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 measure whose goal is to benefit specific categories of tax payers, benefit some activities, 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.

This Tax Expenditure Report is prepared in accordance with the provisions of the Public Finance Management Act, 2012 Section 77 (a) that mandates the National Treasury with maintaining a public record of Tax Expenditures. Additionally, Public Expenditures reporting is considered international best practice targeted at enhancing government budgetary and fiscal transparency. In this regard, the objective of this report is to estimate the national tax expenditures on the main tax heads over a four–year period.

In line with the methodology adopted in this report, tax expenditures in 2020 were 2.96% of GDP. The analysis revealed that tax expenditures have been steadily decreasing over the last 4 years and are markedly reduced from 4.9% of GDP reported in 2017. The recorded level of tax expenditures is comparable to the African average of 2.9% of GDP. Nonetheless, it must be noted that cross-country comparisons of tax expenditures between countries is not always possible, as the Benchmark Tax System used as a reference vary substantially across countries.

The report also established that Tax expenditures on domestic VAT account for the largest share (2.18% of GDP in 2020) of total tax expenditures in Kenya. These tax expenditures are spread across a range of sectors including Agriculture, Manufacturing and Transport. Corporate income tax is the second largest contributor to total tax expenditures in Kenya at 0.53% of GDP in 2020. The bulk of these expenditures are tax allowances and deductions designed to encourage investment in plant and machineries.

Personal income tax expenditures in 2020 stood at 0.04% of GDP while tax expenditures related to taxes on imports (Excise tax on imports and VAT on imports) account for 0.21% of GDP in 2020. Overall, tax expenditures have been on a declining trend from 5.15 % of GDP in 2017 to 2.96 % of GDP in 2020, mirroring rationalization and harmonization of these expenditures in various tax laws.

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LEGAL BASIS FOR THE TAX EXPENDITURE REPORT

The Tax Expenditure Report is published in accordance with Section 77 of the Public Finance Management Act, 2012. It states as follows:

77. Powers of the Cabinet Secretary to waive or vary tax, fees or charges:

The Cabinet Secretary may waive a national tax, a fee or charge imposed by the National Government and its entities in accordance with criteria prescribed in regulations provided that—

(a) the National Treasury shall maintain a public record of each waiver together with the reason for the waiver and report on each waiver in accordance with Section 82 of this Act;

(b) such a waiver or variation has been authorized by an Act of Parliament; and

(c) a State Officer may not be excluded from payment of a tax, fee or charge by reason of the office of the State Officer or the nature of work of the State Officer.

1.0 INTRODUCTION

1.1 Background

The principle role of tax system is to raise revenue to fund Government budgetary demands. 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. Tax system can also be used to achieve specific public policy objectives through targeted preferential tax measures such as exemptions, waivers, deductions or credits. Tax expenditures are therefore the estimates 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 activities or categories of taxpayers and to achieve a given policy goal, since households and companies quickly adjust their behaviour based on tax measures. The 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.

The Public Finance Management Act, 2012 under Section 77 (a) requires the National Treasury to maintain a public record of Tax Expenditures. In addition, Tax expenditure reporting is considered an international best practice to foster government budgetary and fiscal transparency. In this regard, this is the first Tax Expenditures Report and will be published annually to enhance transparency and accessibility of information on national tax expenditures.

Benchmark tax system

1.2 Objectives of the report

The overall objective of this Tax Expenditures Report is to estimate the national tax expenditures. The specific objectives of the report includes:

a) Estimate the of tax expenditures for various tax heads for the period 2017 - 2020;
b) Facilitate monitoring and review of tax expenditures;
c) Provide useful information to inform design of effective tax regimes; and
d) Enhance transparency and accessibility of information on national tax expenditures.

1.3 Scope of the Report

This report presents analysis of the tax expenditures under domestic Value Added Tax (VAT), Income Tax (Personal Income Tax and Corporate Income Tax), taxes on imports (Custom Duty, Excise Duty, and Import VAT) and other taxes (Import Declaration Fees (IDF) and Railway Development Levy) 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 expenditures. Tax heads for which no tax expenditures are identified, only description the benchmark tax system is provided.

