Tax Competition in East Africa

A race to the bottom?

Tax Incentives and Revenue Losses in Kenya

Tax Justice Network-Africa & ActionAid International

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About TJN-A

Tax Justice Network-Africa (TJN-A) is a Pan-African initiative established in 2007 and a member of the global Tax Justice Network. TJN-A seeks to promote socially just, democratic and progressive taxation systems in Africa. TJN-A advocates pro-poor taxation and the strengthening of tax regimes to promote domestic resource mobilization. TJN-A aims to challenge harmful tax policies and practices that favor the wealthy and aggravate and perpetuate inequality.

About ActionAid

ActionAid International (AAI) is a non-partisan, non-religious development organization that has been working in Kenya since 1972. ActionAid seeks to facilitate processes that eradicate poverty and ensure social justice through anti-poverty projects, local institutional capability building and public policy influencing. The organisation is primarily concerned with the promotion and defence of economic, social, cultural, civil and political human rights and supports projects and programmes that promote the interests of poor and marginalized people.

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Recent government estimates are that Kenya is losing over KShs 100 billion (US$ 1.1 billion) a year from all tax incentives and exemptions. Of these, trade-related tax incentives were at least KShs 12 billion (US$ 133 million) in 2007/08 and may have been as high as US$ 566.9 million. Thus the country is being deprived of badly-needed resources to reduce poverty and improve the general welfare of the population. In 2010/11, the government spent more than twice the amount on providing tax incentives (using the figure of KShs 100 billion) than on the country's health budget – a serious situation when 46% of Kenya's 40 million people live in poverty (less than US$ 1.25 a day).

Kenya's provision of tax incentives is part of the tax competition among the members of the East African Community (EAC). Following the EAC's establishment in 1999, Kenya, Tanzania and Uganda created a customs union (a duty-free trade area with a common external tariff) in 2005, and were joined by Rwanda and Burundi in 2009. This has created a larger regional market, and means that firms can be located in any EAC country to service this market. At the same time, however, countries are being tempted to increase tax incentives in order to attract FDI and, they believe, increase jobs and exports. Our analysis suggests that the provision of tax incentives across the East Africa region represents harmful tax competition and may be leading to a 'race to the bottom'.

Kenya provides an array of tax incentives. The more prominent ones concern the Export Processing Zones, which give companies a 10-year corporate income tax holiday and exemptions from import duties on machinery, raw materials, and inputs, and from stamp duty and VAT. Yet a 2006 report by the African Department of the IMF, focusing on East Africa, notes that 'investment incentives – particularly tax incentives – are not

an important factor in attracting foreign investment'. A 2010 study found that the main reasons for firms investing in Kenya are access to the local and regional market, political and economic stability and favourable bilateral trade agreements; fiscal concessions offered by EPZs were mentioned by only 1% of the businesses sampled. Despite its generous tax incentives, Kenya has in recent years attracted very low levels of FDI, largely due to recent political violence and instability. FDI flows to Uganda, which provides fewer incentives than Kenya, are much higher.

The Kenyan government recognises that the current level of tax incentives presents a problem and has committed itself to rationalising and reducing them. However, there are major questions as to how far, and how quickly, the government is really prepared to go.

In our view, the government should:

- Remove tax incentives granted to attract FDI, especially tax holidays and those provided to EPZs and SEZs.
- Undertake a review, to be made public, of all tax incentives with a view to reducing or removing many of them, especially those that involve the exercise of discretionary powers by Ministers.
- Provide on an annual basis, during the budget process, a publicly available tax expenditure analysis, showing annual figures on the cost to the government of tax incentives and showing who are the beneficiaries of such tax expenditure.
- Take greater steps to promote coordination in the EAC to address harmful tax competition.

Acronyms

AfDB	African Development Bank
EAC	East African Community
EPZ	Export Processing Zone
EPZA	Economic Processing Zone Authority
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
KRA	Kenya Revenue Authority
SEZs	Special Economic Zones
UNCTAD	United Nations Conference on Trade and Development
VAT	Value Added Tax

Introduction

The government of Kenya is providing a wide range of tax incentives to businesses to attract greater levels of Foreign Direct Investment (FDI) into the country. Yet this study shows that such tax incentives are leading to very large revenue losses and are anyway not needed to attract FDI. Recent government estimates are that Kenya is losing over KShs 100 billion (US$ 1.1 billion) a year from all tax incentives and exemptions. Of these, trade-related tax incentives were at least KShs 12 billion (US$ 133 million) in 2007/08 and may have been as high as US$ 566.9 million (see section 2). Thus the country is being deprived of badly-needed resources to reduce poverty and improve the general welfare of the population. This is critical when 46% of Kenya's 40 million people live in poverty (less than US$ 1.25 a day).[1]

In 2009/10, Kenya collected KShs 466 billion (US$ 5.16 billion) in tax revenues, nearly half of which came from income tax and a third from VAT.[2] Yet a parliamentary report notes that Kenya's 'tax gap' – the difference between actual and potential revenue collections – was a massive KShs 275 billion (US$ 3.05 billion) in 2009/10; most of the losses were due to failures to collect corporate income taxes, VAT and import duties.[3]

