Financing Industrialization and Transformation in Kenya: Gaps and limitations with policy implications

Joseph Sirengo, MBS
Chief Manager, Research and Surveys
Strategy, Innovation and Risk Management Department
Kenya Revenue Authority

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Introduction

Kenya Revenue Authority (KRA) was established by an Act of Parliament (Cap 469) on 1st July 1995.

Mandate:

- Assess, collect, and account for all revenues in accordance with tax laws
- Advise the Government on all matters relating to the administration of and the collection of revenue under the written laws.

Role in National Development:

- **Domestic resource mobilisation (DRM)**
- **Border Management -** aimed at improving security at the border stations and reducing the level of illicit trade.
- **Trade facilitation –** iCMS to consolidate all customs cargo clearance processes
- **Ease of doing business -** Improve business climate with respect to taxation and trading across borders; tax simplification; expediting VAT refunds to enhance liquidity of exporting firms.

Industrial Transformation in Kenya

1. Kenya's Vision 2030 aim to transform the country into an industrialized middle-income country dispensing a high quality of life to all citizens by 2030.
2. The Big-Four Agenda: identified 4 priority areas (Food security and nutrition, manufacturing, universal health coverage, and affordable housing).
3. Manufacturing - plays a key role in economic transformation through its contribution to national output, employment creation, poverty alleviation, FDI, and building a country's export competitiveness.

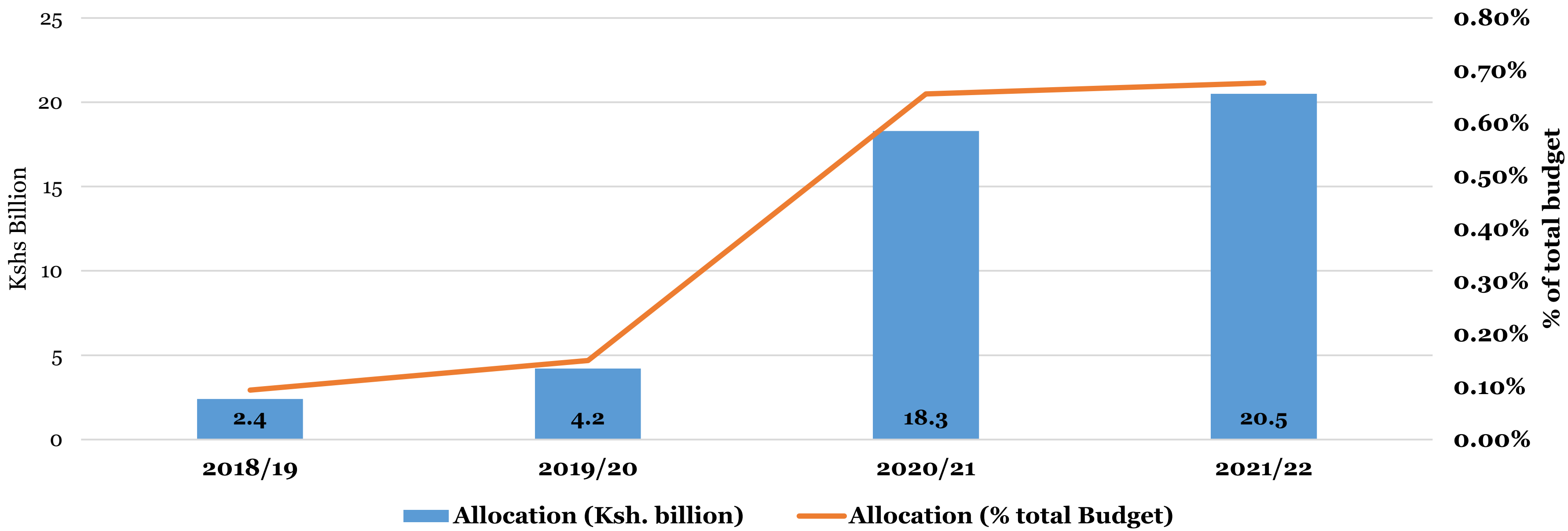
Industrial transformation …

4. The MTP III and the "Big 4 Agenda" sought to:
   a) improve the sector contribution to GDP from 9.2% in 2016 to 15% by 2022,
   b) increase the level of FDI from US$672 million to US$3.8 billion,
   c) create 1 million new jobs, and
   d) improve Ease of Doing Business ranking from 80 in 2017 to 45 by 2022.