2.0 SUMMARY FINDINGS OF TAX EXPENDITURES

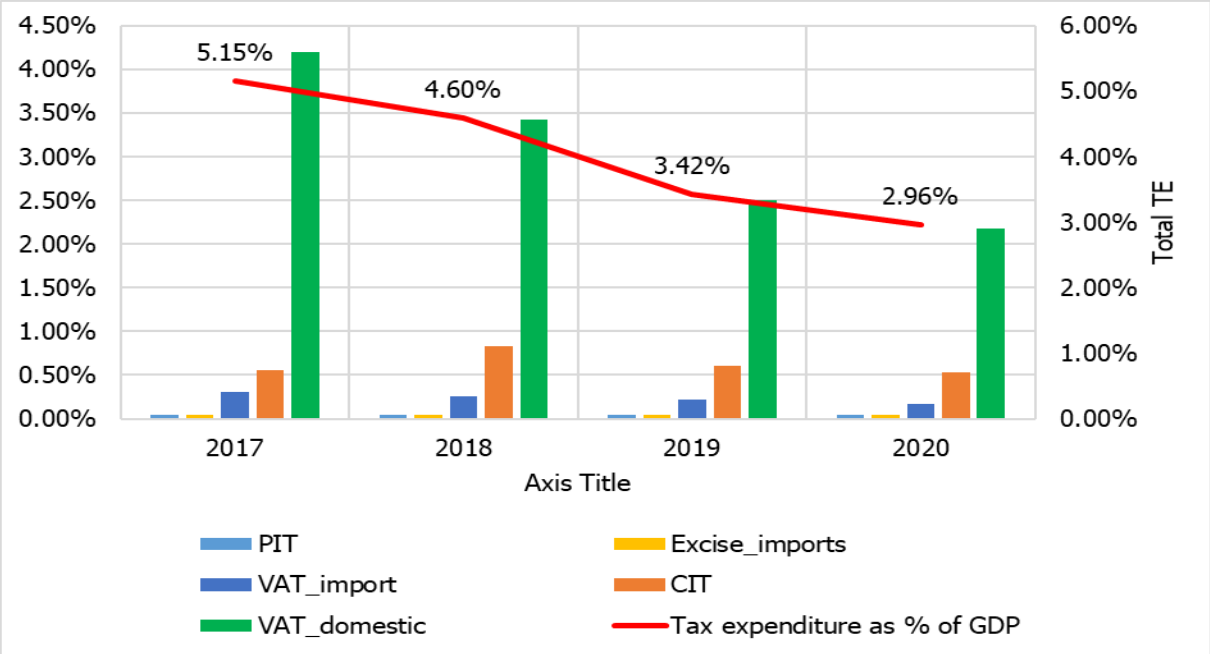
According to the methodology adopted and the benchmarks described in the report, total tax expenditures in 2020 were Ksh. 318.3 billion down from Ksh. 429.3 billion and 350.9 billion in 2018 and 2019, respectively **(Table 1).** Overall, tax expenditures have been on a declining trend over the last 4 years covered in the report.

Table 1: Tax Expenditure (Ksh Million & Percent of GDP)

	2017	2018	2019	2020
PIT	3526.34	3816.17	4653.63	4125.17
CIT	47559.83	77095.82	61980.77	56737.06
VAT_domestic	356707.04	319886.37	257206.30	234378.43
Excise_imports	3777.27	4127.34	4220.87	5388.90
VAT_import	25545.56	24414.90	22794.60	17694.80
Total	437116.05	429340.60	350856.17	318324.36
Nominal GDP	8483396	9340307	10255654	10752992
Tax expenditure as % of GDP	**5.15%**	**4.60%**	**3.42%**	**2.96%**

Total tax expenditures as a percent of GDP was 2.96% in 2020 compared to 4.6% and 3.4% reported in 2018 and 2019,respectively **(Figure 1).**

Figure 1: Tax Expenditure (Percent of GDP)



The reported figures are comparable to the average for African countries of 2.9% of GDP. The cost of tax expenditures in Kenya's GDP is also comparable to other countries: tax expenditures amount to around 4% of GDP on average in the European Union, while they are higher in the United States (>7% of GDP) and in the United Kingdom (>6% of GDP). It must however be noted that comparisons of tax expenditures between countries is always tricky, as the Benchmark Tax System used as a reference vary substantially.