Kenya's provision of tax incentives is part of the tax competition among the members of the East African Community. Following the EAC's establishment in 1999, Kenya, Tanzania and Uganda created a customs union (a duty-free trade area with a common external tariff) in 2005, and were joined by Rwanda and Burundi in 2009. This has created a larger regional market, and means that firms can be located in any EAC country to service this market. At the same time, however, countries are being tempted to increase investment incentives in order to attract FDI and, they believe, increase jobs and exports. As a 2006 IMF report notes:

> *'Increased competition over FDI and growing pressure to provide tax holidays and other investment incentives to attract investors could result in a "race-to-the-bottom" that would eventually hurt all three [ie, Kenya, Uganda and Tanzania] EAC members. Left unchecked, the contest could result in revenue loss, especially in Tanzania and Uganda, and threaten the objective of improving revenue collection.'*[4]

Our analysis suggests that this is indeed happening and that the wide range of tax incentives provided by Kenya and its fellow member states in the EAC are indeed leading to a 'race to the bottom'.

Tax incentives

A tax incentive is defined as 'a deduction, exclusion or exemption from a tax liability, offered as an enticement to engage in a specified activity such as investment in capital goods for a certain period'.[5] Tax incentives are the fiscal form of investment incentives and include corporate income tax holidays and reductions in tax rates. Non-fiscal or non-tax incentives include direct subsidies like government grants, loans and guarantees for target projects. Tax incentives are granted to attract FDI and/or to promote specific economic policies, such as to encourage investment in certain sectors.

Investment Incentives[6]

Corporate income tax incentives

- Tax holidays or reduced tax rates
- Tax credits
- Investment allowances
- Accelerated depreciation
- Reinvestment or expansion allowances

Other tax incentives

- Exemption from or reduction of withholding taxes
- Exemption from import tariffs
- Exemption from export duties
- Exemption from sales, wage income or property taxes
- Reduction of social security contributions

Financial and regulatory incentives

- Subsidised financing
- Grants or loan guarantees
- Provision of infrastructure, training
- Preferential access to government contracts
- Protection from import competition
- Subsidised delivery of goods and services
- Derogation from regulatory rules and standards

1. Tax Incentives in Kenya

Kenya provides an array of tax incentives. The more prominent ones concern the Export Processing Zones, one-off capital investment deductions, exemptions given on withholding tax and the zero rating of VAT payable for goods and services procured by public bodies and privileged institutions.[7] The statutory regimes that govern fiscal incentives are the Income Tax Act[8], the Value Added Tax Act[9] and Customs legislation.[10] The Ministry of Finance has also recently published the Value Added Tax Bill 2011, which is currently undergoing public review and debate. Our analysis is especially concerned with tax incentives granted to attract foreign investment.

Export Processing Zones and related incentives

EPZs were established in 1990 under the Export Processing Zones Act in order to attract FDI and turn Kenya into an export-based economy. The zones were also intended to create jobs for the growing unemployed, lead to technology transfer and create linkages between domestic producers and exporters.[11] The EPZs currently employ around 30,000 people working in 99 enterprises in 42 zones country-wide, 40 of which are privately owned and operated and two of which are publicly owned. Nine are located in Nairobi, 21 in Mombasa, three in Athi River, two in Kilifi, and one each in Voi, Kerio Valley, Thika, Isinya, Ruiru, Malindi and Eldoret.[12] Investments in the zones are valued at KShs 21.7 billion (US$ 241 million). The majority of the EPZ investors (61 per cent) are foreign companies from China, Britain, the US, Netherlands, Qatar, Taiwan and India while a quarter of the firms are joint ventures between Kenyans and foreign companies; 14 per cent of the enterprises are fully owned by Kenyans.[13]

Numerous tax incentives are provided in the EPZs, the most significant of which are:

- a 10-year corporate income tax holiday, followed by a 25% rate (compared to the standard 30%) for the next 10 years

- a 10 year exemption from all withholding taxes
- exemption from import duties on machinery, raw materials, and inputs;
- exemption from stamp duty and VAT on raw materials, machinery and other inputs.[14]

Kenya's system of 'Manufacturing Under Bond', introduced in 1986, encourages investors to manufacture for export, and offers:

- exemption from duty and VAT on imported plant, machinery, equipment, raw materials and other inputs;
- 100% investment allowance on plant, machinery, equipment and buildings;
- exemption of the products from export taxes and levies

The Tax Remission for Exports Office (TREO) encourages domestic manufacturers to export, and offers:

- remission of import duty and VAT on raw materials used in the manufacture of export goods.
- Remission of excise duty on fuel oil and kerosene[15]

Other Tax Incentives and Exemptions

Various tax incentives are provided under the Income Tax Act, the most significant of which in terms of current revenue losses (see next section) are the Wear and Tear Allowance and the investment deductions allowance.

- The Wear and Tear Allowance is a form of capital allowance (or an allowable deduction) on the depreciation of goods such as tractors, computers and motor vehicles and is calculated on the remainder of expenditure after the investment deduction allowance (see below) has been claimed.
- The Investment Deductions Allowance (IDA) is an allowance on company expenditure on building and machinery used for 'manufacture under bond', calculated as a percentage of the expenditure.
- The Mining Deduction Allowance provides for a allowance for expenditure incurred by mining companies equal to 40% of that expenditure in the first year and 10% in the following six years. This includes exploration, discovery and testing of minerals, and acquiring new rights over deposits.
- The Farm Works Allowance allows owners or tenants of agricultural land a capital allowance on expenditure on the construction of farm works and the Industrial

Building Allowance allows businesses a capital allowance on the construction of industrial buildings.

