

THE DISPARITY EQUATION

**A COMPARATIVE STUDY ON TAX INCENTIVES AND
ECONOMIC INEQUALITY IN KENYA'S REGIONAL BLOCS**



TRANSPARENCY
INTERNATIONAL
KENYA

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ABBREVIATIONS AND ACRONYMS

CIT	-	Corporate Income Tax
CMA	-	Capital Markets Authority
EAC	-	East African Community
EPZ	-	Export Processing Zones
FDI	-	Foreign Direct Investment
GDP	-	Gross Domestic Product
GoK	-	Government of Kenya
ITA	-	Income Tax Act
KASIB	-	Kenya Association of Stockbrokers and Investment Banks
KRA	-	Kenya Revenue Authority
LIC	-	Low Income Countries
MNC	-	Multinational Corporations
MSME	-	Micro, Small and Medium-Sized Enterprises
NSE	-	Nairobi Securities Exchange
OECD	-	Organization for Economic Cooperation and Development
OSR	-	Own-Source Revenue
PFMA	-	Public Finance Management Act
REB	-	Regional Economic Blocs
SDGs	-	Sustainable Development Goals
SEZ	-	Special Economic Zones
UN	-	United Nations
UNCTAD	-	United Nations Conference on Trade and Development
VAT	-	Value Added Tax
PAYE	-	Pay As You Earn

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EXECUTIVE SUMMARY

The Constitution of Kenya provides that the government must provide certain services to its citizens. To achieve this, the government levies tax on the income derived in Kenya by individuals or corporations. The taxes become the source of revenue for the government to run its affairs. On the other hand, tax is a burden to citizens and high taxation may discourage investment from both locals and foreigners, which may lower local investment and Foreign Direct Investment. As a way of encouraging investments in a country, governments usually provide tax incentives to potential investors. A tax incentive is a legal provision that creates favourable conditions for a person or activity and deviates from the normal provisions of the tax legislation.

The problem with tax incentives and the purpose of the study

In Kenya, the provision of tax incentives is surrounded by limited transparency and low accountability, hence not creating the desired effect. There is no clear evidence on whether the tax incentives have in any way increased investment. In some cases, the administration of the incentives is usually left to tax officers who have discretion on who qualifies for the incentives and who does not. This leaves room for corruption and loss of revenue and the expected benefits from tax incentives are not realised which may lead to income inequality. The purpose of this study was to produce a comparative analysis report of the existing tax incentives and decision-making processes across the seven economic blocs in Kenya and where relevant, the East Africa Community (EAC) region to transpose learnings from neighbouring countries.

Methodology

The study was based on desk research from secondary sources on Kenya tax laws and other laws that guide tax incentives, the County Governments Waiver Administration Act for the different counties and the relevant County Government Acts, a review of global best practices and responses from various key informants from the national government, regional economic blocs, the private sector and civil society. Stakeholders were engaged in the study where key informants were identified to represent different players in the development of tax incentives policies and legislation, those involved in the implementation of the policies and the beneficiaries or those affected by the incentives.

An interview guide was developed and shared with key informants who were then followed to schedule meetings with the stakeholders. The focus of the discussion was on governance and rule of law in the administration of tax incentives, transparency in the implementation of tax incentives policies, effectiveness and efficiency in the implementation of tax incentives policies and review of the implementation of tax incentives policies. In data analysis, document review was used while data from respondents were analysed in form of content analysis. The results of the findings are presented in form of themes.

Findings of the Study

From the study, it was noted that there were positive contributions of tax incentives to the economy. However, the main shortcoming with this is that there is no documented evidence to support the positive contributions. Some of the positive contributions noted were: encouragement of investment, increase in employment, encourages investment in specific geographic areas, drives technology transfer, encourages export and capital accumulation and usage of certain products.

The study further analysed the relationship between tax incentives and income inequalities. The study noted that there is some weakness in the administration of tax incentives that leads to income inequality in regional economic blocs and the country. The main weaknesses in the administration of the tax incentives leading to income inequalities are:

- i. Gaps in administration of tax laws resulting into investors claiming tax incentives unfairly, where they use available tax incentives to claim the same. This particularly favoured the wealthy as they have capability to engage tax planners to guide assist them evade taxation.
- ii. There is no regulation or framework approved by the National Assembly for the implementation of tax incentives.
- iii. There are no watertight criteria for issuing and monitoring firms granted incentives. This results in the following risks that disadvantage the government in revenue collection and the small-scale taxpayers and creates room for corruption:
 - Firms in EPZ or SEZ transforming into new entities after the expiry of the tax holiday period.
 - There is a displacement of investment of small-scale investors by big investors.
 - Discretionary powers by the tax granting authority are prone to abuse.
 - Domestic firms restructuring as foreign investors to enjoy tax incentives, yet the beneficial owners are Kenyan nationals.
- iv. Tax incentives policies are a result of lobbying by the wealthy in society and this leaves out the vulnerable. Tax exemption of capital gain is also considered to favour the wealthy in society and the threshold for some incentives is out of reach for small enterprises.
- v. Information on tax incentives is not freely accessible to the vulnerable in society. Thus, even if there is an incentive for the taxpayer, he/she does not utilise it.

- vi. There was no effectiveness and efficiency in the implementation of tax incentives where tax incentives being granted lacked clarity on the level of contribution by those exempted from tax. For example, it is not clear what level of employment should be created by EPZ given the fact that they are enjoying tax incentives. The land rates and rent arrears waivers in counties benefit a few individuals who own property against the principle of equity with no quantified benefit to society.
- vii. There is no evidence of cost-benefit analysis that is done before tax incentives policy is developed or tax incentives granted. This leads to inefficiency in the administration of tax incentives, leading to erosion of the tax base, disproportionate treatment of taxpayers and redundancy although they are still available and claimed.
- viii. There is no monitoring and evaluation by the government to ensure organisations continue to serve the original purpose for which they were granted tax incentives.
- ix. The economic blocs have not put mechanisms in place that will help them collaborate in the tax collection process and administration of waivers.

Recommendations

Income inequalities will persist if the indicated weaknesses are not corrected. This study makes the following recommendations:

- i. The national government and county governments should, through a consultative process, develop a national/county tax policy that addresses all the issues relating to tax incentives.
- ii. The government should develop tax incentives granting criteria that will ensure that tax incentives are granted after clear, evidence-based economic, social and environmental impact assessments.
- iii. The government should develop a monitoring and evaluation mechanism that will monitor the behaviour of the organisations granted tax incentives to ensure that they continue fulfilling the mandate they declared at the time of requesting tax incentives.
- iv. The government should publish and publicise the beneficiaries of tax incentives as provided for in the Constitution.
- v. Where possible, all tax incentives for investment should be consolidated under the authority of one government body, where possible.
- vi. The government should develop a mechanism for reviewing the tax incentives to weed out redundant tax incentives.