3.0 INCOME TAX

3.1 Overview

Income tax in Kenya is imposed on different categories or sources of income in Kenya. 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 includes:

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 through Personal Income Tax (PIT) regime while companies are taxed through Corporate Income Tax (CIT) regime.

3.2 Personal Income Tax (PIT)

Personal Income 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. Pay As You Earn (PAYE) is the primary method of collecting PIT 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.

The PAYE tax is a progressive tax because the percentage of income that individuals pay in taxes tends to increase with increasing 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 2**. 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 2: 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, which are described in the **Table 3**.

Table 3: 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%

3.1.1 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.

3.1.2 PIT Tax Expenditure

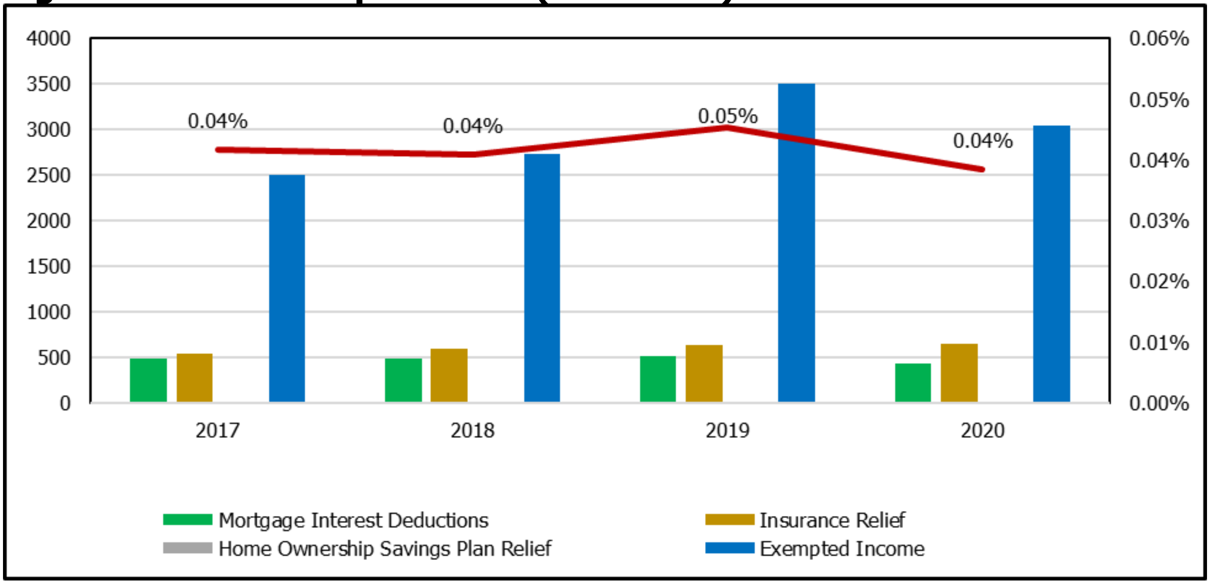
Given the benchmark regime described, the tax expenditures take the form of some reliefs to taxpayers to encourage savings, home ownership and reduce tax burden, among other reasons. These reliefs include; insurance relief, relief related to persons with disability (PWD) and mortgage relief among others. Tax expenditure estimates for the period 2017 to 2020 are as shown in **Table 4.**

Table 4: 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	2504.29	2735.41	3507.35	3041.28
Total	3526.34	3816.17	4653.63	4125.17
Nominal GDP	8483396	9340307	10255654	10752992
Total in % of GDP (right-hand scale)	**0.04%**	**0.04%**	**0.05%**	**0.04%**

Total PIT expenditure stood at **Ksh 41.3 billion** in 2020, an increase from **Ksh 38.2 billion** in 2018. In 2019, the PIT expenditure was **Ksh 46.5 billion (Table 2 & Figure 2).**

Figure 2: PIT Tax Expenditure (% of GDP)



2.3 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.

2.2.1 CIT Benchmark

The benchmark unit of taxation for corporate income tax is a 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 Kenyan 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 expenditures. 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.

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.