Capital Gains Tax, which was introduced in 1975, was suspended in 1985 on both land and company equity. The suspension arose reportedly after lobbying by some politically-connected individuals who at the height of public land grabbing in the 1980s wanted to transfer these properties without paying tax.[16]

The VAT Act also provides for various tax exemptions. Section 23 allows the Finance Minister to remit taxes payable on any goods or services if he is satisfied that it is in the public interest to do so.[17] The Eighth Schedule provides for zero rating of various goods and services.[18]

2. Revenue Losses from Tax Incentives

A lack of transparency on the extent of tax incentives has long prevented the public adequately scrutinising them. Yet the available sources suggest that tax incentives and exemptions entail very significant revenue losses in Kenya. Figures vary, however, depending on the sources (see box below). The Economic Secretary Geoffrey Mwau, has said that Kenya is losing over KShs 100 billion (US$ 1.1 billion) a year from all tax incentives and exemptions; much of these losses come from VAT exemptions. This would amount to around 3.1% of GDP. Government figures show that losses from trade-related tax incentives, including those provided in the EPZs, were at least KShs 12 billion (US$ 133 million) in 2007/08. Still other figures, from the East African Community Secretariat, show that Kenya lost US$ 566.9 million in 2008 from import duty exemptions alone.

Revenue Loss Estimates: Different Sources

Government

In August 2011, the Economic Secretary Geoffrey Mwau, said that Kenya was losing over KShs 100 billion (US$ 1.1 billion) a year from *all tax incentives and exemptions*.[19] This would amount to around 3.1% of GDP.[20]

Treasury Permanent Secretary Joseph Kinyua said in March 2011 that Kenya is foregoing revenues of KShs 60 billion (US$ 669 million) a year in *VAT exemptions* alone.[21]

The table below, using figures from the Kenya Revenue Authority, provides further figures but excludes key policies such as VAT exemptions and the suspended Capital Gains Tax.

Estimated Revenue Loss from Tax Incentives (Kshs Million)

	2003/04	2004/05	2005/06	2006/07	2007/08	TOTAL
Investment Incentives						
Investment Deductions	4,031	14,703	4,323	4,295	11,842	39,134
Industrial Building Allowance	481	1,021	539 298	494	2,833	
Wear and Tear	19,007	21,294	21,684	11,109	40	73,134
Farm Works Allowance	814	1,130	1,256	609	876	4,685
Mining Operation Deductions	203	715	45	70	215	1,248
Sub-total	24,536	38,863	27,847	16,381	13,467	121,094
Trade Related Incentives						
EPZ	103	1,712	5,300	6,694	5,804	19,613
MUB	20	310	937	721	96	2,084
TREO	2,979	2,537	3,974	7,591	6,149	23,590
Sub Total	3,102	4,559	10,211	15,366	12,049	45,287
Total	27,638	43,422	38,058	31,747	25,516	166,381
Revenue loss as % of GDP	1.43	1.66	2.08	1.85	1.29	

Source: KRA

The table shows:

- *Total losses* of KShs 25.5 billion (US$ 282 million) in 2007/08, and cumulative losses over the five years of KShs 166 billion (US$ 1.84 billion). These losses amount to an average of 1.7% of GDP.
- *Losses as a result of trade-related tax incentives* of KShs 34.3 billion over the five years, of which KShs 19.6 billion (US$ 217 million) relates to EPZs.

East African Community Secretariat

EAC figures – which cover *import duty exemptions* only – show that in 2008 the value of goods imported by Kenya that qualified for tax exemptions was US$ 2.3 billion, which resulted in a revenue loss of US$ 566.9 million. In the four years 2005-08, Kenya lost revenues of US$ 1.49 billion.

Import Duty Exemptions Granted by Kenya (US$ millions)

Heading	2005	2006	2007	2008
Value of Exemptions	800.9	1370.8	1626.7	2306.2
Revenue Foregone	201.4	289.5	430.8	566.90
Total Trade Taxes	1529.7	1749.0	2273.2	2451.6
Percentage Foregone	11.6	14.2	15.9	18.8

Source: EAC Secretariat, *EAC Trade Report* 2008, 2010, p.51

IMF

In March 2011, the IMF Resident Representative in Kenya, Ragnar Gudmundsson, said that Kenya was losing KShs 40 billion (US$ 443 million) a year in tax exemptions.[22]

Development foregone

Tax incentives waste government resources that could better be used to eradicate poverty. In 2010/11, the government's entire health budget was KShs 41.5 billion.[23] Yet the government paid more than twice this amount in providing tax incentives (using the government's estimate, noted above, of losses of KShs 100 billion).