The study, therefore, concluded that tax incentives have been widening the inequality gap and the recommendations given should be implemented to reverse the trend.

DEFINITION OF TERMS

- 1. Economic Blocs:** These are groups of counties that have come together voluntarily to deepen their trade relations. Some of the economic blocs in Kenya include Frontier Counties Development Council (FCDC), North Rift Economic Bloc (NOREB), Lake Region Economic Bloc (LREB), Jumuia ya Kaunti za Pwani, South Eastern Kenya Economic Bloc and Mt Kenya and Aberdares Region Economic Bloc.
- 2. Fines and penalties:** Incurred as a punishment for violation of rules and procedures set out in the legal and regulatory framework.
- 3. Other income (non-tax):** Interest on loans, tender document sales, asset disposal.
- 4. Regulatory licensing or user charges with regulatory 'elements':** Fees or charges connected with licensing and regulatory activities of government e.g., Single Business Permits, advertising, building permits and liquor licensing among others.
- 5. Tax Incentives/waiver Objective:** Encouraging investment in the economy/ County, Foreign Direct Investments and local investments.
- 6. Tax Incentive/waiver:** These are special provisions that allow for exemption from tax, reduced rates of taxes, tax deductions on expenditure, tax credits, or deferral of tax liability. Tax exemptions take many forms and include tax holidays, zero-rating or exemption from VAT and exemption from customs rates.
- 7. Taxes:** A compulsory contribution levied by a government body on income or the value of goods, services or transactions for general revenue purposes and not connected to a particular benefit e.g. property rates and entertainment tax; means all types of taxes and revenue streams such as PAYE, VAT, corporate tax, exercise duty, customs duty, levies, fees, land rent, cess and permits etc.
- 8. User charges:** Governmental charges that are incurred in exchange for a benefit, which should approximate the payer's fair share of the costs incurred by the government in providing the benefit e.g., hospital fees, market fees/ rent, parking fees, lease rents and wildlife park entry fees.

1 INTRODUCTION

1.1 Background

The Constitution of Kenya provides that the government has a responsibility to provide for its citizens (The Constitution of Kenya, 2010). Some of the services that the government should provide include quality healthcare, education, infrastructure development as well as social security. For these services to be provided, the government must have finances. The government levies taxes on its citizens to raise revenue to meet the services. The government taxes individuals and corporations where the tax includes value-added tax, income tax, excise tax and customs tax among others. Article 10 of the Constitution 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 (Kaufmann & Kraay, 2011). While implementing tax policies, they must adhere to the principles of accountability, transparency, efficiency and integrity.

In the implementation of tax policies, the government grants tax incentives. Tax incentives are special provisions that allow for exemption from tax, reduced rates of taxes, tax deductions on expenditure, tax credits, or deferral of tax liability. Tax exemptions take many forms and include tax holidays, zero-rating or exemption from Value Added Tax (VAT) and exemption from customs rates. Rice (2011) 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 (Rice, 2011).

Some of the expectations from tax incentives are to attract greater levels of Foreign Direct Investment (FDI) into the country which creates more job opportunities. 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.

A good tax system should adhere to policies and principles as per Article 10 of the Constitution, the system should be fair, equitable and simple to administer. For the various taxes to achieve the intended objective and for there to be fairness and equity, there should be good governance in tax administration. Good governance is a quintessential element of sustained economic development (Kaufmann D, Kraay, 2011). Good governance 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. 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 (Constitution of Kenya, 2010). 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 (Kaufmann D, Kraay, 2011). 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 as per the Constitution of Kenya.

1.2 Legal background

The legal basis of taxation is in the Constitution of Kenya, 2010 where in Article 201, the Constitution provides that the public finance system shall promote an equitable society, and in particular the burden of taxation shall be shared fairly. It is therefore envisioned that the operationalisation of tax laws should be equitable and as fair as possible. Further in Article 209, the Constitution provides that only the national government has the power to impose taxes and charges. The taxes provided by the Constitution includes income tax, value-added tax, customs duties and other duties on import and export goods and excise tax. However, it allows the County Government to impose property rates and entertainment taxes. The Constitution further provides that the national and county governments may impose charges for the services they provide.

The National Treasury is bestowed with the implementation of fiscal policy where it shall manage the national government's public finances following the Constitution, and the principles of fiscal responsibility. In managing the national government's public finances, the National Treasury shall enforce the fiscal responsibility principles by ensuring a reasonable degree of predictability concerning the level of tax rates and tax bases shall be maintained, considering any tax reforms that may be made in the future.

In terms of legislation for the achievement of expected fiscal policy, the government prepares a Finance Bill every financial year where proposed changes on the composition of the tax revenue are made. The National Assembly has a responsibility to consider the impact of the proposed changes on tax revenue touching on direct and indirect taxes and considers domestic, regional and international tax trends. In the Finance Bill, the National Assembly also considers the taxation and other tariff agreements and obligations that Kenya has ratified, including taxation and tariff agreements under the East African Community Treaty (Public Finance Management Act (PFMA), 40).

Tax incentives/waivers are given to investors and the public through different parliamentary legislations. The purpose of tax incentives/waivers is to encourage investment, encouraging or discouraging certain behaviour or as it may be required by international practices. For the investors, the Investment Promotion Act provides the prerequisites for one to qualify for incentives which include: the creation of employment for Kenyans, acquisition of new skills or technology for Kenyans, contribution to tax revenues or other Government revenues, transfer of technology to Kenya, increase in foreign exchange, utilisation of domestic raw materials, supplies and services and adoption of value addition in the processing of local, natural and

agricultural resources. For one to qualify for such waivers, one needs to be registered as an investor as per the Investment Promotion Act. On the implementation of tax incentives, the Constitution of Kenya 2010, Article 210 provides that if any legislation permits the waiver of any tax or licensing fee, a public record of each waiver shall be maintained together with the reason for the waiver and shall be reported to the Auditor- General.

In operationalising the provisions of the Constitution, PFMA, section (77) provides that the Cabinet Secretary may waive a national tax, a fee, or charge imposed by the national government and its entities under criteria prescribed in regulations provided that the National Treasury shall maintain a public record of each waiver together with the reason for the waiver and report on each waiver and such a waiver or variation has been authorised by an Act of Parliament. In section 78 of PFMA, Kenya Revenue Authority is mandated to collect tax revenue on behalf of the national government. To give life to this provision, the Income Tax Act (ITA) Section 15 provides that the Cabinet Secretary, may, by notice in the Gazette, provide that any income or class of income which accrued in or was derived from Kenya shall be exempt from tax to the extent specified in such notice. According to PFMA 82 (4), it is provided that not later than three months after the end of each financial year, a receiver of revenue for the national government shall submit to the Auditor-General a report for all waivers and variations of taxes, fees or charges granted by the receiver or collector during that year. The information provided here shall be published and publicised for transparency.

