



**AN ANALYSIS OF KENYA’S GOVERNING FRAMEWORK ON TAX  
INCENTIVES: MAKING A CASE FOR THE ADOPTION OF POLICIES THAT  
PROTECT ITS PEOPLE AND ECONOMY**

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**DECLARATION**

I, ANNE WARIGIA MBURU, do hereby declare that this research is my original work and that to the best of my knowledge and belief, it has not been previously, in its entirety or in part, been submitted to any other university for a degree or diploma. Other works cited or referred to are accordingly acknowledged.



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## ABSTRACT

Tax incentives are tools used by governments to encourage Foreign Direct Investment in various sectors of the economy such as the manufacturing and export sector, the extractives industry, the financial services sector, and the agricultural sector. Incentives may take the form of tax deferrals, exemptions, allowances and credits. When properly governed, these incentives have been deemed to be advantageous in promoting the growth of these sectors. In Kenya however, the regulatory framework is lacking in policies that promote transparency, integrity, accountability, and efficiency which are elements of good governance. This study highlights the shortcomings of this regulatory framework. It makes the assertion that the current regulatory framework creates loopholes for bribery, corruption, and tax avoidance. Due to these shortcomings, the tax incentive regime has had a negative impact on Kenya's economy and its people as it promotes inequity and social injustice. This dissertation, using South Africa as a comparative study, discusses the regulatory policies that Kenya should adopt to prevent these harmful practices. It recommends a re-design of Kenya's tax incentives that will repeal those that are ineffective; the establishment of a clear eligibility criterion in awarding of incentives; the adoption of rule-based based incentives that do not allow for discretion by the tax authorities; and the enactment of sunset provisions that would prevent the permanence of these incentives. The study relies on literature review to make the above findings and conclusions.

**Keywords:** Accountability, efficiency, equity, efficiency, integrity, social injustice, tax incentives, transparency

## **LIST OF ABBREVIATIONS**

FDI – Foreign Direct Investment

IMF – International Monetary Fund

ITA- Income Tax Act

KRA- Kenya Revenue Authority

OECD- Organisation of Economic Co-operation and Development

UN – United Nations

VAT- Value Added Tax

ICT- Information and Communications Technology

IDA- Investment Deduction Allowance

MDA- Mining Deduction Allowance

FDA- Farmwork Deduction Allowance

UNCTAD- United Nations Conference on Trade and Development

SANEDI- South African National Energy Development Institute

SARS- South African Revenue Service

SADC- south African Development Community

COMESA- common Market for Eastern and Southern Africa

EAC – East African Community

OSHA- Occupational Safety and Health Administration

## **LIST OF CASES**

*Commissioners of Inland Revenue v Willoughby* (1997), The United Kingdom House of Lords.

## **LIST OF STATUTES**

*Constitution of Kenya* (2010)

*Employment Incentive Act* (Act No. 26 of 2013) (South Africa)

*Excise Duty Act* (No. 3 of 2015)

*Export Processing Zones Act*, (Act No.12 of 1990)

*Income Tax Act* ( Act No 58 of 1962) (South Africa)

*Income Tax Act* (CAP 470)

*Kenya Revenue Authority Act* (No.2 of 1995)

*Value Added Tax Act* (CAP 476)

## I. Chapter One: Introduction

### i. Background

One of the roles of government is to provide various public goods and services to its citizens. Examples of such services include quality healthcare, education, infrastructure development as well as social security. For these services to be availed, government collects taxes from the citizenry as one of its sources of revenue.<sup>1</sup> Taxpayers, individuals and entities alike, generally dislike paying taxes and find them burdensome.

To lighten the burden and hence encourage investment that will boost the economy, governments employ the use of tax incentives. Tax incentives are inducements whose objective is to attract the inflow of capital into various sectors of the economy in a bid to undertake investment activities.<sup>2</sup> They include but are not limited to: 1) tax deferrals which is the delay in the payment of tax to a date in the future; 2) Exemptions, which can exclude one's income fully or partially from taxation. They can either be granted through statute or exemption application protocols when applying for an extension; 3) Credits are the amounts deducted from one's tax liability and; 4) Allowances, which are amounts that are allowed as deductions in the computation of one's taxable income.<sup>3</sup> A more detailed discussion on how they work will be discussed at a later stage.

The essence of a tax incentive is that certain persons get an advantage over other members of society. The advantage is accorded to them, in the hope that they will re-invest their surplus income into creating more job opportunities and engaging in other activities that will be beneficial to the society as a whole.<sup>4</sup> Governments believe that there is a direct correlation between tax incentives and Foreign Direct Investment (FDI) in that, the more the incentives, the more the investment hence positive economic growth.<sup>5</sup> However, no definitive conclusion has been reached on the correlation between the use of tax incentives by governments to attract FDI.<sup>6</sup> Over the years, this issue has created a heated debate among policymakers, theorists, and

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<sup>1</sup> Mutua J, *A citizen's handbook on taxation in Kenya*, Institute of Economic affairs, Nairobi, 2011, 8.

<sup>2</sup> Padilla A, Biyani N, Maranga J and Quantrill A *Use and abuse of tax breaks report*, January 2020,8.

<sup>3</sup> International Monetary Fund, *Kenya fiscal transparency evaluation update*, January 2020, 25.

<sup>4</sup> Rice R, 'Tax reform and tax incentives' 34(4) *Law and Contemporary Problems*, 1969,783.

<sup>5</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 1.

<sup>6</sup> Munongo S, Akanbi O, Robinson Z 'Do tax incentives matter for investment? A literature review' 13(2) *Business and Economic Horizons*, 2017, 152.

economists on whether tax incentives should be used as a tool for inducing FDI into countries. Are they really effective? On the one hand, proponents of tax incentives have argued that tax incentives have alleviated the welfare of the people in the jurisdictions in which they have been used.<sup>7</sup> However, critics argue that tax incentives are doing the opposite of what the legislators of these fiscal policies had envisioned. This is because tax incentives lead to very large revenue losses and promote inequity and social injustices within our society.<sup>8</sup> Empirical evidence also shows that they are not instrumental in attracting FDI.<sup>9</sup>

Furthermore, reports indicate that investors are willing to accept a higher tax burden if the country can guarantee business-enabling market conditions, a stable political and legal framework, and last but not least, the availability of skilled labourers.<sup>10</sup> Governments have however remained adamant in choosing tax incentives over dealing with the aforementioned factors. This is because it is much simpler and cheaper to give tax benefits as opposed to correcting the infrastructural deficiencies within their jurisdictions. Correcting the deficiencies within the system, tends to be more costly and long-term – a feature that does not entice governments.<sup>11</sup>

In Kenya, tax incentives have been deemed to be numerous and inefficient because the structures put in place to govern their implementation, are weak and ineffective.<sup>12</sup> This has been to the detriment of the Kenyan economy and the welfare of its citizens.<sup>13</sup> Due to this poor governing framework, there have been various problems brought about by these incentives. Firstly, is the loss of current and future tax revenue and a lack of transparency of the same. Kenya does not publish any regular report that discloses the tax incentives awarded and the estimated revenue lost from the same.<sup>14</sup> This is also contrary to Article 210 (1) of the Constitution which requires that any tax waiver given, should be recorded and availed to the public and the reason for this waiver should be reported to the auditor- general.<sup>15</sup> To give a

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<sup>7</sup> Yelapaala K, 'The efficacy of tax incentives within the framework of neoclassical theory of foreign direct investment: A legislative policy analysis' 19(2) *Texas International Law Journal*, 1984, 366.

<sup>8</sup> Tax Justice Network -Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 1.

<sup>9</sup> Klemm A and Van P, 'Empirical evidence on the effects of tax incentives', 9 (5), *International Tax and Public Finance*, 2012, 21.

<sup>10</sup> Organisation of Economic Co-operation and Development, *Policy framework for investment*, 2013, 3.

<sup>11</sup> United Nations, '*Design and assessment of tax incentives in developing countries*', May 2018, 13.

<sup>12</sup> Tirimba, Muturi, Sifunjo, 'Effects of tax incentives on performance of listed firms in Kenya', 678.

<sup>13</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 9.

<sup>14</sup> International Monetary Fund, *Kenya fiscal transparency evaluation update*, January 2020, 24.

<sup>15</sup> Article 210 (1), *Constitution of Kenya* (2010).

more practical example of the lack of transparency in the administration of tax incentives, the paper will briefly touch on the ten-year tax holidays given to Export Processing Zone industries (EPZs) under the ITA.<sup>16</sup>

Further supplementing the aforementioned regulation in the ITA, is the EPZ Act which grants the Cabinet Secretary powers to grant any other exemptions in addition to the ones that have already been given in the ITA.<sup>17</sup> This gives the Cabinet Secretary the discretion to choose who benefits from the incentives. The arbitrariness and the lack of transparency as to how they are awarded has paved the way for political lobbying and corruption to influence policymaking in favour of offering tax incentives. Furthermore, in cases where incentives already exist, the clamour is to have them extended. Very little is known of the criteria used to grant these extensions.<sup>18</sup> This has greatly undermined the integrity of the system. Another example of the adverse effects of arbitrary power was witnessed in the ‘Goldenberg scandal’, where hundreds of millions in money, was lost through false export declarations under the subsidy scheme that was created to enhance export performance.<sup>19</sup> According to the Bosire report on the Goldenberg affair, the people involved included high ranking politicians such as the Late President Daniel Arap Moi and the Late George Saitoti. Their political party, Kenya Africa National Union (KANU) is said to have been financed by the money that was stolen.<sup>20</sup>

Secondly, administering these numerous and ineffective tax incentives is quite costly as they require additional tasks from the tax authorities. Resources have to be spent on inspection of which firms qualify, processing returns, and monitoring and evaluation of these firms.<sup>21</sup> Taxpayers’ money is used to finance the administration of these incentives and Kenyans are forced to bear the burden of paying more tax to compensate for the revenue deficit brought about by these concessions.<sup>22</sup> Lastly, the revenue foregone is what the government could have

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<sup>16</sup> Clause 2(f), third schedule, *Income Tax Act* (CAP 470).

<sup>17</sup> Section 29, *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>18</sup> Holland D and Vann R, ‘Income tax incentives for investments’ in Thuronyi V vol 2, *Tax law design and drafting*, International Monetary Fund, Washington DC, 1998, 2.

<sup>19</sup> Nathan -MSI Group, *Effectiveness and economic impact of tax incentives in the SADC region*, February 2004, 3-8.

<sup>20</sup> Republic of Kenya, *Report of the judicial commission of inquiry into the Goldenberg affair*, October 2005, 185.

<sup>21</sup> Padilla A, Biyani N, Maranga J and Quantrill A *Use and abuse of tax breaks report*, January 2020, 21.