3. Problems with Kenya's Tax Incentives

All the evidence suggests that the disadvantages of tax incentives vastly outweigh the advantages and that such incentives are not needed to attract FDI.[24]

Proponents of tax incentives often argue that lower tax burdens give investors a higher net rate of return and therefore free up additional income for re-investment. The host country thus attracts increased FDI, raises its income and also benefits from the transfer of technology. A further argument, particularly in relation to the less developed countries, is that it is imperative to provide incentives to investors given the otherwise poor investment climate: the volatility in politics, dilapidated infrastructure, the high cost of doing business, the macroeconomic instability, corruption and an inefficient judiciary. Revenue losses are rationalized by arguing that the capital and jobs created will improve the welfare of citizens and expand the economy.

However, there are a long list of disadvantages with tax incentives, as outlined in a recent IMF report, which argues that they:

- Result in a loss of current and future tax revenue
- Create differences in effective tax rates and thus distortions between activities that are subsidized and those that are not
- Could require large administrative resources
- Could result in rent-seeking and other undesirable activities
- Could, in the case of income tax holidays, be a particularly ineffective way of promoting investment. Companies that are not profitable in the early years of operation, or companies from countries which apply a foreign tax credit to reduce the home country's tax on the foreign source income, would not benefit from income tax holidays. In contrast, such holidays would be of less importance to companies that are profitable from the start of their operation

- Could attract mainly footloose firms
- Can be outside the budget and non-transparent[25]

Tax incentives tend to reduce government revenues by 1-2 per cent of GDP, according to the OECD.[26] The IMF notes that investment incentives, if they are to be of benefit, should be well-targeted and focused narrowly on the activities they seek to promote but that 'the corporate income tax holiday usually does not meet the criterion of a well-targeted incentive'.[27] Tax holidays strongly favour transitory rather than sustainable investments and create glaring opportunities for aggressive tax avoidance.[28] A joint report by the IMF, OECD, UN and World Bank comes to the same conclusion, noting that, where governance is poor, corporate income tax exemptions 'may do little to attract investment' and when they do, 'this may well be at the expense of domestic investment'.[29]

The application of different rules and procedures complicates tax administration and increases costs while there are social costs caused by corruption and rent-seeking where the administration of tax incentives is abused, as is often the case.[30] A public officer in research and project planning informed the authors that the administration of tax deductions has led to an increase in corruption; there is a heightened risk of this when Ministers have wide discretionary powers to waive taxes and duties. Tax incentives are also prone to abuse when the incentive is exhausted and the promoters of the business fraudulently wind it down and simultaneously establish another entity to be accorded the same tax incentives. Tax incentives also tend to favour elite private investors who actually have adequate own capital.[31] In addition, once incentives have been selectively granted, sectors that consider themselves excluded will agitate for inclusion thus widening the incentives still further. Once incentives are provided, they are politically difficult to remove. In some cases, incentives are a further waste of resources in that many companies would anyway invest without the incentive. Generally, investment incentives are recommended when the business is in the nature of a public good, such as with projects for encouraging green technologies, primary health care and disease prevention, upgrading skills of workers and research and development.[23]

Tax incentives and FDI

Studies... suggest that tax-driven investment does not provide a stable source of investment in the recipient country' (Joint IMF, OECD, UN and World Bank report for the G-20)[33]

Evidence suggests that tax incentives are not needed to attract FDI. A 2006 report by the African Department of the IMF, focusing on tax incentives in East Africa, notes that the above-mentioned list of disadvantages of tax incentives is:

> *'supported by available empirical evidence which mostly confirms that investment incentives – particularly tax incentives – are not an important factor in attracting foreign investment'.*[34]

The IMF report argues that countries that have been most successful in attracting foreign investors have not offered large tax or other incentives and that providing such incentives was not sufficient to attract large foreign investment if other conditions were not in place. The report also notes that in 'specific circumstances, well-targeted investment incentives could be a factor affecting investment decisions' but that 'in the end, investment incentives seldom appear to be the most important factor in investment decisions'.[35] More important factors in attracting FDI are good quality infrastructure, low administrative costs of setting up and running businesses, political stability and predictable macro-economic policy.[36]

A 2010 study found that the main reasons for firms investing in Kenya are access to the local and regional market, political and economic stability and favourable bilateral trade agreements; fiscal concessions offered by EPZs were mentioned by only 1% of the businesses sampled.[37] Indeed, this reasoning partly explains why the IMF, and other international organisations such as the African Development Bank, has been pressing Kenya, and other governments in East Africa, to radically reduce their tax exemptions (see section 4).

Despite its generous tax incentives, Kenya has in recent years attracted very low levels of FDI, largely due to recent political violence and instability. FDI flows to Uganda, which provides fewer incentives than Kenya, are much higher.[38] The table below shows that Uganda has received the largest FDI flows in the region, which have been increasing. FDI to Tanzania has been significant but largely static while in Kenya FDI is low and erratic.