1.3 Tax incentives in Kenya

Investors consider tax as a burden in their business that affects the productivity of the economy, and this may affect the overall productivity towards the Gross Domestic Product (GDP). To encourage investment and boost growth in the economy, the Kenya government has been granting tax waivers. Dagney and Michael (2010) observed that tax incentives are components of the tax code designed to encourage certain behaviours in the economy that includes job creation, investment in specific geographic areas and protection of certain industries. Tax incentives that include jobs tax exemptions, tax deductions, investment tax credits, training credits, tax holidays, tax-free zones and property tax abatement are common types of incentives used by many governments. These tax waivers are usually divided into two broad categories which are statutory and discretionary tax credits. Mainly statutory exemptions are available to businesses meeting certain criteria, such as being in a targeted industry and creating a minimum number of jobs. On the other hand, discretionary tax credits are offered to attract or retain firms (Dagney & Michael, 2010)

The focus of tax incentives 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 society (Rice, 1969; GoK, 2004). Specifically, the government looks at the creation of employment for Kenyans, the addition of new

technology or skills for Kenyans and contribution to Kenya's tax revenues. Technology can increase foreign exchange either through export or import, utilisation of domestic raw materials supply and value addition in the processing of local resources. Further, incentives promote the development and implementation of information and communication technology, among others. The government believes 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 (Tax Justice Network Africa and ActionAid International, 2012).

Governments grant tax incentives to stimulate investment in the economy and to attract FDIs. The FDIs are expected to bring inflows, capital and jobs to a country. They are also expected to spur competition and increase the efficiency of domestic markets more widely and therefore contribute to a country's overall economic development. Tax incentive policies also often aim to promote specific economic sectors or types of activities as part of an industrial development strategy or to address regional development needs. From previous studies, growth regressions indeed generally find positive correlations between inward FDI and economic growth (Adams, 2009).

Padilla, Biyani, Maranga and Quantrill (2020) in their study on tax incentives indicated that 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. Incentives include but are not limited to: tax deferrals which are the delay in the payment of tax to a date in the future; exemptions which can exclude one's income fully or partially from taxation and they can either be granted through statute or exemption application protocols when applying for an extension; credits are the amounts deducted from one's tax liability and; allowances, are amounts that are allowed as deductions in the computation of one's taxable income (International Monetary Fund, 2020). Thus, when tax incentive policies are implemented effectively, they are expected to trigger investment in the country.

The main argument for the provision of tax incentives is the view that tax incentives help in the growth of enterprises. Orkaido and Beriso (2021) in their study to find the relationship between the performance of MSMEs revealed that tax allowance, tax holiday, accelerated depreciation, reduction in the tax rate, loss carry forward and tax exemption have a positive and statistically significant effect on the sustainability of the MSMEs. This study concluded that the existence of tax incentive practice has a positive contribution to the sustainability of micro, small and medium-sized enterprises.

A United Nations Report (2018) on a study about tax incentives design noted that new foreign direct investment may bring substantial benefits, some of which are not easily quantifiable. It indicated that a well-targeted tax incentive programme may be successful in attracting specific projects or specific types of investors at reasonable costs compared with the benefits received. In this case, the benefits from tax incentives for foreign investment are the benefits commonly associated with foreign direct investment, which include knowledge and technology transfers,

increased capital, increased employment and assistance in improving conditions in less developed areas. Apart from the stated advantages, the UN (2018) was of the view that foreign direct investment may also generate substantial spillover effects. A good example is the case of choice of location for the establishment of a large manufacturing facility. This will not only result in increased investment and employment in that facility but also in firms that supply and distribute the products emanating from that facility that will be established and this may transform the location, directly and indirectly. It will result in economic growth that will increase the spending power of the country's residents and that, in turn, will increase demand for new goods and services. In the long run, the increased investment will, in a way, increase government tax revenue directly from taxes paid by the investor during the tax holiday and after the expiration of the tax holiday period, and further indirectly through increased tax revenue received from employees, suppliers and consumers.

With tax incentives, developing countries can deliver significant economic benefits to the local economy and help to achieve a shared aim of creating more prosperous societies worldwide. Economics identifies the core benefits of FDI to the host economy as including job creation (particularly higher skilled, higher paid jobs), transfer of technology, stronger managerial and operational business practices, increased access to foreign markets and access to international finance. Evidence from the World Bank indicates that FDI has become the largest source of external finance for many developing countries, with over 40 per cent of global FDI flows going to developing countries. Expansion by multinational corporations (MNCs) to developing countries is one example of FDI and is driven by various factors that depend on the business strategies of the respective MNC. The World Bank suggests motivations generally include lowering production costs, strong domestic growth prospects, access to local markets and/or regions and the ability to tap into a country's natural resources and raw materials.

In developed countries, tax incentives are usually given in the form of investment tax credits, accelerated depreciation and favourable tax treatment for expenditures on research and development. These incentives are used to encourage domestic industries to attract foreign investment. Economists have made significant advances in determining the correlation between increased tax incentives and increased investment; that where there is an increase in tax incentives, there is also an increase in investment. However, it is quite challenging to determine whether these tax incentives have contributed to additional investments or not. In other economies, tax incentives have been defined in terms of their effect on reducing the effective tax burden for a specific project. This approach involves comparing the relative tax burden on a project that qualifies for a tax incentive to the tax burden that would be borne in the absence of a special tax provision. This approach is useful in comparing the relative effectiveness of different types of tax incentives in reducing the tax burden associated with a project.

Despite all these efforts, no definite conclusion has been drawn on the correlation between the use of tax incentives by governments to attract FDI (Munongo, Akanbi & Robinson, 2017). Due to the lack of this connection, this issue has created a heated debate among policymakers, theorists and economists on whether tax incentives should be used as a tool for inducing FDI into countries. On the one hand, proponents of tax incentives have argued that tax incentives have elevated the welfare of the people in the jurisdictions in which they have been used. 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 (Yelpaala, 1984). Empirical evidence also shows that they are not instrumental in attracting FDI or investment from local investors (Klemm & Van, 2012).