<sup>22</sup> Igadwah L, ‘Sh. 480 bn: price Kenyans are paying for tax breaks’, *Business Daily*, 4 September 2019, - < <https://www.businessdailyafrica.com/corporate/companies/Sh480bn--Price-Kenyans-are-paying-for-tax-breaks/4003102-5259864-15u6xt/index.html> >- on 20 March 2020.

otherwise utilised in the development of the country's infrastructure, healthcare, and education which are in dire need of funding.<sup>23</sup>

The shortcomings of the tax incentive system show that Kenya lacks a robust governing framework on tax incentives. There is therefore an incessant need to evaluate Kenya's tax incentive policies in a bid to align them to the good governance principles of accountability, transparency, efficiency and integrity. This can be a starting point to cure the problems brought about by the current governing framework on tax incentives in Kenya.

*ii. Statement of the Problem*

Investment incentives are of benefit when they are properly governed and well-targeted especially towards businesses that are in the nature of the public good. This includes projects that promote healthcare, upgrade the skills of workers and enhance research and development.

However, the current tax law regime in Kenya allows for numerous tax incentives some of which lead to more losses than gains. Similarly, the secretive and discretionary nature of the incentive regime has fuelled corruption and fraudulent practices by both investors and government officials. As a result of this, money that could have been used to improve the quality of life of the common 'mwananchi' is lost. Even worse, taxpayers are forced to bear the burden of paying more tax to compensate for the revenue deficit brought about by the tax incentives. This undermines the principles of good governance such as equity, integrity, transparency and accountability – values that should be reflected in every law and public policy decision.

A review of the law surrounding the incentive regime can be done to determine how to best regulate and administer tax incentives in Kenya

*iii. Justification of the Study*

Tax incentives in Kenya are numerous, discretionary, and secretive. Kenya lacks regular reports disclosing the incentives that have been awarded to various companies. This also extends to the lack of information disclosing the estimated revenue lost from tax incentives. The lack of information has not only greatly undermined the integrity of the system but also

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<sup>23</sup> Budget information Programme Team, *Tax incentives and exemption regime in Kenya: is it working?*, 2012, 6.

contributed to the social injustices faced by the peoples of Kenya. It is therefore important to highlight the shortcomings of Kenya's lack of a robust and comprehensive governing framework on tax incentives, and advocate for the creation of policies and structures that can be used to make tax incentives more transparent, efficient, effective and equitable.

The results of the study will be useful to policymakers, legislators, and regulatory bodies such as the Kenya Revenue Authority (KRA), to improve the tax incentive regime in Kenya. This will then trickle down to the citizens who can benefit from the revenue lost in giving tax concessions. This revenue can instead be used to develop infrastructure in the country and better the lives of Kenyan citizens.

*iv. Hypotheses*

The paper will test the following hypotheses:

1. The Kenyan tax incentive regime undermines good governance principles such as accountability, transparency, integrity and efficiency.
2. The governing framework on tax incentives in Kenya falls short of aiding the tax incentive regime in achieving its intended objective of positively impacting Kenya's economy and instead contributes to the social injustices suffered by the people of Kenya.
3. Having an elaborate tax incentive framework allows governments to effectively review and repeal incentives that are not creating a positive impact on the economy and the welfare of its people.

*v. Statement of Aim and Objectives*

This study aims to investigate the governing framework on tax incentives in Kenya, its shortcomings and challenges and the negative impact it has had on the people of Kenya. It will then propose a way forward on how to best deal with the issue.

The following objectives will facilitate the achievement of this aim:

1. To look into Kenya's tax incentive regime and show it undermines good governance principles such as accountability, transparency, integrity and efficiency.
2. To show how the lack of good governance principles within the tax incentive regulatory framework has had a negative impact on the people of Kenya and its economy.

3. To propose a way forward on how to best regulate tax incentives in Kenya so that they can be in alignment with the principles of good governance and have a positive impact on the people of Kenya.

*vi. Research Questions*

1. How does Kenya's policy framework on tax incentives undermine good governance principles?
2. What negative impact has the current governing framework on tax incentives had on the people of Kenya?
3. What policy measures must Kenya adopt to deal with the shortcomings of the current tax incentive regime ?

vii. *Literature Review*

Good governance is a quintessential element of sustained economic development.<sup>24</sup> It is the process through which both public and private institutions carry out public affairs and utilise public resources in a manner that promotes civil, cultural, economic, political and social rights. This is the test used to determine whether an institution and structures within that institution adhere to this principle.<sup>25</sup> Good governance is also a Constitutional principle in Kenya that binds all state organs, public officers, and persons whenever they are enacting, applying or implementing the law.<sup>26</sup> The World Bank's determinates of good governance include accountability, transparency, democracy, rule of law, independence of the judiciary, freedom of information and expression and a good administrative system that will lead to efficiency and effectiveness.<sup>27</sup> The tax incentive regime came as a result of a series of policies legislated upon by parliament. Therefore, these policies are required to espouse and uphold the principles of transparency, accountability, integrity, efficiency and effectiveness. This paper will analyse whether these very fundamental values are present in our current tax incentive regime.

Rice defines a tax incentive as a legal provision that creates favourable conditions for a person or activity and deviates from the normal provisions of the tax legislation. The imbalance is created in the hope that the advantage given to these persons or companies will induce conduct that is beneficial to society as a whole.<sup>28</sup> For example, attract greater levels of FDI into the country which will create more job opportunities.<sup>29</sup> This has been the position held by very many countries for a long time. They are used by countries to compete for investments in the realm of global finance and this is the case with the countries in East Africa. As elaborated earlier, incentives may take the form of allowances, exemptions, rate reliefs and credits.

A further review of the literature shows that there is a discourse among legal scholars, theorists, economists and policymakers on whether tax incentives are effective and whether they benefit society. Tirimba argues that proponents of tax incentives have relied on the argument that lower

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<sup>24</sup> Kaufmann D, Kraay A, 'Governance Indicators: Where are we, where should we be going?', 2.

<sup>25</sup> Bachelet M, 'OCHR and good governance' Office of the United Nations High Commissioner for Human Rights, 1 September 2020  
<<https://www.ohchr.org/en/issues/Development/GoodGovernance/Pages/GoodGovernanceIndex.aspx>> on 2 October 2020.

<sup>26</sup> Article 10 (2) (c), *Constitution of Kenya* (2010).

<sup>27</sup> Kaufmann D, Kraay A, 'Governance Indicators: Where are we, where should we be going?' , 17.

<sup>28</sup> Rice R, 'Tax reform and tax incentives', 784.

<sup>29</sup> Rice R, 'Tax reform and tax incentives', 783.

tax burdens give investors a higher rate of return which allows for more income that could be re-invested.<sup>30</sup> In developing countries especially, tax incentives have readily been given by governments to counter the already poor existing investment climates such as political instability, poor infrastructure, macroeconomic instability, corruption and the high cost of doing business.<sup>31</sup> This is because governments are generally reluctant to correct the existing deficiencies within their countries as it would involve injecting money into projects that could be channelled elsewhere.

A report done by the Tax Justice Network states that when the critics challenge the proponents on the revenue losses created by tax incentives, the proponents argue that the benefits outweigh the losses. They rationalise these losses by arguing that the jobs and capital created have not only improved the welfare of citizens but also expanded the economy.<sup>32</sup> This has been the justification used by policymakers and bureaucrats who sometimes pursue their own selfish gains in the form of the benefits that they accrue from lobbying by investors. The Bosire report on the Goldenberg Affair shows how people in high ranking positions can amass wealth through tax incentives and subsidies. These funds are then used to fund their political agendas.<sup>33</sup>

Despite the numerous disadvantages of tax incentives, a policy report done by the Organisation of Economic Co-operation and Development (OECD) states that people should not be quick to conclude that tax incentives always lead to great revenue losses. In countries such as Costa Rica, Malaysia, Ireland and Mauritius, tax incentives have been effective. However, what often misses from the discussion of the successes experienced by some of these countries, is the fact that in addition to these tax incentives, these countries experience stable economic and political conditions; a dependable legal system; a well-educated labour force; and good infrastructure.<sup>34</sup> In short, these countries have created a suitable environment in which tax incentives can be effective. As shall be discussed later in the paper, this may not be the case for all the countries that utilise the incentive regime.

On the flip side, Brauner argues that tax incentives could have adverse effects on the economy

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<sup>30</sup> Tirimba, Muturi, Sifunjo , 'Effects of Tax incentives on performance of listed firms in Kenya', 379.

<sup>31</sup> Tirimba, Muturi, Sifunjo , 'Effects of Tax incentives on performance of listed firms in Kenya',380.

<sup>32</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 8.

<sup>33</sup> Republic of Kenya, *Report of the judicial commission of inquiry into the Goldenberg affair*, October 2005, 185.

<sup>34</sup> Organisation of Economic Co-operation and Development, *Policy framework for investment*, 2013,15.

and the State in general.<sup>35</sup> John Rawl's difference principle dictates that a society can have inequalities within its system for as long as these inequalities benefit the least well off.<sup>36</sup> Sugin used this theory to argue that the inequalities in taxation that fail to benefit the most disadvantaged, should be foreclosed on the account of violating the difference principle which allows for inequalities within a society in so long as they benefit the disadvantaged within that particular society.<sup>37</sup> What this therefore means is that if the tax incentives given by the government does more harm than good, then the government should revise or discard them.

A case study done in 2010 showed that the Kenyan government's health budget in 2010-2011 was Ksh 41.5 billion. Yet, the government had paid more than twice the amount in providing tax incentives that led to losses of approximately Ksh100 billion.<sup>38</sup> Kenya loses approximately \$1.1 billion every year to tax incentives.<sup>39</sup> Therefore, tax incentives have the potential to waste a lot of government resources that could otherwise be used to develop Kenya's healthcare and education system.<sup>40</sup> This undermines the people's constitutional rights.<sup>41</sup> At this juncture, it would be important to highlight the elephant in the room – the fact that the reports on revenue loss seem not to be regularly updated and have largely remained unchanged since 2014. This is because Kenya does not publish any regular reports that disclose the estimated amount of revenue losses incurred from tax incentives and expenditures alike.<sup>42</sup>

An assessment done by the United Nations (UN), discovered that due to the discretionary nature of tax incentives, especially in tax incentive regimes where officials have a lot of discretion in determining which investors will benefit, this leads to corruption to the detriment of the other members of the society.<sup>43</sup> Furthermore, incentive regimes encourage firms to use fraudulent means to be exempt from taxes. An example is a scenario where a tax incentive is available to foreign investors. What local firms do is channel their investment through foreign companies or where an incentive is given only to new companies, firms have been known to set up many new related companies to benefit from this incentive.<sup>44</sup> What this means is that

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<sup>35</sup> Brauner Y, *The future of tax incentives for developing countries*, Edward Elgar Publishing, Cheltenham, 2014.

<sup>36</sup> Rawls J, *A theory of justice*, 52.

<sup>37</sup> Sugin L ' Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems 72(5) *Fordham Law Review*, 2004, 1999.