2.2.2 Tax Expenditure

Given the benchmark tax regime described above, CIT tax expenditures take the form of deductions such as mining deductions, industrial deductions, farm-works 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 as depicted in **Table 5.**

Table 5: 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

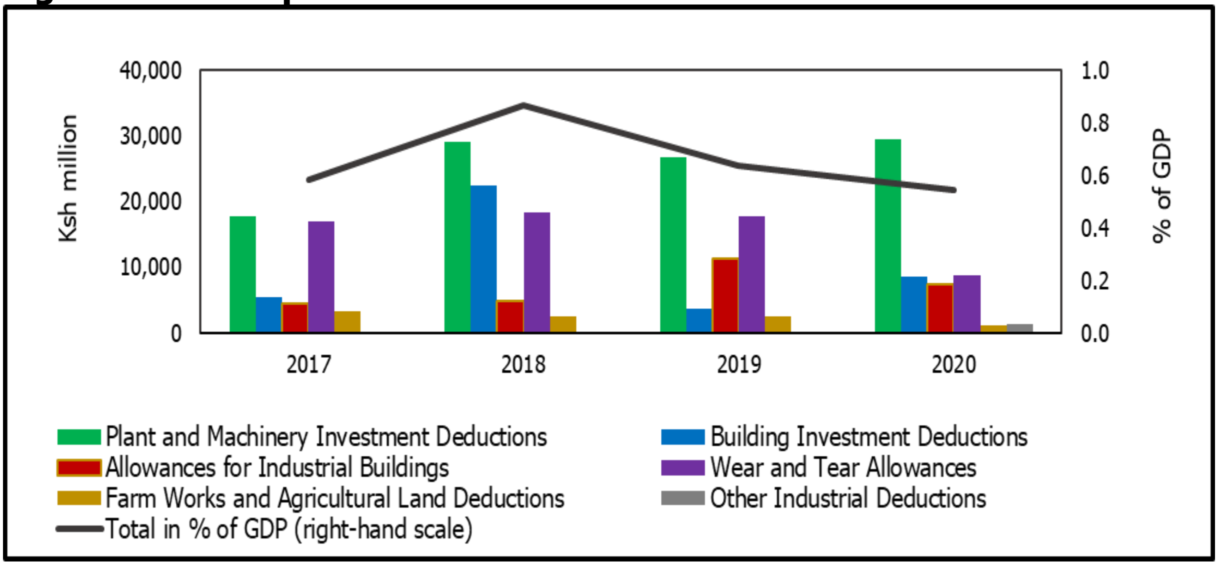
Total CIT expenditure stood at Ksh 56.7 billion in 2020, a decline from Ksh 62.0 billion in 2019 **(Table 6).** The decline is attributed to the fact that allowances related to the corporate income tax underwent major reforms in 2020 with a harmonization and reduction in the amount of wear and tear allowances.

Table 6: CIT Expenditure

	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	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%

As shown in **Figure 3**, corporate tax expenditures as a percent of GDP over the last few years remained relatively stable and stood at 0.5 % of GDP in 2020, a slight decline from 0.6% 2019.

Figure 3: CIT Expenditures as Percent of GDP



3.0 VALUE ADDED TAX (VAT)

3.1 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. In Kenya only traders with an annual turnover of Ksh 5 Million and above are required to charge VAT. Nonetheless, a person with a less than Ksh 5 million is allowed to register on voluntary basis.

3.2 VAT Benchmark

There are three types of VAT rates: the general rate at 16%, petroleum products rate at 8% and zero rate. The benchmark tax system for domestic VAT is the standard rate of either 16% or 0%. The benchmark unit of taxation is the final consumer of taxable goods and services. However, there are items that are contained in Tax exemption and zero rating categories in the First and Second Schedules of the VAT Act, 2013 that are considered as benchmark and not as tax expenditures (Annex II).