Over time, the need for tax incentives has reduced globally. For instance, by 2005, more than 80 per cent of countries offered tax holidays and 50 per cent had adopted free zones (Keen and Mansour, 2010). However, it has been observed that the average length of tax holidays has declined somewhat in various regions of the world (Abbas and Klemm, 2013). Though not confirmed, the global declining trend in Corporate Income Tax (CIT) rates, including in low-income countries, might indeed be that the benefit for investors for receiving tax incentives has somewhat diminished. Thus, the decrease in the need for incentives can be further confirmed by other studies that have indicated that tax incentives usually do not top the list of investment factors in developing countries. A survey was done by United Nations Industrial Development Organization (UNIDO) to find out the importance of tax among other parameters in 2010. 7,000 companies in 19 Sub-Saharan African countries in the areas of agriculture, manufacturing, construction, mining, utilities and services sectors were included in the study. Investors were required to rank the importance of 12 location factors and to assess how they might have changed, improved or worsened, in the preceding three years. The results suggest that tax incentives ranked eleventh out of 12 in importance, just second last, and this importance fell over time. Transparency of the legal framework ranked fifth in investors' concerns and grew in importance. This indicates that investors are more interested in deficient legislation and onerous regulations than in the availability of tax incentives (UNIDO, 2011).

It is worth noting that the benefits that accrue from the incentives depend on the effectiveness of the implementation of the incentives. Effectiveness varies between different countries and different sectors. In some countries, tax incentives seem to have played an important role in attracting new investment and spurring economic growth. Some of the great examples globally are Korea and Singapore, where tax incentives that were offered as part of a broader strategy to attract investment seem to have encouraged rapid industrialization (Tanzi and Shome, 1992). Countries in Sub-Saharan Africa are inefficient in the implementation of tax incentives and due to this, the incentives do more harm than good. Effectiveness in attracting incremental investments is often questionable.

1.4 The study context

The Kenyan government has formulated tax incentives/waivers that grant tax preferences to different taxpayers in the country. Effective application of tax incentives can help the country achieve the intended objective. However, the effectiveness of tax incentives in Africa is very low and Kenya is not exceptional. There is no clear evidence that tax incentives have helped in achieving the intended objectives and whether the right decision-making process is followed during the development of the tax incentives policies. Non-effectiveness in the administration of tax incentives usually has an adverse impact on inequality including gender inequality. The forgone tax can be used to provide services to its citizens and when public services such as health and education are deprived of proper funding, women and girls bear a bigger burden. When the government grants tax breaks of questionable economic value, it is forfeiting many times the amount of spending targeted at women's rights and empowerment.

Tax incentives, (particularly for foreign direct investment) have been considered as being bad in theory and practice. It has been noted that tax incentives are ineffective, inefficient and prone to abuse and corruption, and they distort investment decisions in the country. Due to poor administration, the government loses much-needed revenue and in the end, the poor in society who need government services do not receive them. It is worth noting that most of the persons who benefit from most of the tax incentives are the well-to-do in society. This cannot continue as long as poverty persists, and basic public services remain deprived of funding. This is why organisations dealing with poverty alleviation and economic development are concerned when tax incentives are not given as expected.

Against this backdrop, the study will thus focus on:

- The decision-making process in the tax incentives and whether this may lead to inequality.
- Whether tax incentives that are provided to attract investment may lead to corruption.
- Establish the problem that may arise in international tax competition and the risk of a 'race to the bottom' in terms of corporate income tax.
- The implication of tax incentives on eroding country and county tax bases and hindering the mobilisation of domestic resources that are essential for funding the public policies necessary to achieve Sustainable Development Goals (SDGs).
- The cost implication of tax incentives on investment, job creation and economic growth.
- The implication of tax incentives on revenue loss, low economic efficiency, little investments, increased administrative and compliance costs and excessive tax planning and tax evasion.

- How the study can strengthen social accountability over policy and decision-making to reduce income and wealth inequalities in Kenya through strengthened civil society oversight of public resources to enable them to carry out evidence-based advocacy regarding economic inequality linked to tax policy in Kenya. The study will evaluate the decision process during the determination of tax waivers.
- How to strengthen social accountability over policy and decision-making to reduce income and wealth inequalities in Kenya through strengthened civil society oversight of public resources to enable them to carry out evidence-based advocacy regarding economic inequality linked to tax policy in Kenya. The vulnerable in society were also noted to bear the brunt of the negative effects of tax incentives.
- Mechanisms of advancing greater access to public resources by vulnerable and marginalised groups in Kenya by improving fiscal policies that amplify the voices /of marginalised groups (particularly the women, youth, children, Persons with Disabilities, and People living with HIV and Aids) to oversee the award of tax incentives, prudent public funds spending and contribute to public policy.
- The action(s) will also seek to establish a level playing field across all the Regional Economic Blocs in Kenya and where relevant the EAC region by engaging in evidence-based advocacy to promote the development and operationalisation of cost-effective tax incentives policies and laws that do not promote economic inequalities in Kenya, the EAC region and the neighbouring countries.

1.5 Problem Statement

For a long time, Kenya has not published any regular report that discloses the tax incentives awarded and the estimated revenue lost from the same (IMF, 2020). This is 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 reported to the Auditor-General (Constitution of Kenya, 2010). The first tax expenditure report was developed in 2021 which covered for financial years 2017 to 2020. The report indicated that the budget deficit would have been covered in the absence of the huge tax expenditures. Compared to the GDP, 2017 had the highest tax expenditure 5.15 per cent of the GDP, translating to 437.1 billion. This amount was sufficient to cater for the budget deficit for that particular year. In 2020, the tax expenditure was 2.96 per cent of the GDP which again was above the Africa average which is 2.9 per cent. This is a clear indication that the revenue forgone due to tax incentives is quite high. The amount of tax foregone is enough for the 47 county governments of Kenya.

Though tax incentives are policy instruments implemented by the government to create a favourable environment for economic growth, this has not been the case (Kaufmann & Kraay, 2011). 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 (OECD, 2013). Furthermore, the proper use and administration of these tax policies have become a challenge to the government concerning revenue loss, especially where there are no comprehensive records that can aid it in evaluating the incentives that exist (World Bank 2004).

The more disturbing problem for governments is the propagation of vices such as corruption, tax avoidance and tax evasion brought about by tax incentives. Tax incentives tend to favour the wealthy in society as compared to the vulnerable. The poor may not know the available tax incentives that they can take advantage of. At the same time, it can be noted that most of the incentives given are for capital investments that are mostly available to wealthy people in society who undertake capital investment. Some of the incentives provided for investors include capital allowance, investment deduction, allowance in the telecommunication sector, allowance for computer software, farm works deductions, tax holidays for export processing zones, incentives for newly listed companies and real estate allowances (ITA, 2012). Most of these are more favourable to people who are undertaking capital investments, mostly done by wealthy people in society.