5. The government has put in place measures and initiatives to enhance the growth and development of the manufacturing sector including;
   a) Ease of Doing Business Programme
   b) Industrial Clusters Programme
   c) Special Economic Zones (SEZ) Programme
   d) Industrial and Small and Medium Enterprise (SMEs) Parks Programme
   e) Micro, Small and Medium Enterprises (MSMEs) Development Programme.
   f) Favourable tax regime for MSME (expansion of turnover tax threshold from Kshs 5 million to Kshs 50 million and reduction of the turnover tax rate from 3% to 1%).

Financing the Industrial Transformation

1. To constantly finance this sector, the budgetary allocation for the sector has grown more than 8-fold over the last 4 years from Kshs. 2.4 billion in 2019/20 to Kshs. 20.5 billion in 2021/22.

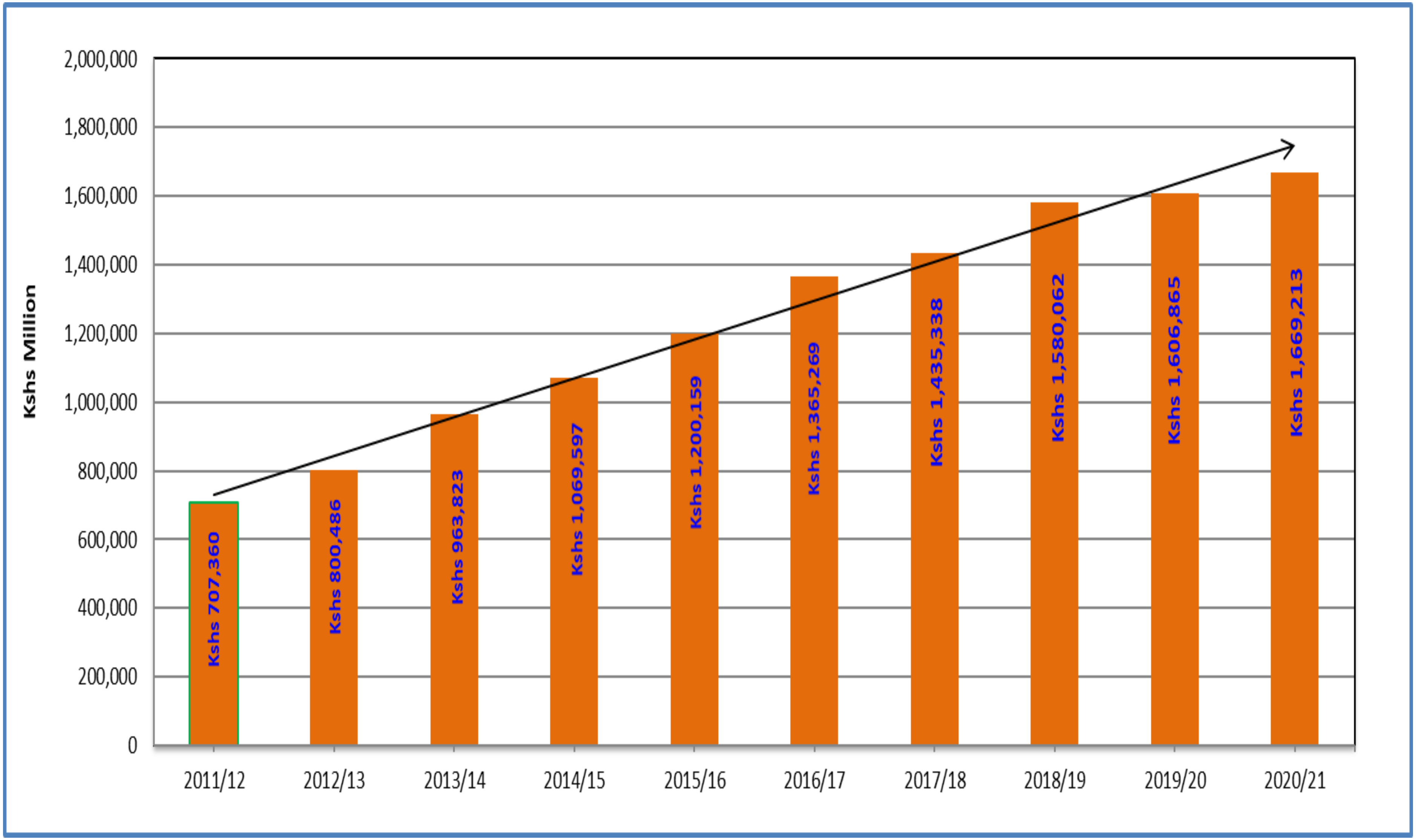