3.3 Tax Expenditure

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

a) **Tax exemptions:** This means remission or waiver of a national tax, a fee or a charge. It, therefore, follows that suppliers of items that qualify for exemptions can neither charge output VAT nor claim input VAT. Thus, no VAT is chargeable on the supply of exempt goods or services.

b) **Zero ratings:** This involves total waiver of taxes on goods and services mainly due to their societal importance or personal necessity. Thus, no VAT is payable on the supply (it is charged at 0%). However, for zero ratings, firms can still reclaim 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. In addition, the preferential VAT rate of 8% on petroleum products forms part of the Tax Expenditure. VAT Tax Expenditure as percent of GDP declined from 3% in 2019 to 2% in 2020 as shown in **Table 7.**

Table 7: VAT Tax Expenditures

	2017	2018	2019	2020
Exempt items	164,070.50	134,622.07	84,224.75	82,913.22
Zero-rated items	192,636.54	185,264.29	172,981.55	151,465.21
Total	356,707.04	319,886.37	257,206.30	234,378.43
Nominal GDP	8,483,396.0	9,340,307.0	10,255,654.0	10,752,992.0
Total in % of GDP	4%	3%	3%	2%

Exemption on financial and insurance services are the main contributors to total VAT revenues foregone, accounting for 29% of the total, followed by Information and communication (16%), Retail Trade constitute (13%), Manufacturing (11%), and supplies related to Agriculture, Forestry and Fishing accounting for 7% as shown in **Table 8**.

Table 8: VAT Tax Expenditures for 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%**

For zero-rated VAT transactions, the manufacturing sector contributes the largest share of revenue foregone at 32%, followed by Transportation and Storage (20%) and Agriculture, Forestry and Fishing (19%). Administrative and Support Service Activities, Mining and Quarrying and Information and communication sectors contributes the least percentage of the total revenue forgone at 3% as shown in **Table 9:**

Table 9: VAT Tax Expenditures for 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%**

4.0 TAXES ON IMPORTS

4.1 Overview

Import duty in 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 CIF value of imported goods. Preferential treatments under customs are normally in form of waivers, exemptions, 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. The rules governing the imposition of excise duty are contained in the Excise Duty Act, 2015. The duty is mostly levied on 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-own price elasticity of demand.

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

4.2 Benchmark System for Taxes on Imports

Import duties

Import duties are levied at rates of 0%, 10% and 25% 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 of more than 25% while, goods emanating from EAC member States and other COMESA countries are imported duty free.

The Fifth Schedule to the East African Community Customs Management Act (EACCMA), 2004 provides for exemption from import duty in form of import duty exemption importation, manufacturing under bond, bonded warehousing, inward processing and Export Processing Zones or Free Zones. The 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 of the Act provides for lists the goods and services, which are exempt from excise duty. Majority of the items listed in this Schedule form part of the Benchmark Tax System.

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

v. 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;

vi. 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);

vii. 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.

viii. Excisable goods imported by the Kenya Red Cross or St John Ambulance for official use in the provision of relief services in Kenya.

ix. 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.;

x. 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.

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

xii. 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;

xiii. 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);

xiv. 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 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 identity of the supplier or person supplied; and regardless of whether the goods are for personal use or for business purposes. The application of import VAT 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 taxation period VAT is the calendar month.

4.3 Tax expenditures

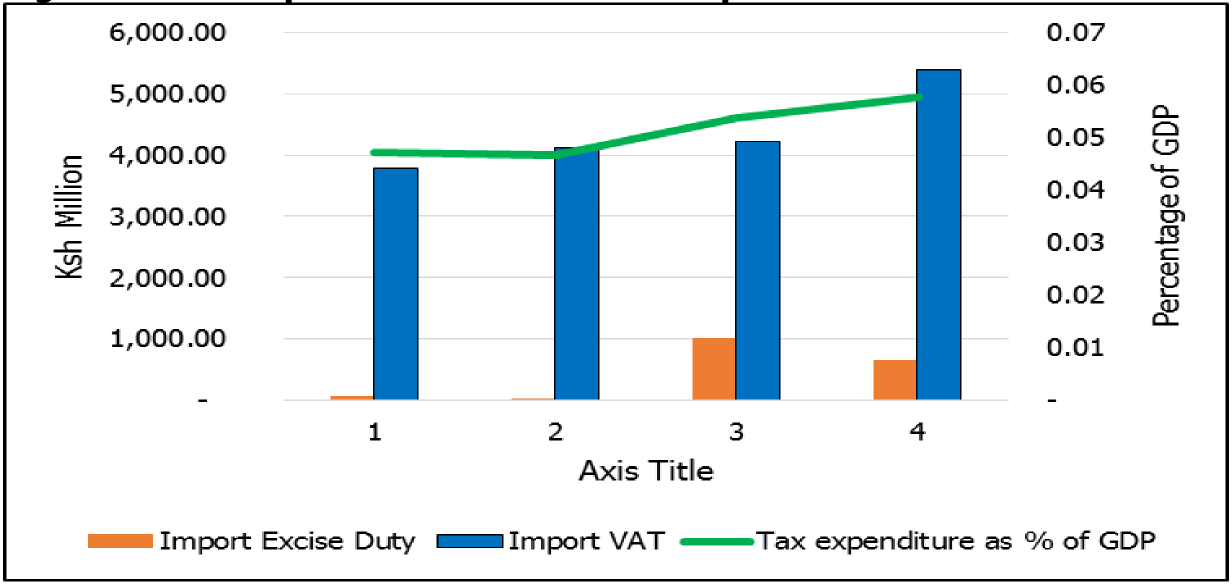
Import duties are based on regional agreements which are ratified and harmonized in the EACCMA, 2004 and other international agreements. Therefore, expenditures emanating from these agreements do not constitute tax expenditures.