With tax incentives, it is expected that investment will increase, there will be enhanced productivity in the economy and more employment created. However, studies have indicated that no evidence can show a relationship between investment and employment creation in the community where these businesses are set up. On the flip side, it has been noted that where some of the establishments are set up, they affect the poor negatively. To support this argument, a study by Kiria (2015) observed that in developing countries, modern supply chains are increasing their market shares in food retailing at the expense of spot markets and traditional shops which are mainly owned by small-scale traders. It is important to note that these supply chain establishments enjoy investment allowances that small retailers cannot qualify for.

Scholars have argued that the way tax incentives are structured seem to favour the wealthy as compared to the vulnerable in society. It has been indicated that tax incentives targeting the rich are mostly direct taxes while incentives targeting the poor and vulnerable groups are mostly indirect taxes. Where the poor and vulnerable groups were given direct taxes, again these taxes were kept to a certain amount. An example is tax incentives targeting people with disability that is capped at KShs 150,000 per month. Other direct tax incentives targeting vulnerable groups such as low-income earners and the youth have a maximum limit. In some cases, conditions attached to qualify for the incentives make them discriminatory and at times the target persons are unable to enjoy them. However, where there are capital investment allowances like in the real estate sector and manufacturing sectors, the incentives are not capped. This may increase the inequality gap (Oxfam 2017).

The legislation providing tax incentives is usually done through Parliament. However, there is the view that some of the policies are crafted due to lobbying and political considerations. The tax incentives lack a robust legislative and governing framework,

tax incentives have done more harm than good as they favour the rich at the expense of the poor (Mburu, 2021; Wawire, 2020). Lack of governing framework, tax legislation gives tax officials wide discretionary powers to determine the application of these incentives to the taxpayers (Oxfam International, 2017). For example, EPZ Act in Kenya allows the Cabinet Secretary for National Treasury to grant any other exemptions they may deem applicable to the entity (Export Processing Zones Act, 2010). This exposes the entire tax administration to abuse and the risk of corruption.

The lack of a robust tax incentive framework has seen taxpayers taking advantage of the discretionary extension of tax holidays, with entities experiencing tax losses able to apply for an extension beyond the ten years that they are allowed to carry forward their losses. This leaves the entire tax administration open to corruption as businesspeople may try to negotiate their way out by providing bribes (IMF and World Bank, 2020). The tax incentives legislation does not indicate a comprehensive criterion of which entities can be given incentives (Oxfam 2017). This leaves the entire matter vague as to the minimum investment and shareholding required to qualify for waivers, the number of local people who will be employed within these entities to promote job creation and how it will be ensured the expected beneficiaries have benefited. This opens a window of corruption in the tax administration (United Nations Conference on Trade and Development (UNCTAD, 2000).

The objective of tax incentives is to encourage investment and certain behaviour in the economy. Women are usually economically disadvantaged as compared to men (Oxfam, 2017). It is rather unfortunate that there are no taxes incentives targeting women specifically as a way of encouraging them to invest except for VAT exemption on sanitary pads. This is even though women, for instance, most of the time earn low income compared to men even for similar job grades. Women are also over-represented in the informal sector and have historically been discriminated against in economic matters such as property ownership. Even when tax incentives are given, generally, women benefit the least. Evidence has shown that only 33 per cent of women in Kenya own movable property and only 1 per cent of women own titles to land. Therefore, when there are capital allowances given in the tax incentives, most women do not enjoy this allowance since they do not undertake capital investment and do not own land (Oxfam, 2017). Thus, the benefit given through tax is not fair to women.

The vulnerable people in society rely heavily on the government for services such as medical and education. Failure by the government to collect enough tax due to tax incentives may affect service delivery, with the most affected remaining vulnerable. However, the government has not been proving reports on the amount of tax forgone and the amount of investment made as a result of tax incentives (Tirimba, Muturi, Sifunjo, 2016). Generally, 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 and there is no evidence that there were investments due to tax forgone (Ricciuti & Savoia, 2019). The forgone revenue, therefore, may have huge implications for the vulnerable in society.

1.6 Rationale for the study

A good tax system should be equitable, fair and efficient and maximises revenue collection in the country. Therefore, whether there are tax incentives or not, the tax system should be just for everyone. Unfortunately, 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 forgone from tax incentives.

From the aforementioned, tax incentives in Kenya seem not to be working for the benefit of Kenyans on 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 targeted revenue, the government has been known to indirectly shift the taxes to existing consumers and businesses. This leaves a huge burden of tax to common citizens or smaller businesses, both of whom are struggling to stay afloat in the already harsh economic times. Similarly, incentives tend to discriminate against local firms as they are mostly granted to foreign investment companies, hence disadvantaging local companies. The result of the tax incentives is an increase in inequality in the country.

Due to the inefficiencies, tax incentives act as a trigger of inequality instead of being a tool for the redistribution of income in the country. It is therefore important to undertake this study on tax incentives and whether it creates income inequality in the country. 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.

1.7 Objectives of the study

The objective of the study is to produce a comparative analysis report on the existing tax incentives and decision-making processes across the seven economic blocs in Kenya and where relevant, the East African Community (EAC) region to transpose learnings from neighbouring countries.

1.7.1 Comparative Study Objectives and Expected Results

The following were the specific objectives of the study:

- i. To undertake an overview of tax incentives offered in Kenya and develop a comparative analysis report on existing tax incentives and decision-making processes employed in Kenya and, across the seven economic blocs and where necessary, the EAC region.
- ii. To explore the positive and negative impacts of tax incentives by multinational corporations and other agencies present in Kenya and how they contribute towards income and wealth inequalities in Kenya.

- iii. To find out whether there is a correlation between tax incentives and high levels of corruption in the granting of tax incentives by government officials to entice investment.
- iv. To examine the tax incentives and decision-making process that lead to income and wealth inequalities in Kenya.
- v. Preparing a report where the findings of this research will help in coming up with viable alternatives that can serve to highlight existing tax incentives and decision-making processes that drive income and wealth inequalities and whether this has led to high levels of corruption in Kenya.

1.8 Scope of the study

The purpose of the study was to carry out a comparative analysis report of the existing tax incentives and decision-making processes that lead to income and wealth inequalities across the seven economic blocs in Kenya, where the study focused. Tax incentives may have different implications for the economy. However, this study focused on the influence of tax incentives and the decision-making processes that lead to income and wealth inequalities.

1.9 Significance of the study

The government has been giving tax incentives to investors in the country and counties have been giving tax waivers to investors at the counties. The incentives have been noted not to achieve the intended objectives as there could be an abuse of the tax incentives in the country. The study will be of great help to both national governments and county governments as they will be able to know how to improve tax incentives policies and framework to enhance implementation of the tax incentives policies. The current tax policies are not effective and efficient, making the government to lose revenue from the tax incentives that are claimed by business that take advantage of the loopholes in existing tax policies. With recommendations from this study, the government will be able to improve the tax laws and policies and seal some of the gaps. This will minimise the revenue lost during the administration of the incentive.