<sup>38</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 9.

<sup>39</sup> Oxfam International, *Taxing for a more equal Kenya*, November 2017, 29.

<sup>40</sup> Budget information Programme Team, *Tax incentives and exemption regime in Kenya: is it working?* ,2012,6

<sup>41</sup> Article 43, *Constitution of Kenya* (2010).

<sup>42</sup> International Monetary Fund, *Kenya fiscal transparency evaluation update*, January 2020,2.4

<sup>43</sup> United Nations, *Design and assessment of tax incentives in developing countries*, May 2018, 18.

<sup>44</sup> United Nations, *Design and assessment of tax incentives in developing countries*, May 2018,16.

due to the effects of a non-transparent and corrupt tax incentive regime, the burden of taxation will not be shared fairly.<sup>45</sup> Yelapaala states that this further violates the principles of horizontal and vertical equity that are to be upheld for a tax system to be considered equitable and effective.<sup>46</sup>

The literature reviewed above has shown that good governance and the principles espoused in good governance are very fundamental to how a government structures its affairs. It has shown that a well-governed tax incentive framework would be one where the government has taken steps to analyse the economical, fiscal, institutional and political conditions within its jurisdiction as a good precautionary measure for introducing tax incentives. It has also shown that Kenya's current legal provisions on tax incentives preclude a transparent and just economic arrangement within its society. Because of this, the study will attempt to show why the government should review and rationalize tax incentives within Kenya and align them with the values and principles enshrined in Article 10 of the Constitution.

#### *viii. Research Methodology*

This study will use qualitative analysis and literature review to prove its hypotheses. It will involve reviewing the provisions of the law governing tax incentives such as the Kenyan ITA, Cap 470 of the laws of Kenya further supplemented by the EPZ Act, No. 12 of 1990. The types of incentives to be analysed include tax holidays, tax credits, investment allowances, and carry forward and carry back losses. The paper will then proceed to look into books, journals and reports that show how these incentives affect the people of Kenya.

The study will also rely on comparative jurisprudence from South Africa to discuss the policy measures that Kenya can adopt to better govern its tax incentive regime. South Africa is a suitable case study because firstly, both Kenya and South Africa are common law jurisdictions meaning they have almost similar legislative processes and governing systems and secondly, South Africa offers some tax incentives that are similar to Kenya's incentives such as investment allowances, credits and carry forward losses.

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<sup>45</sup> Article 201, *Constitution of Kenya* (2010).

<sup>46</sup> Yelapaala K, 'The efficacy of tax incentives within the framework of neoclassical theory of foreign direct investment: A legislative policy analysis', 398.

Despite the common features, the countries have various differences that will make the comparative analysis more comprehensive. Firstly, South Africa does not offer tax holidays which have been deemed to be expensive, poorly targeted and ineffective.<sup>47</sup> Will this have a positive effect on their tax revenue base? Secondly, the two countries, though in Africa, belong to different trade blocs with South Africa being a member of the South African Development Committee (SADC) and Kenya in the East, a member of the East African Community (EAC)<sup>48</sup> as well as the Common Market for Eastern and Southern Africa (COMESA).<sup>49</sup>

*ix. Limitations*

This study is limited with regard to the general lack of reports that comprehensively disclose the financial position of Kenya, especially in matters to do with fiscal policy. A lot of the reports that exist were published almost six years ago and may not comprehensively reflect Kenya's position today. Secondly, a lot of the literature available on matters to do with tax incentives focus on the economic rather than the socio-legal impact of the tax incentive regime and lastly, literature is lacking in the processes used to administer tax incentives. Their administration tends not to be recorded and is often carried out behind closed doors. This limits the research in that most of these dealings are generally spoken about, but very few investigative reports have been done giving conclusive evidence that implicates the fraudulent parties involved.

Furthermore, in discussing the tax incentive regime, the study has limited itself to the incentives under the Kenyan Income Tax (ITA) with more emphasis given to tax holidays, carryforward and carryback losses, tax credits, and investment allowances. This is because the ITA has numerous incentives that cannot be sufficiently covered in this paper. Furthermore, the author is of the opinion that the regulation surrounding these four incentives is lacking in policies that promote the principles of good governance which has negatively impacted the people of Kenya and its economy.

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<sup>47</sup> Barbour P, 'An assessment of South Africa's investment incentive regime with a focus on the manufacturing sector' Overseas Development Institute, Economics and Statistics Analysis Unit Working Paper Number 14, 2005, 18 - [https://www.files.ethz.ch/isn/19643/esau\\_wp14.pdf](https://www.files.ethz.ch/isn/19643/esau_wp14.pdf) on 31 December 2020.

<sup>48</sup> -< <https://www.eac.int/>> on 31 December 2020.

<sup>49</sup> -< <https://www.comesa.int/members/>> on 31 December 2020.

*x. Chapter Breakdown*

The study is divided into five chapters. Chapter 1 provides a background to the study and gives a general outline of how the study will flow. It also discusses the scope of the study and its limitations.

Chapter 2, through piecing together various scholarly works and theories, discusses the principle good governance as enshrined in Article 10 of the Constitution. Under good governance, the principles that are discussed include transparency, integrity, accountability, efficiency and equity. It then attempts to give an analysis of whether the current tax incentive regime is in alignment with the principles of good governance.

Chapter 3 discusses Kenya as its main case study. It gives an overview of the types of tax incentives in Kenya and how they work. It then proceeds to highlight the challenges Kenya's tax incentive regime is facing and concludes by discussing the impact of these challenges on the people of Kenya.

Chapter 4, through a comparative analysis, looks into South Africa's tax incentive regime. As mentioned previously, the logical justification as to why these two countries have been chosen as suitable case studies is because they are all emerging countries in the Global South, are closer in demographics and both countries are fairly young economies compared to countries in the Global North. The study gives a brief overview of the type of incentives offered in South Africa and the lessons that Kenya could borrow to better its tax incentive regime in a bid to promote transparency, accountability, efficiency, and social justice within its own system.

Chapter 5 concludes the study. This chapter begins by restating the problem and briefly discussing the findings of the study. It then proceeds to give recommendations on the policies Kenya can adopt to have a more robust, effective, and well-governed tax incentive regime. The chapter concludes by highlighting a potential area for further research.

*xi. Conclusion*

This Chapter has provided the background to the problem being taken on by the study. It has laid down the groundwork to test the hypotheses that Kenya's current tax incentive regime not only falls short of upholding principles of a good tax system but also that the current tax incentive regime in Kenya, undermines the characteristics of good governance such as equity,

transparency, and accountability. The Chapter has concluded by providing a chapter breakdown that will be very instrumental in giving a more in-depth analysis of the issues outlined and suggest a way forward that will help better the lives of Kenyans.

## II. Chapter Two: Theoretical Framework

### *i. Introduction*

The Constitution of Kenya, under Article 10, outlines the various policies and principles that should be adhered to and upheld by all state organs, state officers, public officers, and all persons whenever they make or implement public policy decisions. One of these principles is good governance. This principle has certain elements as highlighted by the World Bank which includes accountability, transparency, efficiency, and integrity which in turn promote other principles such as equity.<sup>50</sup> To define and give an in-depth analysis of what these characteristics entail, this paper will make use of the public choice theory and Rawl's theory on distributive justice. More importantly, this chapter will conclude by discussing whether these quintessential values and principles are present in our current tax incentive regime.

### *ii. Public Choice Theory*

The public choice theory was propounded by Nobel Prize Laureate James Buchanan and his colleague, Gordon Tullock. It attempts to explain how public decisions are made. It borrows the economic model of rational behaviour within a marketplace which posits that people's actions and decisions within a marketplace are often geared towards achieving their own interests.<sup>51</sup> In public choice theory, the marketplace is the political market whose participants include voters, politicians, lobbyists and bureaucrats,<sup>52</sup> and in the scope of this paper, taxpayers. Similar to a normal marketplace, these 'free' participants tend to act in their own interests. In the context of public policy actions, public officials may choose to be honest or corrupt. They are portrayed as a rational utility maximiser who may engage in corruption in instances where potential benefits exceed potential costs.<sup>53</sup>

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<sup>50</sup> Kaufmann D, Kraay A, 'Governance Indicators: Where are we, where should we be going?' , 17

<sup>51</sup> Buchanan J , Tullock G, *The calculus of consent: Logical foundations of constitutional democracy*, University of Michigan Press, 1962, 4.

<sup>52</sup> Shaw S. Jane ' Public choice theory' The Concise Encyclopedia of Economics - <<https://www.econlib.org/library/Enc1/PublicChoiceTheory.html> > on 20 October 2020.

<sup>53</sup> Graff D, 'Causes of corruption: Towards a contextual theory of corruption' 1(31) *Public Administration Quarterly* , 2007, 47.

Transparency in its most demotic definition is that which one can ‘see through easily’ the same way one can see through a ‘clean window.’<sup>54</sup> It is widely recognised as one of the pillars of good governance and is an instrumental value that promotes democracy, legitimacy of public institutions and authorities which encourages trust in the decisions of public institutions.<sup>55</sup> Transparency in public policy decisions or processes relates to the full access of information within a polity.<sup>56</sup> This allows for public scrutiny by the populace and ensures that state agencies and state officers are accountable when discharging their mandate. From the public choice theory perspective and in the context of the secrecy of the tax incentive regime, transparency may discourage a public official from engaging in corrupt behaviour due to the following reasons.

Firstly, transparency increases the chances of one being caught. If tax incentives are published and made available for all to analyse, it will make it harder for public officials to facilitate deals that are beneficial to them but detrimental to the wider society.<sup>57</sup> In the converse, when this information is withheld and hidden from public scrutiny, public officials in these offices may use the secrecy and mystery opportunity to enrich themselves.

Secondly, non-transparent environments tend to instil a culture of corruption and impunity. This is because officials can pay their way out of the justice system and court processes they are subjected to once they are caught.<sup>58</sup> This makes it easier for the officials to engage in corrupt practices knowing they can easily disentangle themselves from the law enforcement mechanisms put in place to inhibit such behaviour. In a transparent environment where law enforcement mechanisms are not only just but also transparent, it is very difficult for an official to undertake an action that will lead to heavy sanctions. This, therefore, disincentivises impunity and corrupt practices.

Lastly, because transparency also allows for participation and accountability, it will allow interested parties to prevent public authorities from taking decisions that harm the economy as

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<sup>54</sup> Mock W, ‘An interdisciplinary introduction to legal transparency: A tool for rational development’ , *Penn State International Law Review* 18 (2), 2000, 295.

<sup>55</sup> Heald D, ‘Transparency as an Instrumental Value,’ in Hood C and Heald D (eds), *Transparency, the Key to Better Governance?* , Oxford University Press, 2006, 59.

<sup>56</sup> Hollyer J, Rosendoff P and Vreeland R, ‘Measuring transparency’ 22(4) *Cambridge University Press*, 2014, 413.