FDI Flows (US$ million)

	2006	2007	2008	2009	2010
Kenya	51	729	96	141	133
Tanzania	597	647	679	645	700
Uganda	644	792	729	816	848

Source: UNCTAD, *World Investment Report 2011*, Annex Table 1.1

Problems with Kenya's tax incentives

The EPZ tax regime has long been the subject of intense debate and controversy. Despite the generous tax incentives, Kenya's EPZs do not employ a huge number of people – around 30,000 – and have not achieved massive investment – around KShs 22 billion (US$ 244 million).[39] Some exports from the EPZs, notably textiles, are largely driven by the US African Growth and Opportunity Act – which gives African exporters access to US markets – rather than by government incentives: 70% of exports from the EPZs are exported under AGOA.[40] Some EPZ companies have also been criticised for allegedly setting up operations to benefit from the 10-year tax holiday, only to close shop at the expiry of the grace period. The decline in the number of workers in the zones from around 38,000 in 2005 to the current 30,000 could be an indication of these businesses relocating. Other criticisms of the EPZs concern environmental pollution and the low wages and hazardous working conditions endured by some Kenyans.[41]

Kenya's Economic Secretary, Geoffery Mwau, has been quoted as saying that 'the EPZ exemptions have not benefited us. We think the key to success of the EPZs is not the exemptions but reducing the cost of doing business'.[42] Similarly, a 2010 Parliamentary Budget Office report has suggested that the loss from the EPZs tax incentives is greater than the economic gains from them:

> *'Preliminary EPZ data for 2005 would appear to indicate that the growth in the ratio of taxes foregone to domestic product was 90.8% compared to 13% in 2003 which is unlikely and an indication of either poor data capture or abuse of the system to bring in untaxed imports. Alternatively, the scheme appears to be more costly to revenue performance compared to the overall economic gains accruing from the EPZs'*[43]

Experience with EPZs shows that Mauritius, Malaysia and Ireland have been relatively successful because they offered much more than tax incentives, and heavily promoted integrated trade strategies, infrastructure development, management of the political environment and predictable dispute settlement systems.[44] An official at a national tax payers' association interviewed in this research held similar views, arguing that tax incentives have encouraged firms to leave, or threaten to leave, once the tax incentive is spent, and that there are few long term benefits for the country from such 'mobile investment'. The EPZs have become a micro economy, with poor linkages and transfer of technology to other parts of the economy, and also encouraged practices such as transfer pricing and declaration of losses. As regards transfer pricing – the pricing of products between a resident company and its non-resident related companies, which allows companies to under- or over-declare prices to reduce their tax burden – Kenya has, by one estimate, lost around KShs 156 billion (US$ 1.7 billion) between 2000 and 2008.[45]

There are problems with Kenya's other tax incentives and exemptions:

- With regards, to customs and import duty exemptions, the Customs and Excise Code gives wide discretion to Ministers to remit or rebate any duties payable. Economic Secretary Geoffery Mwau has singled out for criticism the removal of the tax on maize imports to allow the country to replenish maize stocks at the height of a severe shortage in April 2011, stating the move only benefited businessmen involved in importing. At the time, the Government also abolished duty on wheat and kerosene. 'When these trades import maize duty free, they do not pass the benefits to Kenyans', Mwau has been quoted as saying.[46]
- With regard to the Investment Deductions Allowance (IDA), the Parliamentary Budget Office (PBO) observes that IDA increased significantly from 2003, when the 100% deduction allowance was implemented; investment deductions rose 260% between 2003 and 2004 alone. The PBO posits that tax payers must be using this advantage to suppress their payments and that the rise in these exemptions implies that large companies 'could be hiding under investment expansion to claim 100% investment deduction'.[47]
- The Tax Remission for Exports Office (TREO) incentives are prone to abuse in that all an importer is required to show in support of an application for a VAT refund is proof of import, not proof of the export of the finished product, and payment of tax. A private tax practitioner told the authors that the incentive is prone to abuse

and constitutes 'capital flight but inbound'. He cited the experience of Tanzania and suggested that manufacturing plants be segregated at establishment as producing goods either for domestic or foreign markets.

- There have long been public calls to reinstate the suspended Capital Gains Tax since it has the potential for raising significant revenues. Transfers of blue chip businesses, particularly in the telecommunications, property, land and financial sectors, have not generated any revenue for the government. Kencell, the first mobile phone operator in Kenya, has changed ownership several times, most recently following India's Bharti Airtel's takeover of Zain Africa in 2010. This transaction reportedly resulted in revenue losses to the government of around KShs 7.5 billion (US$ 83 million).[48]
- Exempting a range of essential goods and services from VAT can benefit the poor. But the African Development Bank notes that a particular question mark hangs over the socio-economic rationale for domestic zero rating of VAT since, in most instances, it does not result in lowering consumer prices for the targeted beneficiaries and that it may benefit business people as windfall profits.[49]

The 'Race to the Bottom'

Fiscal incentives imposed in one country can lead to tax competition among countries and a 'race to the bottom', a process we are witnessing in East Africa. Tax competition can occur when firms are able to locate where tax rates are lowest, thereby encouraging other countries to lower their tax rates in order to retain and attract dynamic firms and able workers.[50] Tax competition can make it difficult for countries to maintain desired tax rates, leading to ever-declining tax rates and revenues. In both Tanzania and Uganda, for example, governments are also granting massive tax incentives, partly in a competition to attract FDI, with the result being significant revenues losses for the government, as in Kenya. Tax rate disparities in the East African Community have also encouraged illicit trade, complicated operational systems for companies wishing to carry on business throughout the EAC and slowed down the integration process.