2. Budget allocation to the manufacturing sector has been growing relative to the total budget

Financing …

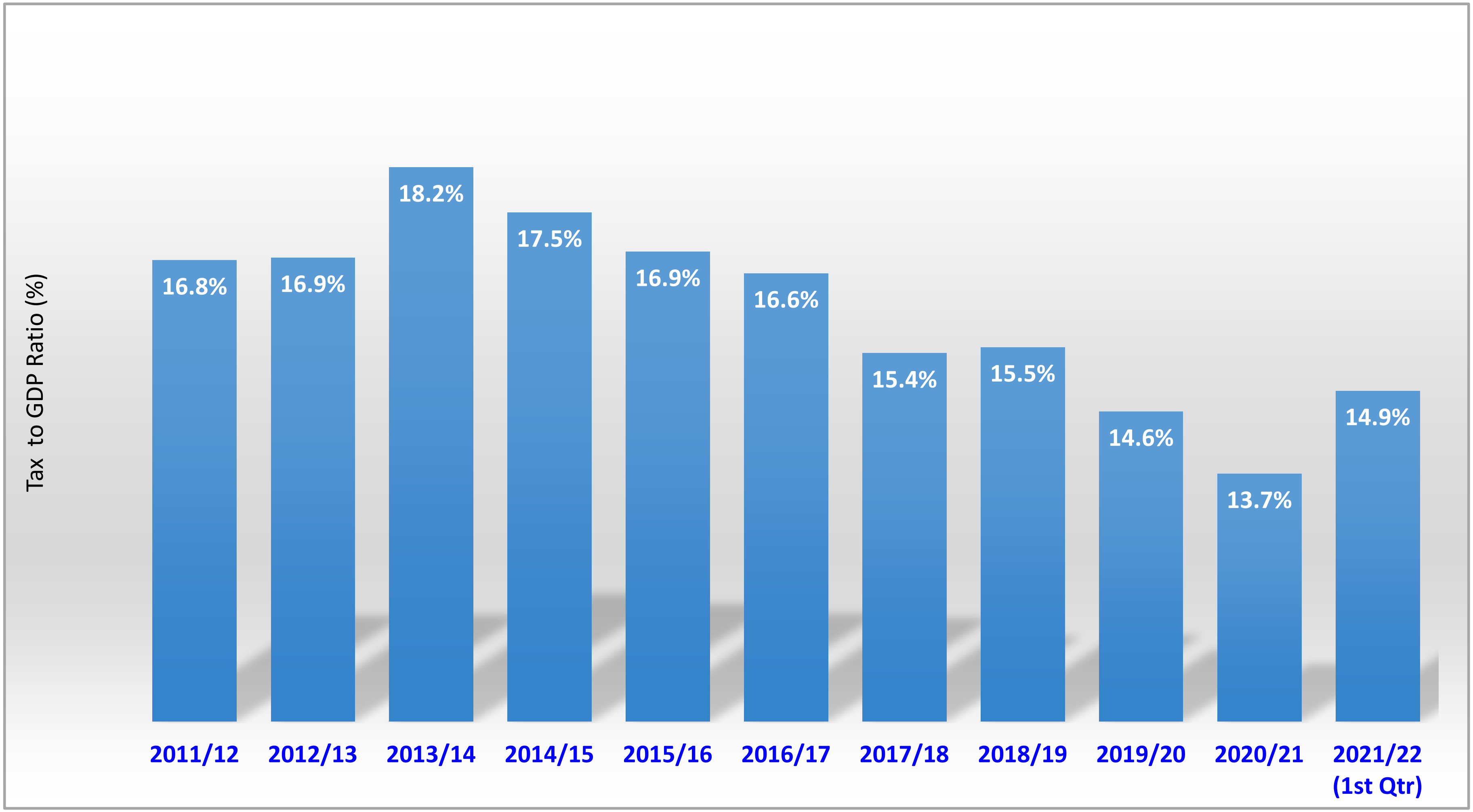
3. In financing the industrial transformation in Kenya, the government in the FY 2021/22 allocated:
   a) Kshs. 2 billion to the Credit Guarantee Scheme to enhance access to affordable Credit by Micro, Small, and Medium Enterprises (MSMEs) in the manufacturing sector
   b) Kshs. 500 million in support of the development of various MSMEs
   c) Kshs. 600 million for the provision of finances to the MSMEs through the Kenya Industrial Estates
   d) Kshs. 8.3 billion for Dongo Kundu Special Economic Zone
   e) Kshs. 350 million for the development of the SEZ (Naivasha Textile Park, Kenanie Leather Industrial Park and Athi River Textile Hub)
   f) Kshs. 90 million for the Freeport and Industrial Park Special Economic Zone in Mombasa.