<sup>57</sup> Graff D, ‘Causes of corruption: Towards a contextual theory of corruption’ 31(1) *Public Administration Quarterly* , 2007, 48.

<sup>58</sup> Kolstad I, Wiig A, ‘Is transparency the key to reducing corruption in resource-rich countries?’ 37(3) *Pergamon-Elsevier Science*, 2009, 526.

a whole.<sup>59</sup> In this case, if the Kenyan people could access the record of accounts showing how incentives are given and how much money is lost as a result, they may take certain steps towards the prevention of such arbitrary policies. Therefore, not only should there be a list of incentives published but also any decisions made on the awarding of tax incentives should be open.

### *iii. Theory on Distributive Justice*

As a matter of moral and political philosophy, John Rawls discusses distributive justice as the task of constructing principles by which social burdens and benefits are divided among a group of persons within society.<sup>60</sup> Furthermore, in his theory on justice as fairness, he talks about the difference principle which allows for inequalities within a society in so long as they benefit the disadvantaged within that particular society.<sup>61</sup> Rawls' theory can be aligned to tax incentive regimes. To begin with, taxes are social burdens placed upon members of the society by their respective governments, for the sole purpose of raising revenue to fund public services.<sup>62</sup> Additionally, governments in a bid to exploit investment opportunities, create inequalities and imbalances by granting tax incentives to companies.<sup>63</sup> This is done with the anticipation that it will have the domino effect of encouraging investment, which will in turn increase capital and job opportunities, and have an overall positive impact on the economic growth of the country.

However, studies have shown that more often than not, the intended benefits of tax incentives do not benefit the society. If anything, it has led to revenue losses and tax deficits that are then to be settled by the members of the society.<sup>64</sup> This goes against Rawl's difference principle and his theory on distributive justice. Closely tied to Rawl's theory on benefiting the worst-off within a society, is Amartya Sen's conception of what real human freedoms should be. He terms such 'freedoms' to include economic facilities, social opportunities, transparency

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<sup>59</sup> Mock W, 'An interdisciplinary introduction to legal transparency: A tool for rational development,' 303-304.

<sup>60</sup> Rawls J, *A theory of justice*, Harvard University Press, Boston, 1999, 4.

<sup>61</sup> Sugin L 'Theories of distributive justice and limitations on taxation: What Rawls demands from tax systems 72(5) *Fordham Law Review*, 2004, 1999.

<sup>62</sup> Mutua , *A citizen's handbook on taxation in Kenya*, Institute of Economic affairs, 8.

<sup>63</sup> Tirimba, Muturi, Sifunjo , 'Effects of Tax incentives on performance of listed firms in Kenya', 678.

<sup>64</sup> Igadwah L, 'Sh. 480 bn: price Kenyans are paying for tax breaks', 4 September 2019, - < <https://www.businessdailyafrica.com/corporate/companies/Sh480bn--Price-Kenyans-are-paying-for-tax-breaks/4003102-5259864-15u6xt/index.html> > on 21 March 2020.

guarantees, and political freedoms. According to him, these freedoms are both the primary and objective ends of development.<sup>65</sup> Unfortunately, these freedoms are denied to the citizens when governments implement poor tax incentive regimes. This is because governments forego a lot of revenue that could have been used to enhance the healthcare system, education system and build better infrastructure that would create opportunities for people and hence allow them to attain real freedom.<sup>66</sup>

Treasury data has shown that Kenya's tax revenue foregone, inclusive of incentives, was Ksh 535.9 billion in 2018.<sup>67</sup> Within that same year, the health budget was at Ksh 207 billion which is less than twice the amount lost through the tax revenue foregone.<sup>68</sup> Kenya faces very high levels of inequity in terms of access to healthcare services. The wealthy and middle-income earners are able to pay for private hospitals while the poor are forced to rely on public hospitals where the quality of the services, in some instances, is subpar.<sup>69</sup> A lot of the revenue lost could be channelled towards providing better healthcare services to improve people's overall health and well-being.

#### *iv. Conclusion*

This chapter has attempted to provide the lens through which the tax incentive regime in Kenya can be analysed. It is the first step towards addressing the hypothesis positing that the Kenyan tax incentive regime undermines the principles of good governance such as transparency, accountability, integrity and efficiency. It also states that because of this, the people of Kenya face a lot of inequity and social injustices in the public sector.

Using the public choice theory, it has shown that public officials, much like actors in a marketplace, tend to make decisions that advance their own interests. Transparency is used to discourage this. This is because when public officials are scrutinised, they will make decisions

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<sup>65</sup> Sen A, *Development as freedom*, Anchor books, New York, 2000, 36.

<sup>66</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 9.

<sup>67</sup> Kivuva E, 'Treasury to review tax incentives on revenue pressure' Business Daily, 9 November 2020, <<https://www.businessdailyafrica.com/bd/markets/capital-markets/treasury-tax-incentives-on-revenue-pressure-3015264>> on 9 December 2020.

<sup>68</sup> Ministry of Health, *National and county health budget analysis*, 2019, 6.

<sup>69</sup> Giorgio L, Salari P and Chuma J, 'Socio-economic inequality and inequity in the use of health care services in Kenya: evidence from the fourth Kenya household health expenditure and utilization survey' 18 (196) *International Journal for Equity in Health*, 2019, 2.

that are beneficial to the polity. This also extends to the justice system, which is required to be transparent to ensure that the rule of law is followed. Such a system allows for public officials to be held accountable for their actions. The final theory discussed on the difference principle has shown that inequality within the society is allowed to the extent that it benefits disadvantaged groups in the long- run. The tax incentive regime is not doing this. It is instead making the 'haves' richer to the detriment of the 'have nots'. The welfare of the citizens of Kenya should be paramount.

### III. Chapter Three: The Tax Incentive Regime in Kenya

#### *i. Introduction*

Tax incentives are policy instruments implemented by government in an attempt to create a favourable environment for economic growth.<sup>70</sup> However, as mentioned earlier, the correlation between FDI and tax incentives is not the only motivating factor for companies to set up shop in Kenya. Other aspects that are considered include a good political climate, macroeconomic stability and infrastructural development.<sup>71</sup> Furthermore, the proper use and administration of these tax policies has become a challenge to the government with regard to revenue loss, especially where there are no comprehensive records that can aid it in evaluating the incentives that exist.<sup>72</sup> An even more disconcerting problem for governments is the propagation of vices such as corruption, tax avoidance and tax evasion brought about by tax incentives. This chapter, in an attempt to respond to the research questions, will give an overview of the incentives that exist under the current tax incentive regime, highlight the challenges facing the current tax incentive regime, and therein conclude by discussing the impact of these challenges on the people of Kenya.

#### *ii. Overview of the Types of Incentives under the Kenyan ITA*

As discussed severally, tax incentives are awarded by governments to 1) Attract investors to invest in marginalised areas; 2) Create employment due to the creation of new industries; 3) Transfer of technology due to the introduction of advanced technology into the country and; 4) Export promotion.<sup>73</sup> The paper provides an overview of some of the fiscal incentives offered by the Kenyan government. It mainly focuses on tax holidays, carryforward and carryback losses, tax credits, and investment allowances. This is because the design of these incentives has created a number of problems that have had a negative impact on the Kenya's economy and its people. It is instructive to note that most of the rates used in the paper are the new rates introduced by the Tax Law (amendments) Act in 2020, which amended the second schedule of the ITA that gives the various rates for incentives.<sup>74</sup>

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<sup>70</sup> Kaufmann D, Kraay A, 'Governance Indicators: Where are we, where should we be going?', 17.

<sup>71</sup> Organisation of Economic Co-operation and Development, *Policy framework for investment*, 2013, 3.

<sup>72</sup> The World Bank, *Tax expenditures- shedding light on government spending through the tax system*, 2004, 5.

<sup>73</sup> Financial transparency coalition and Tax justice network Africa, *Use and abuse of tax breaks; how tax incentives have become harmful*, January 2020, 8.

<sup>74</sup> PriceWaterhouseCoopers, *highlights of the tax laws amendment Act*, 2020, 2.

## Tax holidays

Tax holidays are considered to be a common phenomenon used in developing countries to attract FDI.<sup>75</sup> They exempt firms and companies from paying taxes for a stipulated amount of time. This exemption could be in the form of 1) completely not paying taxes on the firm's profits, not paying some taxes such as VAT and the exemption of import duty on raw materials and machinery input<sup>76</sup> and; 2) they could also take the form of reduced tax rates. In some instances, the two are combined.<sup>77</sup> To give a more practical example, under Kenya's ITA, an export processing zone enterprise which does not carry out any commercial activities is exempted from corporate income tax for the first ten years.<sup>78</sup> Commercial activities, in the context of this provision include trading in, repacking, and relabelling of the industrial raw materials and goods.<sup>79</sup> After the ten years have lapsed, they are required to pay taxes at a reduced rate of 25% as opposed to the standard rate of 30% for another 10 years.<sup>80</sup> It is also within this time period that they are exempted from all import duties on machinery, raw materials, and inputs.<sup>81</sup>

Tax holidays are considered to be very attractive and simple incentives because; 1) the burden imposed on the companies to take steps to comply is generally low. For example, a company may not need to calculate its income tax during the ten-year period. However, for long-term investments, companies will only be required to keep records of their capital expenditures to ensure a smooth transition from the holiday to being required to comply with the tax system once the holiday is over.<sup>82</sup> Similarly, tax authorities find them simpler to administer because the need to monitor them is quite low.<sup>83</sup> While they may be considered a simple incentive, tax holidays have often been considered to be harmful to the country because of some of the loopholes within their governing framework. An example of this is the discretionary power given to the Cabinet Minister in the EPZ Act which allows granting any other exemptions in

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<sup>75</sup> United Nations Conference on Trade and Development (UNCTAD), *Tax incentives and foreign direct investment: a global survey*, 2000,20.

<sup>76</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, iv.

<sup>77</sup> United Nations, *Design and assessment of tax incentives in developing countries*, May 2018, 22.

<sup>78</sup> Clause 2(f) third schedule, *Income Tax Act* (CAP 470).

<sup>79</sup> Section 2, *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>80</sup> Clause 2(f) third schedule, *Income Tax Act* (CAP 470).

<sup>81</sup> Section 29(1)(d), *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>82</sup> United Nations Conference on Trade and Development (UNCTAD), *Tax incentives and foreign direct investment: a global survey*, 2000,24.

<sup>83</sup> Zee H and Tanzi V, 'Tax policy for emerging markets: Developing Countries' International Monetary Fund, WP/00/35, March 2000, 25- <https://www.imf.org/external/pubs/ft/wp/2000/wp0035.pdf> on 9 December 2020.

addition to the ones given by the law.<sup>84</sup> This discretionary power may pave way for lobbying and corruption. Other problems include tax avoidance and rent-seeking behaviour. These issues will be analysed more deeply under the discussion on challenges brought about by the tax incentive regime.