The results of this study will be beneficial to the public. As noted in earlier studies, tax incentives increase the income inequality gap. This study will identify where the government goes wrong in the development of tax incentives policies and implementation of the same, a great benefit to the public. Several scholars have been undertaking research on tax incentives and the debate on whether tax incentives are beneficial to an economy has never been concluded. This study will add to the body of knowledge about tax incentives. The study will also benefit the potential investors who are the main beneficiaries of the tax incentives. An effective and efficient tax incentives policy makes it easier for investors to enjoy the tax incentives provided by governments. The objective of tax incentives is to encourage investment that will result in employment. If the incentives are implemented effectively and the employment opportunities objective is achieved, the public will benefit from the new job opportunities.

1.10 Risks to conducting the assignment

We have identified two risk factors that can affect the workflow and reports from this assignment:

- i. Individual and focused-group meetings: The resurgence of COVID-19 creates a challenge when it comes to meetings. The assumption was that the respondents would be able to meet the researcher despite this, and that the consultant will be facilitated for timely access throughout the assignment. The necessary COVID-19 protocols as guided by the Ministry of Health were adhered to and this ensured that the study went as guided.
- ii. Political climate: This research was undertaken at a time of active politics for different offices in Kenya. Some of the target respondents were involved in the campaigns and this affected the completion of the study. It was realised that due to elections some target respondents were involved in the elections either directly or indirectly. It was also noted that after elections, there were transitions taking place and this affected availability of respondents. To mitigate this risk, the researcher persuaded the respondents and indicated the importance of the study during the transition period. Where possible, TI-Kenya contacted the respondents directly as a way of lobbying for responses.
- iii. Delay in completion of the report: Due to the delay in getting the respondents, there was the risk of delay in the completion of the report. To mitigate this risk, the researcher developed a crush programme that ensured the final report was given within 15 days after the end of the contract without compromising the quality of the study.

2 THEORETICAL UNDERPINNING

This section discusses the theories that support this study. The research is anchored in the Laffer Curve theory and New Growth (endogenous) theory.

2.1 Laffer Curve Theory

This theory was originated in 1974 by supply-side economist Arthur Laffer to show the relationship between tax rates and the amount of tax revenue collected by governments. In this theory, the curve is used to demonstrate Laffer's argument that at times reducing tax rates can increase total tax revenue. He explained that a lower tax rate could encourage additional output and would increase income, which builds a bigger tax base in an economy by improving the growth of business enterprises (Latif et al. 2019). Thus, even if the government may lose some tax due to reduced tax rates, in the long run, the government will benefit from more tax revenue. The theory is of the view that tax incentives have a positive and statistically significant effect on the growth of the economy. The theory holds that tax incentive is all about ways of reducing taxes for businesses and individuals in exchange for specific desirable actions or investments on their part. The research, therefore, used the Laffer curve theory because it provides an economic justification for the politically popular policy of cutting tax rates.

2.2 New Growth Theory

Economist Paul Romer developed this theory of economic growth with "endogenous" technological change. The core idea of endogenous growth theory maintains that economic growth is primarily the result of internal forces, rather than external ones. It argues that productivity improvements can be tied directly to faster innovation and more investments in human capital from governments and private sector institutions. The provision of tax incentives is in the form of either tax relief or cash grants. International experience shows that such incentives play only a minor role in investment decisions. Firms make investment decisions based on many factors including projections of future demand, certainty about future government policy, prevailing interest rates and moves by competitors. In general, neo-classics see incentives as good to have, but not deal-breaking. Yet incentives remain a popular policy for both developed and developing countries. This theory, therefore, holds that the influence of tax incentives on investment is minimal, if any.

3 METHODOLOGY

This section discusses the methodology, target population, key stakeholders of the study, data collection procedure and data collection tool.

3.1 Research methodology

The study was based on desk research from secondary sources on Kenya tax laws and other regulations that guide tax incentives, County Governments Waiver Administration Act for the different counties and the relevant County Government Acts, a review of global best practices and responses from various key informants from the national government, regional economic blocs, private sector and civil society. The policy and legal review for this study adhered to several principles that included:

- Being strategic in the review by identifying common issues and challenges among all the taxpayers.
- Considering how the study will support and strengthen policy and legislation tax incentives development and implementation.
- The value added to what is already known and well-documented in the previous studies on Kenya on tax incentives.
- Establishing the link between the impact of tax incentives and the influence on income inequalities in the economy.
- Developing recommendations that will help in the improvement of policy and legal framework, both in the national government and the economic blocs.
- Appreciating that policy and legal frameworks are interdependent and are both essential for successful tax incentive policy implementation.
- Following a practical and realistic approach and not a technocratic approach gives a bit of more realistic advice.

To achieve the objective

- i. Tax policies and relevant legislation were reviewed in line with the tax incentives provided. This involved reviewing all the Acts of Parliament.
- ii. The previous study on tax incentives was reviewed and key findings documented.
- iii. Reports on best practices globally were reviewed and key observations documented.

3.2 Stakeholder engagement

An important aspect of tax incentives was to involve the stakeholders in this study. To achieve this, key informants were identified who were to represent different players in the development of tax incentives policies and legislation, those involved in the implementation of the policies and the beneficiaries or those affected by the incentives. An interview guide was developed and shared with key informants who were then followed to schedule meetings with the stakeholders. The focus of the discussion was on governance and rule of law in the administration of tax incentives, transparency in the implementation of tax incentives policies, effectiveness and efficiency in the implementation of tax incentives policies and review of the implementation of tax incentives policies.

3.3 Population of study and key stakeholders

For this study, the population is all parties that interact with tax incentives in one way or another. The accessible population for the study is indicated in Appendix I.

3.4 Data collection procedure

To achieve the objectives, this study started with a document review that included different legislation documents that have been developed on tax matters. Policy guidelines by the government that steer the implementation of tax incentives in Kenya were also included. This also included other government reports that guide the implementation of tax incentives. The different studies conducted on tax incentives also formed the basis of document review. From the reports, the guiding principles in decision-making during the development of tax incentives were well identified and understood.

Having completed the document review, the study then collected data from key stakeholders who interact with tax incentives in different capacities as key informants. This was done through structured interviews and focus group discussions as was the case with different stakeholders. A report was then prepared on the comparative analysis of the effect of tax incentives and income inequality in Kenya.