Economic and Finance Ministers in the European Union have defined harmful tax competition as including factors such as: an effective level of taxation which is significantly lower than the general level of taxation in the country concerned; the presence of tax benefit categories reserved for non-residents; and tax incentives for activities which are isolated from the domestic economy and therefore have no impact on the national tax base.[51]

The EAC has taken some concrete steps to widen and deepen economic cooperation among its members, and Article 83 of the Treaty establishing the EAC provides for monetary and fiscal harmonization including the removal of tax distortions. Tariff barriers between Kenya, Uganda and Tanzania, the original member countries, were removed in 1999, and Rwanda and Burundi joined the membership in 2007.[52] Yet Kenya, along with the other EAC members, is taking only limited steps to promote such fiscal coordination.

Kenya's narrow tax base

Reducing tax incentives would expand the tax base in Kenya, which is currently narrow. Kenya has relatively efficient tax collection – taxes bring in 19% of GDP, compared to 17.3% in Tanzania and 11.8% in Uganda.[53] Yet the tax base could still be substantially widened, and not only from reducing tax incentives. A parliamentary report notes that bringing the informal economy – which accounts for around 80% of the workforce[54] – into the tax net could increase the tax base by over KShs 79 billion (US$ 873 million).[55] The challenge is to enlarge the net of the taxed public in a manner that is equitable and transparent, especially since the wealthy are often able to use tax avoidance schemes.

One big impediment is that many people evade paying taxes because the benefit is not instantly visible and the government is perceived as corrupt. Most micro and small enterprises evade taxes simply because they can – the KRA lacks the capacity to follow up on each eligible tax payer, particularly those in the informal sector. The high administrative burdens of paying tax in Kenya also contribute to sub-optimal revenue collection. According to the World Bank, firms have to make 41 different tax payments a year (compared to an average of 37 in sub-Saharan Africa and 13 in the OCED), and spend 393 hours a year compiling and paying tax returns (compared to 318 in sub-Saharan Africa and 186 in the OECD).[56] These administrative burdens should be reduced alongside the country's generous tax incentives.

4. Government Policy on Tax Incentives

The Kenyan government recognises that the current level of tax incentives presents a problem and has committed itself to rationalising and reducing them. However, there are major questions as to how far, and how quickly, the government is really prepared to go.

In January 2011, the government committed itself in its 'letter of intent' to the IMF to 'rationalising existing tax incentives, expanding the income base and removing tax exemptions as envisaged in the constitution'.[57] In June 2011, a further letter of intent committed the government to undertaking a 'comprehensive review of tax policy', following the appointment of a Tax Reform Commission in 2011/12, which 'will aim at simplifying our tax code in line with best practices, in order to help improve tax compliance, minimize delays and raise revenue'. Specifically, the government has said it will make 'comprehensive amendments' to the VAT legislation in 2011/12 in order to 'minimize revenue losses linked to exemptions'.[58] Economic Secretary Geoffery Mwau even said in August 2011 that tax incentives granted to investors in the Export Processing Zones could be abolished in the near future.[59]

Past attempts to reform tax incentives and exemptions have failed to promote genuine equity. A 2010 African Development Bank report notes that:

> *'In the past, GOK extended tax exemptions and incentives, especially on import duties to various taxpayers. Since there were no open criteria for these exemptions and incentives, they developed into favours for the well connected. This practice undermined equity and fairness of the tax system and revenue potential... The EAC Customs Management Act of 2004 has restricted the range and quantum of tax exemptions and incentives by member states. However, GOK has gone around this restriction by paying duties on behalf of select institutions such as*

> *faith groups and other charities that provide public services. Furthermore, exemptions from domestic taxes remain, but are subject to, an internal criterion which guides processing and approval of such requests. Still, there is no guarantee of equity and fairness in the distribution of these exemptions'.*[60]

A draft VAT Bill was published for public debate in July 2011, and seeks to address the complexity and inefficiency associated with the current VAT Act. The most far reaching proposals concern reduction in exempt and zero-rated taxable items, which would significantly improve equity in taxation in view of Kenya's past experience whereby the President, the military and, before repeal by Parliament in 2001, permanent secretaries, were beneficiaries of the zero-rated taxable goods facility, including for luxury items.[61] One major concern with the proposed legislation is that it still provides for significant discretion on the part of the Commissioner and Cabinet Secretary. Section 30, for example, provides that remissions will be granted upon the determination by the Cabinet Secretary where there is some public interest advanced in so doing. This allows for ad hoc decision making by the executive and the possible abuse of the facility.

Recommendations

In our view, the government should:

Remove tax incentives granted to attract FDI, especially tax holidays and those provided to EPZs and SEZs.

Undertake a review, to be made public, of all tax incentives with a view to reducing or removing many of them, especially those that involve the exercise of discretionary powers by Ministers. Those incentives that remain must be simple to administer and shown by the government to be economically beneficial.

Provide on an annual basis, during the budget process, a publicly available tax expenditure analysis, showing annual figures on the cost to the government of tax incentives and showing who are the beneficiaries of such tax expenditure.

Kenya's Auditor General is required to report to both the National and County Governments on whether public moneys have been applied lawfully and used in an effective manner.[62] The Auditor General should, therefore, be the custodian of a detailed databank on tax incentives and exemptions either granted or intended to be granted.