### **Carryforward and Carryback losses**

A tax loss is a situation in which an entity's expenses within one financial year is greater than its revenue within that financial year. The provision in the ITA on carryforward losses allows a taxpayer, an individual or company, to deduct their tax loss within that year of income and can be carried forward a further 9 years.<sup>85</sup> If the taxpayer is unable to extinguish their deficit within that period they may apply to the Commissioner for an extension giving evidence and reasons why they are unable to do so. The Commissioner may then request the Cabinet Minister to grant the extension.<sup>86</sup> The extension can be granted indefinitely as there are no rules regulating the period for the extension. In the 2018 Income Tax Bill, there were suggestions to have the extension capped to two years.<sup>87</sup> However, this proposed amendment did not make it into the 2020 Amended Income Tax Act. Yet again, this is another instance of the arbitrary powers granted to the Minister and Commissioner. As mentioned previously, this can lead to bribery and corruption hence leading to revenue more loss.

To deal with companies taking advantage of the carry forward incentive, a minimum tax was introduced to the Income Tax Act. The new law will be effective from 1<sup>st</sup> January 2021 and the rate will be at 1% of the gross turnover of the company. It will be payable by all persons and entities irrespective of whether they are making profits or not<sup>88</sup> and will be payable in the instance where the instalment tax is lower than the minimum tax.<sup>89</sup> It does have a few exceptions with some of the incomes being exempted from the tax. Some examples include employment income, income that is subject to turnover tax, capital gains tax, and income from the extractive sector.<sup>90</sup> Very recently, businesses whose prices are under government regulation

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<sup>84</sup> Section 29(2)(i), *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>85</sup> Section 15(4), *Income Tax Act* (CAP 470).

<sup>86</sup> Section 15(4A), *Income Tax Act* (CAP 470).

<sup>87</sup> Ngumy D, 'Kenya: Corporate tax comparative guide', Anjarwhalla and Khanna, 18 November 2019 -<<https://www.mondaq.com/tax/815930/corporate-tax-comparative-guide>> on 30 December 2020.

<sup>88</sup> Kenya Revenue Authority, *Highlights of amendments under the Finance Act, 2020*, 1.

<sup>89</sup> Mutai E, 'Oil firms, insurers win big in tax laws' *Business Daily*, 29 December 2020-<<https://www.businessdailyafrica.com/bd/corporate/companies/oil-firms-insurers-win-big-in-tax-laws-3241894>> on 30 December 2020.

<sup>90</sup> Kenya Revenue Authority, *Highlights of amendments under the Finance Act, 2020*, 1.

were also added to the exemption list. This includes oil marketing companies and insurance firms.<sup>91</sup> It is not yet clear how the law will be implemented, and its effectiveness can only be determined in the years to come.

Carryback losses on the other hand allow the taxpayer to apply their net operating losses to a previous year's tax return. The effect of this will be that it will allow a refund of taxes for the previous years. In Kenya, this incentive applies to companies in the mining and oil and gas industries indefinitely<sup>92</sup> with the effect being that companies in this sector may always get a tax refund and will in a sense, never have to pay taxes. A lot of these companies tend to be International Oil Companies as Kenya is not yet experienced in the field. Understandably, this incentive may be beneficial to companies in this sector because it takes many years before they can begin to make profit from the mining and oil drilling activities. However, having this as an indefinite incentive may be harmful in the long run. Similarly, these oil companies are exempted from paying a minimum tax on their gross turnover.<sup>93</sup>

### **Tax credits and Investment Allowances**

In addition to tax holidays, the Kenyan tax incentive regime also provides for tax credits and investment allowances. A tax credit allows a taxpayer to deduct from the tax payable to the government.<sup>94</sup> This therefore means that at the point of deduction, the taxable income has already been computed. On the other hand, an investment allowance reduces the income to be taxed.<sup>95</sup> It allows for the deduction of expenses of a capital nature and is one of the exceptions to the rule that expenses of a capital nature are not deductible.<sup>96</sup> It is given in addition to wear and tear allowances and is used to encourage various industries to set up shop in Kenya.<sup>97</sup>

Investment allowances are restricted to specific activities, some examples include investment deduction allowances (IDA) which are used to encourage investment in assets such as industrial buildings, plants, and machinery.<sup>98</sup> Secondly, we have mining deduction allowances

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<sup>91</sup>Mutai E, 'Oil firms, insurers win big in tax laws' Business Daily, 29 December 2020-  
<<https://www.businessdailyafrica.com/bd/corporate/companies/oil-firms-insurers-win-big-in-tax-laws-3241894>> on 30 December 2020.

<sup>92</sup> Okello S, Kabochi J and Cheruiyot S, 'Kenya tax summary' PWC -  
<<https://taxsummaries.pwc.com/kenya/corporate/deductions>> on 9 December 2020.

<sup>93</sup> PriceWaterHouseCoopers, *Highlights of the Finance Act, 2020*, 2.

<sup>94</sup> Budget Information Programme Team, *Tax incentives and exemption regime in Kenya: is it working?*, 2012, 2.

<sup>95</sup> United Nations, *Design and assessment of tax incentives in developing countries*, May 2018, 24.

<sup>96</sup> Section 16 (1) (b), *Income Tax Act (CAP 470)*.

<sup>97</sup> 2<sup>nd</sup> schedule, *Income Tax Act (CAP 470)*.

<sup>98</sup> 2<sup>nd</sup> schedule, *Income Tax Act (CAP 470)*.

(MDA) which apply to the machinery used to undertake operations under a prospecting and mining right. This is used to encourage investment in the Kenyan mining industry which is fairly young.<sup>99</sup> Lastly, farmwork deductions (FDA) are capital allowances given to an individual who incurs capital expenses in structures intended to enhance the operations of a farm.<sup>100</sup> Currently, MDA machinery, FDA structures and IDA in relation to hotel buildings, buildings used for manufacture, hospital buildings and petroleum or gas storage facilities are at a rate of 50% in the first year of use, and 25% of the residual value annually on reducing balance.<sup>101</sup>

In some instances, owing to the nature of investment allowances and the high cost of the equipment involved, a company in applying them may end up in a tax loss.<sup>102</sup> The effect of a tax loss is that the entity will not be required to pay taxes for that particular year in which they are at a loss. For instance, if company A buys machinery worth Ksh. 1,000,000, they are allowed to deduct 50%. This means that Ksh.500,000 will be treated as an expense and therefore a deductible. In the instance where the company buys three machines the total amount spent is Ksh.3,000,000. Out of this amount, Ksh.1,500,000 will be a deductible expense. Assuming company A's total revenue for that particular year was Ksh.1,200,000, they will be at a deficit of Ksh.300,000 and therefore in a tax loss and will not have to pay taxes. This can be carried forward for ten years, inclusive of the year in which the loss occurred.<sup>103</sup> If the entity is still at a loss after the 10 years, they can apply for an extension from the minister stating why they require the extension.<sup>104</sup> The danger with this is that the parameters or the criteria used to determine whether the company deserves the extension, do not exist.

### *iii. Challenges Facing Kenya's Tax Incentive Regime*

Due to the lack of a robust legislative and governing framework, tax incentives have done more harm than good. The following section highlights the challenges facing the tax incentive regime and how this has resulted in revenue loss.

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<sup>99</sup> Budget Information Programme Team, *Tax incentives and exemption regime in Kenya: is it working?*, 2012,2.

<sup>100</sup> 2<sup>nd</sup> schedule, *Income Tax Act* (CAP 470).

<sup>101</sup> Okello S, Kabochi J and Cheruiyot S, 'Kenya tax summary' PWC <<https://taxsummaries.pwc.com/kenya/corporate/deductions>> on 9 December 2020.

<sup>102</sup> Oxfam International, *Taxing for a more equal Kenya*, November 2017,29.

<sup>103</sup> Section 15(4), *Income Tax Act* (CAP 470).

<sup>104</sup> Section 15(4), *Income Tax Act* (CAP 470).

## Corruption

Tax incentives are creatures of policy which is enacted by parliament. A lot of these incentives are created based on political considerations with barely any record highlighting the factors that are usually considered when creating these incentive policies.<sup>105</sup> Similarly, the legislation that governs tax incentives in Kenya gives tax officials wide discretionary powers to determine the application of these incentives to the taxpayers.<sup>106</sup> An instance where this power is applied is in relation to EPZ enterprises in Kenya which allows the Cabinet Secretary to grant any other exemptions they may deem applicable to the entity.<sup>107</sup> The danger posed by this is that some firms could be tempted to get tax reductions and exemptions by bribing tax officials.

In addition to the discretionary extension of tax holidays, entities experiencing tax losses could apply for an extension beyond the ten years that they are allowed to carry forward their losses. All that is required of them is to tender an application to the tax authority explaining why they need this extension. This has contributed to a lot of corruption within the tax incentive regime with a few companies bribing the tax officials to grant them extensions. This is a problem for the economy because few people stand to benefit at the expense of all the other taxpayers in Kenya. Similarly, the revenue foregone could be used to develop other sectors of the economy such as infrastructure projects and various sectors of the economy. The lack of revenue has led to Kenya participating in a lot of commercial borrowing through Eurobonds and loans from countries like China. Kenya's sovereign debt has therefore become unsustainable with entities like the IMF and World Bank giving warnings of a looming debt crisis.<sup>108</sup>

Another pertinent issue with the current legislation is the fact that they do not give a comprehensive criterion of which entities can be given incentives.<sup>109</sup> Questions that arise include: What is the minimum investment and shareholding required? How many local people will be employed within these entities to promote job creation? Is it 2%? 50%? How do we ensure that everyone is benefiting and not just the companies colluding with the tax officials? As earlier posited by the public choice theory, actors within a political market, act in their own

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<sup>105</sup>Wawire N, 'Constraints to enhanced revenue mobilization and spending quality in Kenya' Centre for Global Development, Policy Paper 163, January 2020, 12- <https://www.cgdev.org/sites/default/files/PP163-Enhanced-Revenue-Kenya-Full.pdf> on 9 December 2020.

<sup>106</sup> Oxfam International, *Taxing for a more equal Kenya*, November 2017, 29.

<sup>107</sup> Section 29 (2)(i), *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>108</sup> IMF and World Bank, *Joint World Bank- IMF debt sustainability analysis*, May 2020, 2-3.

<sup>109</sup> Oxfam International, *Taxing for a more equal Kenya*, November 2017, 29.

best interests and it is only through regulation that their free choice to pursue their interests, can be limited.<sup>110</sup> There is therefore a need for better policy approaches when it comes to the governing of tax incentives such that tax incentive policies should be automatic and objective as opposed to subjective and discretionary.<sup>111</sup> Comprehensive legislation or principles can be instrumental in guiding tax officials to make guided decisions that would be to the benefit of the public as opposed to a few people. This would make the process more certain taking away the arbitrariness of the decisions made.