REVENUE PERFORMANCE TREND (Kshs Mn)



- Revenue has more than doubled over the last ten years.

TAX TO GDP RATIO TREND



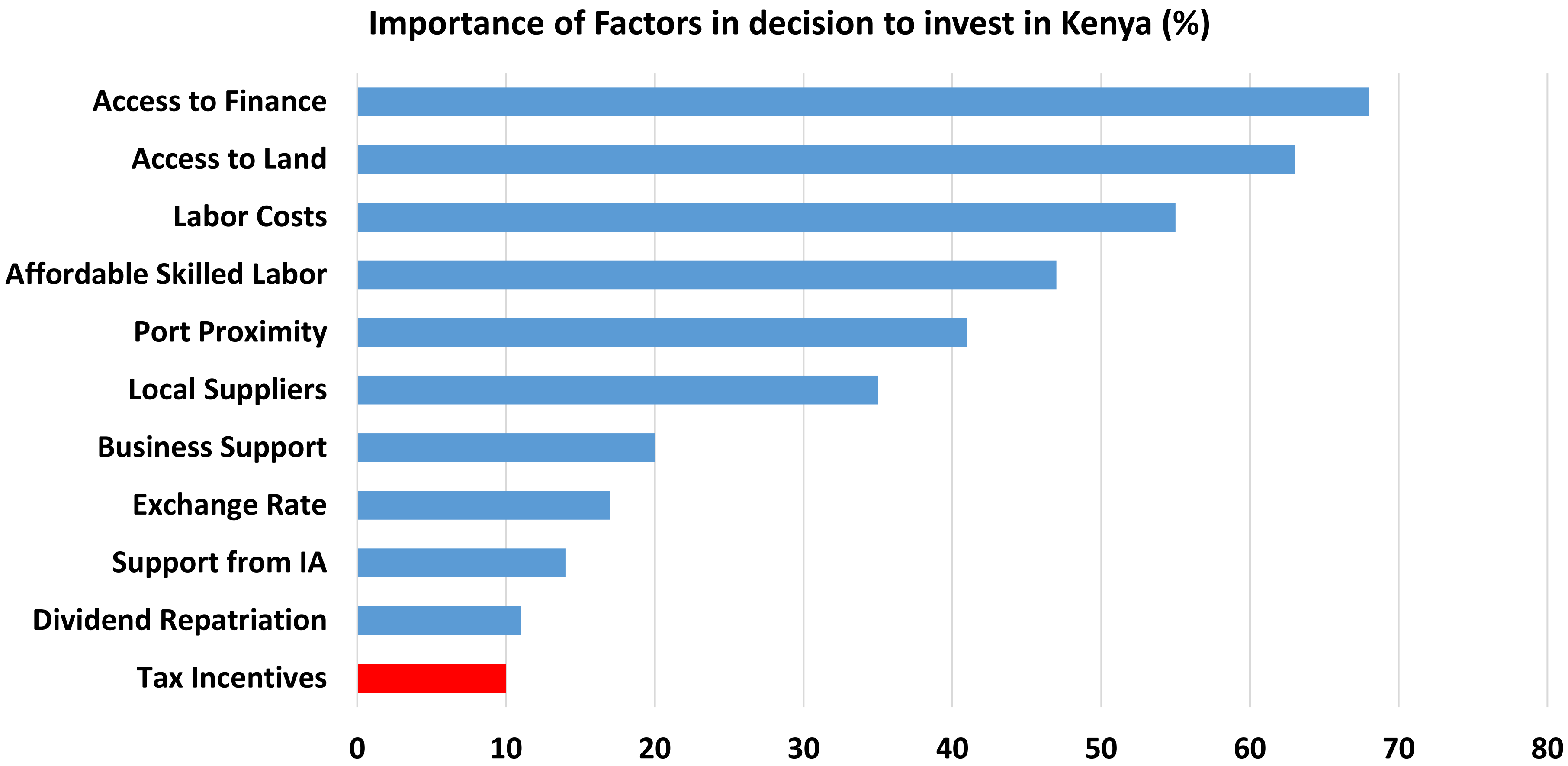
- Turnaround of tax to GDP ratio in 2021/22
- Declining trend prior to 2021/22 attributed to tax policy (tax cuts to mitigate COVID-19 impact) and structure of the economy.