Promote coordination in the EAC to address harmful tax competition. This means agreeing on the removal of all FDI-related tax incentives. It does not mean achieving full tax *harmonisation* in the EAC but increasing tax *coordination*, allowing individual countries fiscal flexibility. In turn, this principally means improving the existing draft Code of Conduct on tax competition in the EAC, and agreeing:

- on *minimum* rates on certain taxes to avoid harmful tax competition
- to provide a mandatory, regular exchange of information to other states concerning proposed tax rate changes

- to adhere to high transparency standards, such as the IMF Code of Good Practices on Fiscal Transparency
- to establish a robust dispute settlement mechanism
- to conduct annual, comparable and publicly available, tax expenditure analyses

List of Institutions Interviewed

New Partnership for Africa's Development
Export Processing Zones Authority
Faulu Kenya
Viva Africa Consultants
Kenya Association of Manufacturers
Kenya Revenue Authority
Kenya Private Sector Alliance
Ministry of Finance
Capital Markets Authority
National Tax Payers' Association
Kenya Investment Authority
Dyer & Blair
KPMG

Endnotes

1 World Bank, Kenya country page, data section, www.worldbank.org
2 IMF, *First Review under the Three-Year Arrangement under the Extended Credit Facility*, 15 June 2011, p.19
3 Parliamentary Budget Office, *Unlocking the Revenue Potential in Kenya*, Policy Working Paper Series, No. 2/2010, p.vi
4 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.5
5 See http://www.businessdictionary.com/definition/tax-incentive.html accessed on 11th April, 2011.
6 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.10
7 African Development Bank, *Domestic Resource Mobilisation for Poverty Reduction in East Africa: Kenya Case Study*, November 2010, p.30
8 Income Tax Act, Chapter 470 of the Laws of Kenya
9 Value Added Tax Act, Chapter 476 of the Laws of Kenya
10 The EACCMA, 2004, and the Customs & Excise (1st Booklet) Code, chapter 472 of the Laws of Kenya
11 The EPZ Program in Kenya is grounded on Sessional Paper No.1 of 1986 on 'Economic Management for Renewed Growth'. The paper's objective was to re-orient Kenya's economic regime from import substitution to export-led growth policies. Subsequent to this, the Industrial Sector Adjustment Program of 1988 recommended restructuring the industrial sector to stimulate productive investment into the export sector. Kenya inaugurated its EPZ programme in 1990 as part of the Export Development Program being undertaken by the government to achieve job creation, diversification and expansion of exports, increase productive investments, transfer technology and create backward linkages between the zones and the domestic economy.
12 Information provided to the authors by an EPZ official; Washington Gikunju, 'Global recovery renews interest in Kenya's EPZs', 23 February 2010, www.businessdailyafrica.com
13 Washington Gikunju, 'Global recovery renews interest in Kenya's EPZs', 23 February 2010, www.businessdailyafrica.com. Kenya's cabinet has approved the conversion of the EPZs into Special Economic Zones (SEZs), and the President has tasked the National Economic and Social Council to undertake the necessary preparatory work. SEZs are 'geographical areas with highly developed infrastructure, which have the potential to be developed into agricultural zones, industrial zones, tourist/recreational parks, commercial zones, EPZs, free ports, free trade zones, science and technology parks, IT parks and incubation centres'. Kenya's draft policy on SEZs states that their development is a flagship programme under Vision 2030's First Medium Term Plan (2008-2012). SEZs are intended to promote economic growth, employment, the reduction of poverty and increase Kenya's competitiveness as an investment destination by providing infrastructure, simplifying business regulations, and promoting clustering and expanded market access. C.Njiru, 'Transformation of EPZ into SEZ Program', Presentation at capacity building seminar for Permanent Secretaries / Accounting Officers, Naivasha, 16 May 2009. Republic of Kenya, Ministry of Trade, 'Draft Policy on Special Economic Zones', 18 March 2010, www.epzkenya.com
14 UN, *An Investment Guide to Kenya*, 2005, p.46, available on Kenya Investment Authority website
15 UNDP, *Doing Business in Kenya: A Handbook for Local Investors*, 2006, p.26, available on the Kenya Investment Authority website
16 See www.pkfea.com/publications/joe.pdf

17 Remission is granted for various goods including for emergency relief and officially recognized refugee camps, equipment and materials for health, sanitary or educational purposes, motor vehicles and aircraft, and taxable services imported or purchased by any company which has been granted an oil exploration or oil prospecting licence, capital equipment and machinery imported or purchased solely for use in the manufacture of goods in a licensed customs bonded factory for export only, goods for official aid funded projects, goods, including motor vehicles imported or purchased by any company which has been granted a geothermal resources license and taxable goods and services supplied by a registered person for use in the construction or expansion of private universities (excluding student hostels and staff housing) with the approval of the Minister, on the recommendation of the Minister responsible for education.

18 These include sports goods and equipment, equipment for disabled, blind and handicapped persons, aircraft operations, life saving apparatus, protective apparel, clothing and accessories, ships and other vessels, materials and equipment for use in the construction or refurbishment of tourist hotels. The beneficiaries include the President, Kenya Armed Forces, Commonwealth and other governments, the diplomatic corps and aid agencies.