### **Tax avoidance**

There has been a lot of contention among scholars and jurists alike on whether tax avoidance is a malpractice. Using a more general definition, tax avoidance is the use of legal methods and practices, to lower one's tax liability. Courts have stated that even though tax avoidance is within the letter of the law, it does not fall in line with the spirit of the law and should therefore be discouraged. Perhaps, Lord Nolan defines it more aptly in the case *Commissioners of Inland Revenue(CIR) v Willoughby* in which he stated that the hallmark of tax avoidance was to reduce one's tax liability without feeling the effect of the economic consequences that parliament intended them to feel.<sup>112</sup> Under Kenyan legislation, the ITA stipulates a general anti-avoidance rule which empowers the Commissioner to ignore or counteract a transaction whose main purpose is to avoid tax.<sup>113</sup>

An incentive like the tax holiday that allows qualifying industries to be exempt from paying taxes for a stipulated time period (10 years in Kenya), has no further guidelines or regulations that would prevent an entity from dissolving its business after the exemption period and registering as a new entity.<sup>114</sup> This paper is arguing that this could be construed to be a form of tax avoidance because, while it is not prohibited by the law, it goes against the intentions of parliament which allowed for tax holidays to benefit Kenya's economy in the long-run. The entities that do this instead benefit and make a profit for those ten years and close shop when it is no longer beneficial to them- a classic tale of one biting the hand that feeds them.

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<sup>110</sup> Buchanan J , Tullock G, *The calculus of consent: Logical foundations of constitutional democracy*,4.

<sup>111</sup> United Nations Conference on Trade and Development (UNCTAD), *Tax incentives and foreign direct investment: a global survey*, 2000,17.

<sup>112</sup> *Commissioners of Inland Revenue v Willoughby* (1997), The United Kingdom House of Lords.

<sup>113</sup> Section 23, *Income Tax Act* (CAP 470).

<sup>114</sup> Oxfam International, *Taxing for a more equal Kenya*, November 2017, 30.

Secondly, companies have been known to use transfer pricing to shift their taxable income to a related non-taxed entity. Therefore, it would be tempting for two companies that are related to opt to shift their profits to the entity that is tax-exempt. To curb this, the transfer pricing rules demand that entities transact at arm's length.<sup>115</sup> While this is laudable, it will not prevent companies from making attempts to carry out such practices and it would cost the revenue authority time and money to monitor such transactions. Another reason why tax holidays are harmful, is because a report carried out by the OECD highlighted the fact that sometimes, entities that qualify for a tax holiday, are used by the non-qualifying entities to purchase assets.<sup>116</sup>

### **Poor targeting of incentives**

In previous sections, this study has highlighted various studies that have proven that the correlation between incentives and economic growth is not as straightforward as governments envisioned it to be.<sup>117</sup> Incentives can either be broadly targeted or narrowly targeted. Targeted tax incentives offer a special tax treatment to specific entities in exchange for a certain activity within the country.<sup>118</sup> Different industries respond differently to tax incentives. For example, export industries may respond positively to tax incentives because of the reduction in costs. However, companies in the oil and mining sector may not use tax incentives as one of the primary reasons for investment. This is because they set up based on the availability of a particular resource. An oil drilling company will not establish itself in Kenya if there are no oil wells discovered during the prospecting operations.<sup>119</sup> Therefore an indefinite period for carryback losses is very costly. This may need to be reviewed to give a more definite time period.

### **The lack of records on the amount of revenue foregone**

Tax incentives are used to encourage investors to bring in money especially where the tax system is seen to be a demotivating factor.<sup>120</sup> What this means is that the government is willing to forego what they would have received in revenue for whatever duration these incentives are

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<sup>115</sup> Section 18(3), *Income Tax Act (CAP 470)*.

<sup>116</sup> Organisation of Economic Co-operation and Development, *Policy framework for investment*, 2013, 27.

<sup>117</sup> Clark S, 'Tax incentives for foreign direct investment: Empirical evidence on effects and alternative policy options' 48(4) *Canadian Tax Journal*, 2000, 1141.

<sup>118</sup> Brunori D, 'Principles of Tax Policy and Targeted Tax Incentives' 29(1) *State and Local Government Review*, 1997, 51.

<sup>119</sup> Financial transparency coalition and Tax justice network Africa, *Use and abuse of tax breaks; how tax incentives have become harmful*, January 2020, 17-18.

<sup>120</sup> Tirimba, Muturi, Sifunjo, 'Effects of Tax incentives on performance of listed firms in Kenya', 678.

granted. Therefore, there is an overall effect of low tax collection rates that inhibit the government from investing in public goods such as health, infrastructure, and education.<sup>121</sup> Furthermore, reports indicating how much revenue the government of Kenya has lost, are almost non-existent.<sup>122</sup> The most recent report was given by the economic secretary in 2011 who stated that Kenya was losing over Ksh 100 billion in tax incentives. This general lack of transparency has prevented members of the public from scrutinizing what the people in power are failing to do.<sup>123</sup>

This is also contrary to Article 210 (1) of the Constitution which allows for the waiving of tax or licensing fee so long as there is a public record of each waiver, the reason for the waiver, and that the said reason be reported to the auditor- general.<sup>124</sup> This has not been happening. The risk that this imposes is that there is a lack of transparency and accountability which makes incentives prone to abuse. This goes against the principle of good governance.

iv. *The Impact of the shortcomings of the current tax incentive regime on the people of Kenya*

### **Inequity and revenue loss**

Whereas principles such as effectiveness and efficiency have looked at how the tax authorities structure their activities, equity focuses on the persons affected by the systems put in place. What exactly is social equity in the public sector? The World Bank has defined social equity as ‘equal access to the opportunities that allow people to pursue a life of their choosing and to avoid extreme deprivations in outcomes.’<sup>125</sup> This can be linked to Amartya Sen’s idea that for man to achieve real freedom, then he must be able to access all opportunities.<sup>126</sup>

Furthermore, George Fredrickson, a prominent social equity scholar argues that persons in authority should not only focus on whether or not a program is working but also who it is

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<sup>121</sup> Ricciuti R and Savoia A, ‘Developing countries would benefit from improved tax collection’ United Nations University, March 2019 -< <https://www.wider.unu.edu/publication/developing-countries-would-benefit-improved-tax-collection>> on 9 December 2020.

<sup>122</sup> International Monetary Fund, *Kenya fiscal transparency evaluation update*, January 2020, 24.

<sup>123</sup> Tax Justice Network Africa and action aid international, *Tax competition in East Africa: a race to the bottom? Tax incentives and revenue losses in Kenya*, May 2012, 7.

<sup>124</sup> Article 210(1), *Constitution of Kenya* (2010).

<sup>125</sup> World Bank, *World Development Report: Equity and development*, 2006.

<sup>126</sup> Sen A, *Development as freedom*, Anchor books,36.

working for.<sup>127</sup> In Kenya, tax incentives seem not to be working for the benefit of Kenyans in matters of economic growth and the creation of employment opportunities. Instead, the tax incentive regime has propelled the success of a few firms, and politicians who lobby on behalf of these firms. It is not disputed that tax concessions have the effect of narrowing the tax base of the nation that grants them and in a bid to broaden the tax base and hence collect the target revenue, government has been known to indirectly shift the taxes to existing consumers and businesses.<sup>128</sup> This is a huge burden to place on the common ‘mwananchi’ or smaller businesses both of whom are struggling to stay afloat in the already harsh economic market. Similarly, incentives tend to discriminate against local firms as they are mostly granted to foreign investment companies, hence disadvantaging local companies. This can lead to round-tripping whereby these local firms move their funds to off-shore companies and tax havens then later re-introduce their money into the economy as foreign investors.<sup>129</sup>

To further show the negative impact of tax incentives, is the fact that granting numerous and poorly targeted tax incentives have undermined the state’s ability to deliver public services to the citizens of Kenya. The revenue foregone could have been utilised to develop infrastructure such as more hospitals, better education, better roads, and any other developmental needs.<sup>130</sup> This also contradicts Rawls’ theory of justice that advocates for the creation of policies that promote a just and fair society for the people at the bottom.<sup>131</sup> Tax incentives should not be prioritised at the expense of the citizens of Kenya who are in dire need of public services.

#### v. *Conclusion*

Chapter three set out to prove the hypothesis that the regulating framework not only undermines the principles of accountability, transparency, efficiency and integrity but also Kenya's fiscal incentives from achieving their intended objectives. Some of these objectives include the creation of employment opportunities and an increase in the amount invested in the country.

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<sup>127</sup> Frederickson G, ‘The State of social equity in American public administration’ 94(4) *National Civic Review*, 2005, 32.

<sup>128</sup> Organisation of Economic Co-operation and Development, *Policy framework for investment*; Investment promotion and facilitation, 2011, 19.

<sup>129</sup> Tax Justice Network, *taxation and development in Ghana: Finance, equity and accountability*, April 2009, 22

<sup>130</sup> Financial transparency coalition and Tax justice network Africa, *Use and abuse of tax breaks; How tax incentives have become harmful*, January 2020, 25.

<sup>131</sup> Sugin L ‘ Theories of distributive justice and limitations on taxation: What Rawls demands from tax systems, 1999.

As has been discussed earlier, the linkage between tax incentives and FDI is not as straightforward as governments would prefer it to be. The stark reality is that in regions where governance is poor, tax incentives will not attract investment. In the instance where they do, it usually to the detriment of domestic industries and the people as is the case of Kenya.<sup>132</sup> The chapter has shown that because of the low revenue collection by the government, the tax burden is indirectly pushed to local businesses and citizens. This has been done through the increase of tax rates to reach the government's target. Similarly, because of the revenue lost through incentives, public services are under-funded. This has proven the paper's third hypothesis that tax incentives contribute to social injustices.

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<sup>132</sup> Kuria J, Omboi B and Achoki G, 'Effect of corporate income tax incentive on the performance of EPZ firms in Kenya' 2(8) *International Journal of finance and accounting*, 2017, 45.

## IV. Chapter Four: Lessons Kenya can borrow from South Africa

### i. Introduction

Incentives in South Africa can be found across their various legislative instruments such as the Income Tax Act (No 58 of 1962) and the Employment Incentive Act (No. 26 of 2013). While South Africa does not have a provision for tax holidays or loss carrybacks,<sup>133</sup> they do have various types of incentives that take the form of investment allowances and credits, carry forward losses, and reduced income tax rates hence similar to Kenya. These incentives can be found under the various programs including the Employment Tax Incentive (ETI), Learnership Agreement tax allowance, and the Energy Efficiency allowance.<sup>134</sup> The incentives discussed below are just a few of the numerous incentives offered by the South African government. This section will discuss each of the incentives and conclude by highlighting various governance aspects of South Africa's tax incentive regime that Kenya could borrow in order to enhance its own regulatory framework.