Having conducted a literature review and collected data and analysed, a report was compiled. The study will document tax incentives offered in Kenya and develop a comparative analysis report of existing tax incentives and decision-making processes employed in Kenya and in particular across the seven economic blocs and where necessary, the EAC region. The study will focus on income tax policies, public finance management policies, tax incentive guidelines and other policy documents relating to tax that will have been reviewed. This report will indicate the different tax measures and the different tax incentives that are given under the current income tax system.

The study will further explore the positive and negative impacts of tax incentives by multinational corporations and other agencies present in Kenya and how they contribute towards income and wealth inequalities in Kenya.

3.5 Data collection tool

In 2015, the G20 Development Working Group requested the staff of the International Monetary Fund, the Organisation for Economic Co-operation and Development, the United Nations and the World Bank to develop a tool that can be used to evaluate tax incentives. The report benefitted from consultation with other organisations working in the tax field, officials of developing countries, civil society organisations and business representatives. The tool developed by the organisation is free to use. Lamb (2004) indicated that the use of existing survey questions is acceptable if the questions are testing the same thing. Laura, Lamb and Bulmer (2006) advise that while using existing questions in a study, customisation is necessary, and the same should be done where there is a need. For this study, the questions developed for G20 for assessing tax incentives will be used and customised as necessary. Customisation was done after the literature review for the research to have a full understanding of tax incentives' implication on income inequities. The questions are categorised into four areas namely: Governance and rule of law, transparency, efficient administration and incentives reviews.

4 POLICY, LEGISLATION REVIEW AND FINDINGS

Under this section, the policy and legal issues surrounding tax incentives and waivers with key principles from international practice and theory are discussed. This section outlines general or overarching policy and legal issues and the implication of income and inequality among the citizens. The review was based on desk research from secondary sources on different legal frameworks, the Kenyan tax system, tax incentives /waivers and international practice as well as responses to interviews held with different stakeholders.

4.1 Legal Framework for Governance and Establishment of Economic Blocs

Kenya follows a devolved system of governance where there is the national government and 47 county governments. The counties have formed six regional blocs in Kenya namely: Lake Region Economic Bloc (LREB), South Eastern Kenya Economic Bloc (SEKEB), Jumuiya ya Kaunti za Pwani (JKP), Frontier Counties Development Council (FCDC), North Rift Economic Bloc (NOREB) and Mt Kenya and Aberdares Region Economic Bloc. The formation of the blocs is anchored on Article 189 (2) of the Constitution, which provides that: “Government at each level, and different governments at the county level, shall co-operate in the performance of functions and exercise of powers and, for that purpose, may set up joint committees and joint authorities”. This provides the legal basis that enables the counties to form economic blocs.

This Article of the Constitution is given effect through the provisions of the Intergovernmental Relations Act, 2012, which provides for inter- and intra-governmental structures for consultation and cooperation, while section 6(3) of the County Governments Act, 2012 provides that: “A County Government may enter into partnerships with any public or private organisation following the provisions of any law relating to public or private partnerships for any work, service or function for which it is responsible within its area of jurisdiction”.

Though the establishment of blocs is supported by law, and the establishment of the blocs was started, the Regional Economic Blocs (REBs) are at various stages of formation and operationalisation. The negative effect is that REBs do not have clear governance structures, pointing to a varied framework of command and leadership. It was also noted that some counties belong to more than one REB and there is no clarity on the specific functions of REBs, owing to a lack of policy and legal framework. This hampers the success of the operationalisation of economic blocs. There is a need for an overarching policy to guide the establishment and operationalisation

of the blocs (CoG, 2021). This inadequacy has affected the integration of economic activities and specifically the crafting of a Finance Bill that stipulates the tax and charges in the county. From the study, counties have not developed strategies to harmonise revenue collection and tax waivers and each county handles its tax matters independently.

4.2 Legal Framework for Revenue Administration and Compliance

The Constitution makes no express provision for powers to collect, administer and enforce taxes or other forms of revenue. This is made clear through legislations that guide tax collection procedures.

4.2.1 National Government taxes

National taxes are reserved to the national government under the Constitution and are collected, administered and enforced following the Tax Procedures Act 2015 and as provided by various tax laws. Article 209(1) reserves the power to raise income tax, values tax, customs duties (and other duties on imports) and excise duty to the national government. The national government may be empowered to raise any other tax by the Act of Parliament, except the two express taxes that are reserved for county governments (Article 209(2)). In the enactment of various laws relating to taxation, the government has been providing tax incentives to meet fiscal needs. To achieve the objective of the study on taxes at the national level, it was necessary to review different laws and policies as indicated below:

- i. The Constitution of Kenya, 2010
- ii. Income Tax Act
- iii. Customs Duty Act
- iv. The Value Added Tax Act, 2013
- v. The Value Added Tax (Electronic Tax Invoice) Regulations, 2019
- vi. Excise Duty Regulations, 2019
- vii. The Tax Procedures (Alternative Dispute Resolution) Regulations, 2019
- viii. Tax Procedures Act, 2015
- ix. Tax Laws (Amendment) ,2020
- x. Export Processing Zones Act
- xi. Special Economic Zone Act
- xii. Public Finance Management Act, 2012
- xiii. Intergovernmental Relations Act, 2012
- xiv. County Governments Act, 2012
- xv. Investment Promotion Act
- xvi. Tax Procedures (Tax Agents) Regulations, 2019

4.2.2 County Government taxes

- Land and property rates
- Parking fees
- Market fees
- Lease rent
- Hospital/health service charges
- Single business permits
- Trade/building permits
- Advertisement and billboard fees
- Liquor licenses

There is no equivalent law (setting out all the administrative powers for enforcement and collection) for the taxes, fees and charges reserved for counties. Historically, these powers are located within the Act that imposes the relevant tax or fee/charge in finance acts passed by county assemblies. This results in differing administration frameworks, dependent on the revenue stream and its enabling legislation. The Public Finance Management Act, 2012 establishes receivers of county revenue and empowers the appointment of collectors of county revenue, including the KRA under specified criteria. On tax waivers in the counties, each County developed the County Governments Waiver Administration Act to guide on granting of waivers at the counties. These Acts provide on how an investor can enjoy tax waivers for the taxes that are within the jurisdiction of the specific county assembly.

4.2.3 Review of reports

Different studies that have been done relating to tax incentives were reviewed, focusing on Kenya or other developing countries. The main focus was on reports touching on tax incentives and some of the articles reviewed in broad perspective are as indicated in the appendices.