Revenue foregone due to tax incentives

Tax Expenditures Kshs. Million				
	2017	**2018**	**2019**	**2020**
PIT	3,526	3,816	4,654	4,125
CIT	47,560	77,096	61,981	56,737
VAT-domestic	356,707	319,886	257,206	234,378
Excise-imports	3,777	4,127	4,221	5,389
VAT-imports	25,546	24,415	22,795	17,695
Total	437,116	429,341	350,856	318,324
Nominal GDP	8,483,396	9,340,307	10,255,654	10,752,992
Tax expenditure as % of GDP	**5.15%**	**4.60%**	**3.42%**	**2.96%**

Source: National Treasury and Planning, September 2021

Do Incentives promote Investment?



- Tax incentives ranked the least among factors that drive investment decisions (World Bank Group, 2013)

Role of KRA in development agenda

1. KRA plays a key role in encouraging business activity and investment through the provision of a favourable tax environment to motivate potential investors to invest in the Kenyan economy
2. Tax incentives for Special Economic Zones (SEZs)
   a) Capital expenditure on buildings and machinery are entitled to investment deductions equal to 100% of the initial capital expenditure
   b) Corporate tax at the rate of 10% for the first 10 years and 15% for the next 10 years
   c) Dividends received by registered venture capital companies in SEZ enterprise are exempt from tax
   d) Dividends paid by SEZ Enterprise, developers, or operators to any non-resident person are exempt.

Role of KRA cont…

3. Tax incentives on inputs/raw materials for the production of various goods

- VAT exemption on:
    a) Inputs/raw materials supplied to solar equipment manufacturers for the manufacture of solar equipment or deep cycle-sealed batteries;
    b) Inputs/raw materials locally purchased/imported by manufacturers of agricultural machinery and implements;
    c) Inputs for the manufacture of pesticides;
    d) Inputs for the manufacture of motherboards;
    e) Inputs or raw materials for manufacturing medicaments;
    f) Agricultural, animal husbandry, and horticultural services.
- Investment deductions in the computation of profits/gains
- Lower rate of import declaration fees (IDF) and Railways Development Levy (RDL)
- Provision of remission and lower import duty rates on raw materials.

Trading across borders

1. ***Facilitate Trading Across Borders program:*** Implementation of a Trading Across Borders facilitative framework for elimination of Head Verification Officer (HVO) /Verification Officer (VO) processes for tea exports through the port of Mombasa
2. ***Elimination of Witnessing of stuffing for tea, coffee, spices and herbs:*** Elimination of customs officers witnessing stuffing of direct exports of tea, coffee, spices and herbs through the port of Mombasa. The officers no longer witness the stuffing of these direct exports. Exports cleared under this reform are scanned upon entry at the port.
3. ***Implementation of Green Channel cargo processing:*** This has led to reduction in clearance bottlenecks and facilitated faster export and import processing.
4. ***Elimination of presentation of manual folders:*** KRA has rolled out paperless clearance of cargo whereby Customs performs paperless examination, approval and release of inbound and outbound goods using iCMS.
5. ***Reduction in the rate of verification:*** The roll out of risk-based verification at the port of Mombasa and Inland Container Depot, Nairobi. Only consignments that have been flagged by the scanners undergo verification.