### ii. Overview of the incentives offered

#### **Employment tax incentive**

The ETI came into effect on January 14<sup>th</sup> and is set to run until February 2029.<sup>135</sup> It is a cost-sharing mechanism between the government and employers that reduces the amount of PAYE employers will have to remit to the government.<sup>136</sup> The requirements as to who can qualify are set out in the ETI Act and are for both the employees and employers. For the latter, they must be eligible to register for PAYE, they should not be a public entity listed in either the second or third schedule of the Public finance Management Act, and should not have been disqualified by the Minister of Finance because of the displacement of an employee.<sup>137</sup> For the employees, their age should range between 18- 29 and their wage should be below R6,000 per month.<sup>138</sup>

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<sup>133</sup> Mandy K, 'South Africa tax summary' PWC -< <https://taxsummaries.pwc.com/south-africa/corporate/deductions>> on 30 December 2020.

<sup>134</sup> KPMG, *A guide to South African government and tax incentives*, June 2020, 19-23.

<sup>135</sup> Section 3, *Employment Incentive Act* (Act No. 26 of 2013) (South Africa).

<sup>136</sup> Bhorat H, Hill R, Khan S, Lilenstein K and Stanwix B, 'The Employment Tax Incentive Scheme in South Africa: An Impact Assessment' Development Policy Research Unit, Working Paper 202007, 2020, 1-< [https://media.africaportal.org/documents/The\\_employment\\_tax\\_incentive\\_scheme.pdf](https://media.africaportal.org/documents/The_employment_tax_incentive_scheme.pdf)> on 1 January 2020.

<sup>137</sup> Section 6, *Employment Incentive Act* ( Act No. 26 of 2013) (South Africa).

<sup>138</sup> Davis Tax Committee, *Small and Medium Enterprises: Taxation Considerations*, Interim Report, 2014, 38.

### **Learnership agreement incentive**

The learnership agreement incentive is aimed at encouraging skills development in the various industries.<sup>139</sup> It takes the form of a deduction which could be an annual allowance or a completion allowance. The annual allowance is availed every year after an assessment of the learner's learnership agreement while the completion allowance is a one-off deduction available in the year of assessment and is given in addition to the annual allowance.<sup>140</sup> The employer can therefore claim both the annual allowance and completion allowance.

### **Energy efficiency incentive**

The energy efficiency incentive is an allowance allows entities registered with the South African National Energy Development Institute (SANEDI) to a tax deduction of 95 cents per kilowatt-hour.<sup>141</sup> It became effective on 1<sup>st</sup> November 2013 and was set to be claimable up until the 1<sup>st</sup> of January 2020<sup>142</sup> but was further extended for three more years in the 2019 budget speech.<sup>143</sup> The entities receive a certificate once their energy use has been measured and verified. The certificate discloses the baseline at the start of the year, the energy use at the end of the year, the energy efficiency savings in kilowatt-hours equivalent to the year of assessment and the methods used to calculate the energy efficiency savings. It encourages entities to improve their energy efficiency and thus promotes sustainability as well as assisting SA in meeting its commitments to reduce carbon emissions in the years to come.<sup>144</sup>

### *iii. Lessons Kenya can Borrow from South Africa*

While it is difficult to conclusively measure the effectiveness of tax incentives in African Countries and whether they meet their objectives, South Africa is a good example of a country that has taken positive steps towards strengthening its policies with regard to the incentives they offer. Their incentive regime, though not perfect, has worked towards promoting good governance principles such as transparency, effectiveness, equitability, accountability, and

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<sup>139</sup> Section 12H, *Income Tax Act* ( Act No 58 of 1962) (South Africa).

<sup>140</sup> The South African Institute of Chartered Accountants, *Section 12H; A brief comparison of the old section 12H vs the new section 12H*, 2017,1.

<sup>141</sup> Section 12L, *Income Tax Act* ( Act No 58 of 1962) (South Africa).

<sup>142</sup> -<<https://www.sanedi.org.za/12L.html>> on 30 December 2020.

<sup>143</sup> Mboweni M, '2019 budget speech' South Africa Government Speeches, 20 February 2019 -<[https://www.gov.za/speeches/budget\\_vote](https://www.gov.za/speeches/budget_vote)> on 30 December 2020.

<sup>144</sup> Zyl N, 'Claiming your tax incentive on energy savings in South Africa' ESI Africa, 26 September 2019-<<https://www.esi-africa.com/industry-sectors/energy-efficiency/claiming-your-tax-incentive-on-energy-savings-in-south-africa/>> on 30 December 2020.

efficiency. Kenya can therefore borrow a few lessons on how to better govern their tax incentive regime.

### **The publication of annual expenditure statements**

SA releases an annual tax revenue report indicating the amount of revenue the government has lost to tax expenditures. This is inclusive of incentives.<sup>145</sup> With the data presented in the expenditure reports, the government of South Africa is then able to monitor, review, and repeal incentives that are ineffective, inefficient, or inequitable.<sup>146</sup> South Africa is one of the few countries known to have this reporting requirement entrenched in law<sup>147</sup> and has been lauded as a leading country in budget transparency conducted by the International Budget Partnership (IBP).<sup>148</sup> Kenya should follow suit and publish annual expenditure statements that could then be used by the government and the public to gauge how much the country is losing in expenditures such as incentives. This will force the government to monitor and possibly review incentives that are leading to a lot of revenue loss.

### **Review and repeal of expensive and ineffective incentives**

In 2020, South Africa's Finance Minister stated that the country's 2020 budget would limit various incentives in a bid to broaden the tax base.<sup>149</sup> A good example of an incentive that was limited is loss carryforwards. South Africa is known to allow losses to be carried forward indefinitely<sup>150</sup> but the 2020 budget brought forth a proposal to have the assessable losses being carried forward to be limited to 80% commencing the first day of January 2021. This means that companies will be obligated to pay tax on 20% of their taxable income.<sup>151</sup> The move limits a company's ability to take full advantage of this incentive because they will not be able to make use of the whole assessed loss within a given year. It is also through these periodic reviews that the government was able to do away with ineffective tax incentives such as the

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<sup>145</sup> National Treasury of South Africa, *2020 budget review*, 2020, 119.

<sup>146</sup> National Treasury of South Africa, *2020 budget review*, 2020, 119.

<sup>147</sup> Lakin J and Carroll A, 'Taxing assignment: Uncovering and analysing tax expenditures' Quarterly Newsletter of the Tax Justice Network, 2012, 6 - < [http://iffoadatabase.trustafrica.org/iff/africa\\_tax\\_spotlight\\_9th\\_edition-tax\\_expenditure.pdf](http://iffoadatabase.trustafrica.org/iff/africa_tax_spotlight_9th_edition-tax_expenditure.pdf)> on 30 December 2020.

<sup>148</sup> National Treasury of South Africa, 'Treasury on South Africa taking first place in the 2019 open budget index survey' National Treasury, 4 May 2020 -< <https://www.gov.za/speeches/treasury-south-africa-taking-first-place-2019-open-budget-index-survey-4-may-2020-0000#:~:text=South%20Africa%20has%20once%20again,to%20a%20transparent%20budget%20process>> on 30 December 2020.

<sup>149</sup> PriceWaterhouseCoopers, *Republic of South Africa 2020 budget highlights*, 2020, 1.

<sup>150</sup> Mandy K, 'South Africa tax summary' PWC -< <https://taxsummaries.pwc.com/south-africa/corporate/deductions>> on 30 December 2020.

<sup>151</sup> PriceWaterhouseCoopers, *PwC budget review- highlights 2020*, 2020, 3.

tax holiday. South Africa phased out the tax holiday because it was deemed to be too expensive, poorly targeted, and its impact on investment was insignificant.<sup>152</sup> Kenya should do the same because tax holidays promote investment by rent-seeking companies that close up shop after the holiday is over.

### **Better targeting of incentives**

From the overview of the incentives offered in South Africa, the country seems to be doing a much better job at targeting their incentives. The ETI scheme has contributed to employment growth in South Africa with data showing that between 2014 and 2016 at least 35, 333 jobs were saved in South Africa. Data collected also shows that the firms who claimed the subsidy hired more employees who qualified for the incentive in relation to companies that opted not to partake in the scheme.<sup>153</sup> This has helped reduce the rate of unemployment in South Africa while having a ripple effect on things such as lower crime rates, and alleviating the standard of living of people in South Africa. Kenya could target their incentives to a similar incentive program to reduce the rate of unemployment in Kenya and in turn, alleviate the suffering of its citizens with some having opted to participate in criminal activities in a bid to survive. Kenya should also carry out more comprehensive surveys discussing whether EPZs in Kenya have truly promoted job creation.

### **Sunset provisions**

South Africa's incentives provide for sunset provisions. Sunset provisions dictate the number of years an incentive can operate within a country before it is reviewed for renewal or repeal. In 2018, the ETI scheme was reviewed and extended to February 2029. During the review, it was discovered that while the cost continues to increase, its benefits were important to the people of South Africa which warranted its extension. The government of South Africa relies on the data collected by the SARS to assess the cost of these incentives which aids in the review.<sup>154</sup> Kenya could borrow from this by having sunset provisions on the incentives it offers. It could then use the data collected by the KRA to estimate the cost of incentives in

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<sup>152</sup> Barbour P, 'An assessment of South Africa's investment incentive regime with a focus on the manufacturing sector', 18.

<sup>153</sup> Borat H *et al*, 'The Employment Tax Incentive Scheme in South Africa: An Impact Assessment', 23.

<sup>154</sup> Lombaard E and Jager N, '2019 budget incentives for business- 'please sir, may I have some more?' KPMG Tax Alert -< <https://home.kpmg/content/dam/kpmg/xx/pdf/2019/02/tnf-sa-feb26-2019.pdf>> on 30 December 2020.

comparison to the benefits in a bid to make accurate determinations on whether an incentive should be extended or repealed.

*iv. Conclusion*

This chapter has proven the hypothesis that having an elaborate governing framework allows governments to effectively review and repeal incentives that are detrimental to the economy and the welfare of its people. It has used South Africa to show what a more elaborate framework should look like and the policy measures that Kenya should adopt if it is to curb the problems created by its tax incentive regime.

## V. Chapter Five: Conclusion and Recommendations

### *i. Introduction*

This is the final chapter of this study. It will begin by highlighting the underlying problem that the study intended to solve and then proceed to briefly and in a concise manner, discuss the findings that were made based on the hypotheses that the study set out to analyse. Based on the findings, the paper will give recommendations on the way forward and highlight potential areas for further research to advance the body of knowledge on ways to regulate tax incentives in Kenya.

### *ii. Restating the problem*

The underlying problem that the study set out to address was based on the fact that Kenya's tax incentive regime is poorly governed and is marred by ineffective and discretionary incentives. The regime, as it is now, promotes corruption, inequity, and social injustice which is to the detriment of the citizens of Kenya. Due to the revenue loss incurred by the issuance of these incentives, taxpayers are forced to bear the burden of paying more tax to meet the country's revenue targets. Similarly, the amount of money foregone could have been utilised to finance other sectors of the economy such as the health and education sector which are key to the welfare of the people of Kenya.