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% on petroleum products.

Tax expenditures related to taxes on imports (Import duty, Excise duty, VAT) account for a minor share of total tax expenditure, with a total of 0.06% of GDP in 2020 as shown in **Figure 4**.

Figure 4: Tax Expenditures Related to Import Taxes



In 2020, the import tax expenditures amounted to **Ksh 6,041.26 million** which was a slight increase from **Ksh 5,238.15 million** registered in 2019 (19% decline) as shown in **Table 10**.

Table 10: Tax Expenditures for import Taxes

In Ksh million	Year			
Tax head	**2017**	**2018**	**2019**	**2020**
Import Excise Duty	73.15	26.16	1,017.28	652.36
Import VAT	3,777.27	4,127.34	4,220.87	5,388.90
Total	3,850.43	4,153.50	5,238.15	6,041.26
Nominal GDP	8,165,842.00	8,892,111.00	9,740,360.00	10,477,351.60
Tax expenditure as % of GDP	0.05	0.05	0.05	0.06

5.0 CONCLUSION

The Tax expenditure reduced in the four years under review from a high of 5.15% in 2017, 4.60% in 2018, 3.42% in 2019 to 2.96% in 2020. The drop was mainly driven by the decline in the domestic VAT occasioned by review of the VAT Act geared towards raising aggregate revenue. It is noted that the reduction in the number of items exempted from VAT accounts for the most of the sizable reduction in tax expenditure over the last four years in Kenya.

The Tax Expenditure estimates for VAT on imports has been decreasing steadily over the 4 years under review. The report shows that VAT imports increased 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 Ksh47.6b 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 or 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 closer to the average for African countries but are slightly lower than those for the European Union, UK and the US. However, it is noted that different countries have different benchmark tax systems thus making comparison of tax expenditure for different countries difficult.

APPENDICES

Annex I: List Of Tax Exemptions and Zero ratings that are not tax expenditures

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
2) consumption on board such Vessel; and Goods for the use of any of the
3) Armed Forces of any allied power.
4) Specified supplies to Diplomats or First Arrivals Persons.
5) Specified supplies to donor agencies with bilateral or multilateral agreements.
6) 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;
7) Supply to the War Graves Commission;
8) Supply to National Red Cross Society and St. John Ambulance;
9) 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;
10) The supply of coffee and tea for export to coffee or tea auction centres;
11) The supply of taxable services to international sea or air carriers on international voyage or Flight;
12) The Supply of taxable services in respect of goods in transit;

13) The exportation of goods or taxable services;
14) Ship stores supplied to international sea or air carriers on international voyage or flight.
15) Transportation of passengers by air carriers on international flight;
16) Goods purchased from duty free shops by passengers departing to places outside Kenya.

Appendix II: Methodology

Data sources

The data for the report is sourced from KRA's data repositories since the Authority is the Principal tax collector for the Government of Kenya.

Estimation of the cost of tax expenditures

The estimation of the budgetary impact of tax expenditures in the report is based on the so-called revenue-forgone approach[1]. In this approach, the cost of tax expenditures is calculated as the difference between the tax actually paid and the theoretical tax 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, we would ideally need 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

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

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

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

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 %).

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

c) Taxation of imports

Tax expenditures 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).

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

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

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