Trading across borders cont…

1. Implementation of Single Customs Territory
2. Automation of Customs processes
3. Implementation of Authorized Economic Operator Program
4. Implementation of Regional Electronic Cargo Tracking System
5. Implementation of Pre- Arrival Processing
6. Implementation of Kenya National Single Window
7. Roll out of Green Channel for Low-risk items
8. Reduction in the number of exports and imports documents
9. Full roll out of Integrated Customs Management System (ICMS) for exports. ICMS integration with National Electronic Single Window allows customs to view all export permits approvals online.
10. Elimination of Pre-shipment inspection by customs for exports.
11. Elimination of all customs manual processes at Inland Container Deport (ICD)
12. Elimination of verification surcharge of $80 and $120 for compliant traders of 20ft and 40ft container respectively by Kenya Port Authority.
13. Implementation of risk-based cargo clearance and 100% scanning of imports leading to reduced physical verification for ICD cargo to below 20%.
14. Waiver by Kenya Bureau of Standards of the requirement to obtain a Certificate of Conformity for importation of brand-new motor vehicle spare parts has reduced cost from $250 to zero.
15. Waiver by Kenya Bureau of Standards of the requirement to obtain a Certificate of Conformity for importation of brand-new motor vehicle spare parts has reduced time from 72 hours to zero hours

Paying taxes

Kenya improved from 125 in DB 2017 to 94 in DB 2020. Some of the reforms that led to the improvements in the rank include:

1. Use of digital technology for improved customer service:
   a) Online PIN registration: available on mobile applications
   b) Online payments: expanded to web-check out: for payments using debit/credit cards, and also available on mobile platforms
   c) Online case management for all DTD processes-registration, refunds, debt recovery, processing objections and appeals
2. Use of digital technology for enhanced tax compliance and reduced compliance cost:
   a) Automatic matching VAT data between suppliers and buyers
   b) Access to third party data to detect revenue loopholes: (iTax/IFMIS/CBK) integration
3. Use of digital technology for strategic partnerships:
   a) KRA & Business Registration Service (BRS) i.e., iTax/E-Citizen integration, for reliable data on company profiles
   b) KRA & NHIF, NSSF and NITA (National Industrial Training Authority) i.e., Unified Payroll Return, for easy administration of payroll taxes (ongoing reform).

Policy and administrative initiatives

Policy and legislative initiatives that have been put in place to expand the tax base include:

1. Introduction of digital service tax, VAT on digital marketplace supplies, and enhanced recruitment of taxpayers (landlords, informal taxpayers, professionals, registered companies, and individuals trading online).
2. Use of Voluntary Tax Disclosure Programme (VTDP) which provides amnesty on penalties and interest for taxpayers with previous undisclosed taxes.
3. Enhanced use of business intelligence and data analytics to improve tax compliance.
4. Prioritization of Value Added Tax refunds.
5. A revamped audit function to foster compliance.
6. Implementation of tax policy reforms to ensure stability and clarity of tax laws
7. Revamped enforcement measures of High Net Worth individuals to ensure compliance.
8. The consideration of a National Tax Policy to guide the taxation framework in Kenya.
9. Enhancing the effectiveness of debt management through the issuance of 7-day last reminder notices, follow-up on unpaid entries, and engagement of debtors in the Tax Appeal Tribunal (TAT) for faster resolution through Alternative Dispute Resolution (ADR).

Gaps and limitations

1. Tax base expansion in view of the growing hard-to-tax sectors such as informal sector, agriculture and digital economy.
2. Kenyan economy also faces internal and external shocks that have disrupted its industrialization and growth prospects from time to time.
3. Determination of user location to establish if tax is chargeable in case of digital service tax
4. Visibility of digital transactions (*Data protection laws limit KRA to have full access to digital transactional data*).
5. Tax incentives identified as one of the least factors in considering investing in Kenya.

Way forward

Post-Covid recovery period, major priorities will be around:

1. Raising voluntary compliance through sector specific education programmes;
2. Curbing evasion and avoidance by building capacity and embedding international best practice and cooperation;
3. Broadening and deepening the tax base: rationalization of tax incentives, modernizing the income tax statute and enhancing taxation of the informal sector; and
4. Finalisation of the Medium Term Revenue Strategy and National Tax Policy to enhance DRM.
5. Streamline/reduce incentives and use the revenue released to support factors that rank on the top in investment decisions (Access to finance, land, labour).


Thank you