### *iii. Findings*

#### **a. The Kenyan tax incentive regime undermines good governance principles such as transparency, accountability, integrity, and efficiency**

In discussing this hypothesis, the study began by stating that an elaborate governing framework with regard to the tax incentive regime, would be one that allows the government to structure its affairs in a manner that will enhance economic growth and have the ripple effect of bettering the lives of Kenyans. It further elaborated on the constitutive elements of good governance. The elements outlined were transparency, accountability, efficiency, and integrity. It found that Kenya's tax incentive regime is not transparent because firstly, the country does not periodically disclose or publish the amount foregone and neither does it declare the incentives that are awarded.

Secondly, the system allows for negotiation between companies and the tax authorities for the extension of the various incentives. While negotiation is not in itself a vice, the parties and the processes involved are prone to vices such as bribery and corruption which greatly undermines the integrity of the system. Similarly, one does not know how these parties are to be held accountable for the revenue lost because there is no opportunity for scrutiny of the process. Due to the secretive nature of the tax incentive regime, a lot of the incentives given are costly, inefficient, redundant, and seek to benefit only a handful of people in Kenya. It is based on this analysis that the study has found that indeed the Kenyan tax incentive regime undermines good governance principles such as transparency, accountability, integrity, and efficiency.

**b. The governing framework on tax incentives in Kenya falls short of aiding the tax incentive regime in achieving its intended objective of positively impacting Kenya's economy and instead contributes to the social injustices suffered by the people of Kenya.**

This hypothesis is an extension of the first hypothesis that sought to show that Kenya's tax incentive regime is poorly governed. The second hypothesis sought to create the link between poor governance, inequity, and social injustice. It is because of the numerous and redundant tax incentives which benefit a few people, that the people of Kenya cannot access quality services – proof that one man's meat is another man's poison. The purpose of tax incentives is to attract investors, encourage the creation of new industries that will in turn lead to an increase in employment. This will have the general effect of positively impacting the economic growth of Kenya. This speaks further to Rawls' difference principle that allows for inequalities within the society provided they can benefit the disadvantaged in the long run.

However, the study has found that these incentives are not achieving their intended objective. Because they are poorly governed, a lot of money that could have been collected in form of tax revenue, is lost. Tax revenue is one of the sources of funding for the government. The tax collected is used to develop infrastructure like roads, hospitals, schools, and other services offered by the government. If this is lacking, Amartya Sen says that we are denying people opportunities to develop and exercise true freedom. Furthermore, poor health and education systems deny the citizens of Kenya their socio-economic rights.

- c. Having an elaborate governing framework allows governments to effectively review and repeal incentives that are not creating a positive impact on the economy and the welfare of its people.**

To test this hypothesis, the study relied on a comparative analysis and identified South Africa as the most suitable case study. It found that South Africa has adopted and continues to adopt policies that promote an elaborate framework for the proper governance of tax incentives. South Africa has taken steps to not only publish the amount of revenue lost to tax incentives but also review and repeal incentives that are inefficient and redundant. The review and repeal processes occur because of the sunset provisions found within their tax laws that allow tax experts and economists to look into whether the incentives are cost-effective.

Lastly, the study has found that with better targeting of incentives, the citizens' welfare in terms of more employment opportunities that will, in turn, raise the standard of living will be upheld and protected. This has proven the hypothesis that having an elaborate governing framework will have a positive impact on the country and its people.

*iv. Recommendations*

Having addressed the hypotheses that this study intended to discuss, the final objective will be to propose a way forward on how to best govern and regulate the tax incentive regime in Kenya for it to achieve its intended objectives. It will base its recommendations on the design toolkit jointly written by the IMF, OECD, UN, and the World Bank.<sup>155</sup> It will be unique in that the recommendations will be tailored to the policy measures that Kenya should adopt in a bid to address the challenges facing its tax incentive regime. The policies to be adopted will be discussed in three main sections, namely the design of the incentive, the governing framework, and reform.

**a. Design**

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<sup>155</sup>International Monetary Fund, Organisation of Economic Co-operation and Development, United Nation and World Bank, *Options for low income countries' effective use of tax incentives for investment*, 15 October 2015, 19.

Designing an incentive is a very critical step for any country because tax incentives are very hard to eliminate once they are granted. The legislature should therefore consider the type of incentive, the eligibility criteria, and the life-cycle of the incentive.<sup>156</sup>

### **Cost-based v profit-based incentives**

With regard to the type of incentive, Kenya should opt for cost-based incentives as opposed to profit-based tax incentives. Cost-based incentives include various types of allowances that are designed to lower the cost of an asset or production factor.<sup>157</sup> Examples that have been discussed in this study include investment allowances and depreciation. On the other hand, profit-based incentives have the effect of exempting or lowering the tax rate of an entity. A good example of this is the tax holiday that Kenya continues to offer to EPZ companies.

Profit-based incentives are redundant and ineffective because companies would have still invested without being granted this incentive. It also allows for tax avoidance and attracts rent-seeking companies that leave or register as new entities once the holiday is over. Kenya should therefore do away with the tax holiday incentive as other countries such as South Africa have done. It could adopt other incentives such as reducing the cost of power for these entities and building better roads to make the transport of goods more efficient.

### **Eligibility criteria**

The qualifications for the awarding of an incentive should be based in law as opposed to having discretionary approval processes for the granting and extension of incentives. A good example is Costa Rica which has been lauded for setting out one of the most comprehensive eligibility criteria allowing no room for negotiation between the investors and the tax officials in its Free Trade Zone law which minimises the discretion of tax officials in the awarding of incentives.<sup>158</sup> Some examples of the policies that they have include minimum investment requirements, strict rule-based incentives that do not allow for negotiation between the companies and tax authorities, and investment thresholds the entities must meet before they can receive additional

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<sup>156</sup>International Monetary Fund, Organisation of Economic Co-operation and Development, United Nations and World Bank, *Options for low income countries' effective use of tax incentives for investment*, 15 October 2015, 20.

<sup>157</sup> Action aid, Christian aid and Oxfam International, *Tax incentives in the global south*, May 2018, 77.

<sup>158</sup> Andersen M, Kett B and Uexkull E, *Corporate tax incentives and FDI in developing countries 2017/2018*, 19 March 2017, 87.

exemptions. For example, if a company re-invests more than 25% of the original investment, they are given an additional one year; two years if it is more than 50%; three years if it exceeds 75%; and four years if it exceeds 100%.<sup>159</sup> This is better than Kenya's system which allows the Cabinet secretary, in the case of EPZs, to grant additional incentives to the already existing ones.<sup>160</sup>

Borrowing from Costa Rica, Kenya should have clear laws stipulating the minimum investment requirements and for the granting and extension of incentives. Additional policies that Kenya could implement include the requirement that companies should comply with environmental policies and supporting documentation showing the same; proof that the entity has been able to provide a certain number of jobs while adhering to the Occupational Safety and Health Administration (OSHA) requirements for its employees; and lastly, fair wages for its employees.

### **Lifecycle of the incentives**

Kenya's tax incentives have no sunset provisions and seem to be permanent. Having temporary incentives, like South Africa, will allow for periodic review and evaluation once the incentive has run its course. This will then allow the government to carry out a cost-benefit analysis to determine whether the incentive should be extended or repealed.<sup>161</sup>

#### **b. Governance**

Transparency is a very fundamental ingredient for good governance. It could further be categorised into legal, economic, and administrative transparency.<sup>162</sup> Legal transparency entails having the incentives written in law such that they are not discretionary. As mentioned previously, in the instance where the law allows the minister to give an extension, there should be further guidelines on the thresholds the entity must meet to qualify for this extension.

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<sup>159</sup> Lang and Asociados, 'Free trade zone regime in Costa Rica' -<  
[https://www.langcr.com/free\\_trade\\_costa\\_rica.html](https://www.langcr.com/free_trade_costa_rica.html)> on 2 January 2020.

<sup>160</sup> Section 29(2)(i), *Export Processing Zones Act*, (Act No.12 of 1990).

<sup>161</sup> Organisation of Economic Co-operation and Development, *Principles to encourage the transparency and governance of tax incentives for investment in developing countries*, 2016, 4.

<sup>162</sup> International Monetary Fund, Organisation of Economic Co-operation and Development, United Nation and World Bank, *Options for low income countries' effective use of tax incentives for investment*, 15 October 2015, 24.

Economic transparency requires that the reason for a particular incentive be disclosed to the public. Kenya still grants the tax holiday despite the fact that economists have proven it to be redundant. The government should therefore be able to conclusively justify to Kenyans why they are still granting it. Lastly, is administrative transparency which requires that the list of incentives in a given year should be published. This step will be congruent with the Constitutional right to information hence allowing Kenyans to know how much the government loses to tax incentives and how it can be brought to task.

### **c. Reform**

This study takes note of the steps taken by the Kenyan government to limit and reduce the number of tax incentives through the *Income Tax laws Amendment Act*. The exemptions that were previously granted under the first schedule of the ITA exempting various parastatals from paying taxes were overhauled.<sup>163</sup> Examples include the income of government parastatals such as the Tea Board of Kenya and the Kenya Dairy Board. The other incentive that was limited was capital allowances whose rates were reduced (buildings used for manufacture and hotels) from 100% to 50% in the first year of the residual value annually on reducing balance.<sup>164</sup>

These are positive steps that show that the government is trying to reform the tax incentive regime. Going forward, the government should invest in carrying out a comprehensive cost-benefit analysis of the various incentives given. They should also ensure that the provisions have ‘sunset clauses’ that will allow for periodic review once the incentive has run its course.

#### *v. Potential area for further research*

The study briefly mentioned a recent amendment introduced by the *Income Tax Laws Amendment Act* on the minimum tax regime. It was introduced to promote fairness and equity by making sure all entities pay tax irrespective of whether or not they make losses. This will be advantageous in that the government will be able to broaden its revenue base by mandating companies to pay at least 1% of the gross turnover. The problem it seeks to solve is the constant habit by companies that claim a tax loss every year with some even forging their documents to be able to benefit from carrying forward their losses.

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<sup>163</sup> PricewaterhouseCoopers, *Highlights of the tax laws amendment act*, 2020, 6.

<sup>164</sup> PricewaterhouseCoopers, *Highlights of the tax laws amendment act*, 2020, 3.

It is not yet clear how KRA will implement this tax. The danger is that some firms that are genuinely in a tax loss, will be forced to close shop as they will not be able to stay afloat. The minimum tax regime could be a new and exciting area for further research. The researchers could look into how it is implemented in other countries, whether it has been successful, and give recommendations on how it can be implemented in Kenya in a manner that will aid in the further regulation of the tax incentive regime, without inhibiting investment.

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