19 Cited in John Njiraini, 'Kenya losing Sh100 billion annually on tax exemptions', *The Standard*, 23 August 2011

20 Based on a nominal GDP estimate of KShs 3.18 trillion in 2011/12. IMF, *First Review under the Three-Year Arrangement under the Extended Credit Facility*, 15 June 2011, p.19

21 Kaburu Mugambi, 'Amended VAT Act to see firms lose billions in the annual tax refunds', all.africa.com, 21 March 2011

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25 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.10

26 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.12

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28 World Bank, Foreign Investment Advisory Service, *Sector Study of the Effective Tax Burden in Tanzania*, May 2006, http://siteresources.worldbank.org/EXTEXPCOMNET/Resources/2463593-1213973103977/09_Tanzania.pdf

29 IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems*, Report to the G-20 Development Working Group, 2011, p.19

30 H.Zee at al, 'Tax Incentives for Business Investment: A Primer for Policy Makers in Developing Countries', *World Development*, Vol. 30, No. 9, 2002, pp. 1497-1516.

31 Goldin and Reinert, 'Globalization for Development, Trade, Finance, Aid, Migration and Policy, 2007; citing also a 1998 World Bank study, the authors argue that poor people face higher tariffs than the non-poor by more than twice. Poor people also face significant tariff peaks in products of export interest to them.

32 Global Tax Simplification Team of the IFC Investment Climate Advisory (April, 2011), presentation at the EAC's Validation Workshop of the Study of Double Taxation Avoidance Model and the Code of Conduct Against Harmful Tax Competition held in Arusha, April 2011

33 IMF, OECD, UN and World Bank, *Supporting the Development of More Effective Tax Systems*, Report to the G-20 Development Working Group, 2011, p.19

34 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.11

35 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.11

36 At a Trade Justice Network-Africa/ActionAid roundtable in Nairobi in July 2011, John Njiraini, the Commissioner of Domestic Taxes in Kenya, confirmed this truism. He cited the example of a large tax payer, a blue chip company in Kenya which increased the level of investment considerably within months of KRA's withdrawal of some previously enjoyed incentive. Apparently, certain

categories of taxpayers, mostly, large, were allowed to offset VAT refunds against other tax liabilities, a facility which was withdrawn due to challenges in managing the same.

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38 IMF, *Kenya, Uganda and United Republic of Tanzania: Selected Issues*, 1 December 2006, p.13
39 Washington Gikunju, 'Global recovery renews interest in Kenya's EPZs', 23 February 2010, www.businessdailyafrica.com
40 'Experts fault tax incentives for EPZ companies', undated, http://www.agoa.info/?view=.&story=news&subtext=1184
41 Washington Gikunju, 'Global recovery renews interest in Kenya's EPZs', 23 February 2010, www.businessdailyafrica.com
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43 Parliamentary Budget Office, *Unlocking the Revenue Potential in Kenya*, Policy Working Paper Series, No. 2/2010, para 130
44 Goldin and Reinert, 'Globalization for Development, Trade, Finance, Aid, Migration and Policy, 2007
45 'Kenya: Nation loses Shs 156 billion in taxation tricks by flower firms', *Daily Nation*, 25 October 25 2010
46 John Njiraini, 'Kenya losing Sh100 billion annually on tax exemptions', *The Standard*, 23 August 2011
47 Parliamentary Budget Office, *Unlocking the Revenue Potential in Kenya*, Policy Working Paper Series, No. 2/2010, p.45
48 The Prime Minister constituted an inter-ministerial task force to scrutinize the tax laws and advise whether it was possible for the Government to raise some tax in the transaction, but the outcome of this inquiry has not been made public. J.Njiraini, 'Zain leaves state high and dry', *The Standard*, 31 March 2010
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50 A.Hansson and K.Olofsdotter,'Integration and Tax Competition: An Empirical Study for OECD Countries', econpapers.repec.org/RePEc:hha:lunewp:2005_004
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52 'About EAC', http://www.eac.int/about-eac.html
53 IMF, *First Review under the Three-Year Arrangement under the Extended Credit Facility*, 15 June 2011, p.20
54 'Highlights of the 2009 Economic Survey', http://fke-kenya.org/download/econsurvey2009.pdf
55 Parliamentary Budget Office, *Unlocking the Revenue Potential in Kenya*, Policy Working Paper Series, No. 2/2010, p.vi
56 World Bank, *Paying Taxes 2012*, Kenya report; http://www.doingbusiness.org/data/exploreeconomies/kenya/#paying-taxes
57 In IMF, *Request for a Three-year Arrangement under the Extended Credit Facility*, 14 January 2011, p.38
58 IMF, *First Review under the Three-Year Arrangement under the Extended Credit Facility*, 15 June 2011, p.30
59 John Njiraini, 'Kenya losing Sh100 billion annually on tax exemptions', *The Standard*, 23 August 2011
60 African Development Bank, *Domestic Resource Mobilisation for Poverty Reduction in East Africa: Kenya Case Study*, November 2010, p.33
61 The proposed law would make some of the currently exempt goods standard rated, make some currently exempt services either standard rated or zero rated, and make some currently zero rated essential goods standard rated. Some public bodies, privileged persons and institutions that previously enjoyed the zero rated status would be brought back within the tax bracket. In view of widespread poverty, it is hoped that basic goods like milk, maize and wheat flour will remain zero rated.
62 Article 229 of the Constitution 2010

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