories, of tariff No.9021.40.00.
28. Car park services provided by National Government, County Government, any political subdivision by an employer to his employees on the premises of the employer.
29. The supply of airtime by any person other than by a provider of cellular
30. Mobile telephone services or wireless telephone services.

Further, the following zero-rated supplies are treated as part of the benchmark and therefore not part of tax expenditure: They include

1. Goods consigned to officers or men on board a naval vessel belonging to another Commonwealth Government for their personal use or for consumption on board such Vessel; and Goods for the use of any of the Armed Forces of any allied power;
2. Specified supplies to Diplomats or First Arrivals Persons;
3. Specified supplies to donor agencies with bilateral or multilateral agreements;
4. Goods and equipment imported by or supplied to donor agencies, international and regional organizations with Diplomatic accreditation or bilateral or multilateral agreements with Kenya for their official use;
5. Supply to the War Graves Commission;
6. Supply to National Red Cross Society and St. John Ambulance;

7. Supply of protective apparel, clothing accessories and equipment; specially designed for safety or protective purposes for use in registered hospitals and clinics or by county government or local authorities in firefighting;
8. The supply of coffee and tea for export to coffee or tea auction centres;
9. The supply of taxable services to international sea or air carriers on international voyage or Flight;
10. The Supply of taxable services in respect of goods in transit;
11. The exportation of goods or taxable services;
12. Ship stores supplied to international sea or air carriers on international voyage or flight;
13. Transportation of passengers by air carriers on international flight; and
14. Goods purchased from duty free shops by passengers departing to places outside Kenya.

Annex II: Methodology

Data sources

The data for the report is from Kenya Revenue Authority.

Estimation of the cost of tax expenditures

The estimation of the tax expenditure is based on the revenue-forgone approach[1]. In this approach, the cost of tax expenditures is calculated as the difference between the tax actually paid and the tax foregone assuming full compliance with the benchmark tax system (BTS).

In this regard, one specific aspect of this methodology worth noting for the interpretation of the estimations in this report is that estimations **do not include dynamic effects**. Our methodology assumes that no change in behaviour following the theoretical removal of a tax expenditure. Depending on each tax expenditure, the actual effect of its removal on the budget might differ in case of behavioural responses by taxpayers.

In practice, the exact formula for the calculation of the theoretical tax varies depending on tax specificities. It also depends a lot on data availability and sometimes require simplifying assumptions.

The methodology for each tax is described below.

a) Personal income tax (PIT)

The methodology for the cost estimation of tax expenditures on personal income tax differs depending on the considered tax relief.

The situation for the General Personal Relief and the Insurance Relief is simple. They are fixed deduction that can be directly obtained and aggregated from the KRA database on PIT.

The situation is more complex for the Mortgage Interest deductions, the Homeowner saving plan and for exempted incomes. For these reliefs, there is need for detailed individual data to be able to simulate the theoretical revenue when applying the progressive tax rates on taxpayers without relief.

The development of a microsimulation framework might be considered in the future but for this first tax expenditure report, an approximate method was used to be able to evaluate those tax expenditures. We assumed that the removal of these reliefs would not alter the structure of taxable income in the revenue bands. Therefore, the cost of the tax expenditure can be estimated as

[1] See IMF, *Tax Expenditure Reporting and Its Use in Fiscal Management: A Guide for Developing Economies,* March 27, 2019.

the loss of taxable income due to the relief multiplied by the effective tax rate observed for PAYE:

Tax Expenditure $_{PIT}$ = Tax base loss x Effective tax rate

b) Domestic VAT

In this report, tax expenditure regarding VAT are exemptions and zero-rate supplies. Consequently, the estimation of the cost consists in gathering the tax base loss for each category of good and service and to apply the rate from the BTS (usually the normal rate of 16 %).

Tax Expenditure $_{Dom.\ VAT}$ = $\sum_{exemption}$ (Tax base loss x BTS rate) + $\sum_{zero\ rate}$ (Tax base loss x BTS rate)

c) Taxation of imports

Tax expenditure on imports taxation consists of exemptions from Import Duty, VAT or Excise Duty. In that case, the cost can be estimated by gathering the tax base loss for each item category from the international harmonized system and apply the normal rate from the BTS (Common External Tariffs for Import Duty, BTS VAT rate and Excise rates).

Tax Expenditure $_{Import\ Duty}$ = $\sum_{exemption}$ (Tax base loss x BTS rate)

Tax Expenditure $_{Import\ VAT}$ = $\sum_{exemption}$ (Tax base loss x BTS rate)

Tax Expenditure $_{Import\ Excise}$ = $\sum_{exemption}$ (Tax base loss x BTS rate)