4.3 Legal Provision on Tax incentives

The Kenyan government provides tax incentives to encourage investment, technology transfer, investment in specific geographic areas, employment, protection certain industries, meet the international obligation and increase consumable income. There are exemptions that all Kenyans can benefit from as long as they attain certain criteria while there are others that requires one to be an investor to qualify. For an investor to qualify for the tax incentives, they must be registered as an investor under

the Investment Promotion Act, 2004. For one to qualify as an investor, he/she must meet the following provisions of the Act:

- Creation of employment for Kenyans
- Acquisition of new skills or technology for Kenyans
- Contribution to tax revenues or other government revenues
- A transfer of technology to Kenya
- An increase in foreign exchange, either through exports or import substitution.
- Utilisation of domestic raw materials supplies and services.
- Adoption of value addition in the processing of local, natural and agricultural resources
- Utilisation, promotion, development and implementation of information and communication technology

Having registered as an investor as per the Investment Promotion Act, 2004, there are some fiscal incentives offered by the Kenyan government. It mainly focuses on tax holidays, carry forward and carry back losses, tax credits and investment allowances. The incentives include:

• Capital Allowances	• Public expenditures
• Investment deduction	• Telecommunication sector allowance
• Industrial building deduction	• Computer software
• Farm works deduction	• Insurance relief
• Special economic zones incentives	• Mortgage relief
• Export processing zones incentives	• Home ownership savings plan (HOSP)
• Incentives for Newly Listed Companies	• Retirement benefits savings relief
• Incentives through Double Tax Agreement	• Collective investment schemes
• Medical Incentives	• Exemptions on VAT

Over time, the government has been giving the above tax incentives. The tax expenditure for the last 4 years is as shown in the table below.

Table 1: Tax Expenditure

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

Source: National Treasury 2022

From the table, the government foregoes huge amounts of tax revenue from the tax incentives. In 2020, a total of KShs 318 billion was the foregone amount which is almost equal to the funds that go to the 47 counties. The question that arises is whether the government benefited from this expenditure in other ways.

4.4 The Influence of Tax Incentives on the Economy

The government provides incentives with the focus of stimulating or inhibiting certain activities in an economy. Generally, the purpose of tax incentives is to encourage investment, technology transfer, investment in specific geographic areas, employment, protection of certain industries, meet international obligations and increase consumable income. From the study, the respondents indicated the contribution of tax incentives that supports the objectives of granting tax incentives. It is important to note that there was no data to support most of the positive contributions that were indicated to be coming from the incentives. The following were the main contributions of the tax incentives.

4.4.1 Encouragement of investment

It was noted that investors consider taxes as a burden to their businesses and therefore tend to shy away from investing in the country when tax rates are high. It was also observed that at the initial period of investment, the returns from a business are low. At the same time, the business may not have recovered from cash outflow during its establishment of the business. When an investor is given a tax holiday or reduced tax rate, it goes a long way in cushioning the financial cash flow of the enterprise and this encourages investment.

4.4.2 Increase in employment

The respondents indicated that tax incentives/waivers had a positive impact on the increase in employment. A case well noted was tax waivers that are given to landlords on land rates arrears and penalties that opened investment in the counties that the waivers were granted. Nairobi City County, Nyeri County and Machakos County were cited as examples. It was noted that some of the properties had accrued land rate arrears and penalties that were so huge that if the investor was to clear the arrears, they will be left with no funds to develop the property. Because of this, the investors avoided such properties. The waiver of arrears and penalties eased the burden on them, and they were able to develop the properties in the counties. The development of the properties triggers economic activities that include the supply of raw materials and labour. But what lacks again, is data to compare the waiver given and the value of employment created.

Encourage investment in specific geographic areas

The focus of this is to encourage investment in other underdeveloped areas of the country. These were incentives that were given to investors who invested outside Nairobi, Mombasa and Kisumu cities. The objective of the policy was to decongest the cities and at the same time, encourage investment outside the cities. It was indicated that few industries were established as a result of this. It was however noted that the industries were not established far from the city centre and secondly, there is no well-documented data on how many industries were set up because of this.

4.4.3 Encourage technology transfer

Technology is a key driver for a more vibrant and growing economy. Cognisant of this, the government has been providing waivers to investors who can demonstrate that by investing in Kenya, they will assist in technology transfer. This includes firms that operate in EPZ, SEZ and the construction industry. The technology transfer has been a success, especially in the construction industry where the involvement of local persons in the construction being undertaken by foreigners has seen the locals gain new technology. The only challenge with this is that there is no data on the level of technology transfer and whether the value of technology transfer is equivalent to the value lost in terms of tax revenue.

Encourage export

To make the export industry competitive, the government provides tax incentives to export processing zones, where the firms enjoy lower tax rates and tax holidays. This gives the firms operating in the zone an advantage over others and therefore motivating them to export than sell internally.

4.4.4 Encourage capital accumulation

Capital accumulation is critical for the development of a country as it influences the economic performance of the country. To encourage capital accumulation, the government suspends capital gain tax on Nairobi Securities Exchange. This has seen investors prefer to retain the profits in the organisations as capital gains are tax-exempt compared to dividends and this helps in capital accumulation. The government also grants tax exemptions for savings in pension schemes as a way of encouraging savings in pension schemes.

4.4.5 Cushion livelihoods

The government grants a waiver to cushion its citizens during harsh economic times. This was done during the COVID-19 pandemic when the government exempted those who were earning income from paying taxes. By this, the disposable income of the citizens increased.

4.4.6 Encourage usage of certain products

Tax waivers are granted to increase consumption of certain products whose usage the government believes is beneficial to the economy. Cases in point are the exemption of solar accessories from VAT as a way of encouraging people to embrace green energy. There is a reduction of VAT on motorbikes as a way of encouraging the usage of motorbikes and in the long run, creating employment. Tax waivers on this have been effective in encouraging consumption and increasing employment. Unfortunately, there is no well-documented information on the actual contribution to the economy.

4.4.7 International obligations

As part of international obligation, some items are exempt from taxation. For instance, supplies that are made by diplomatic service offices are exempt from taxation as an international obligation. These are agreements that exist among the countries as a way of enhancing relations and this has been achieved.

4.5 The relationship between tax incentives and decision-making processes that lead to income and wealth inequalities across the Seven Economic Blocs in Kenya and where relevant, the East African Community (EAC)

The focus of this study was to establish the relationship between tax incentives and whether there is any relationship with income inequalities. The results have synthesised the feedback from the respondents and what was extracted from the documents reviewed. The findings are discussed in the succeeding section.

4.5.1 Gaps in tax laws administration resulting in investors claiming tax incentives unfairly

There is a gap in tax laws, and this allows an unfair claim of tax laws. The Constitution of Kenya provides that the burden of taxation shall be shared fairly. Though the purpose of tax incentives is to attract investments and meet other objectives, there are cases where tax incentives are claimed by investors who ought not to, and this makes the matter of tax incentives unfair.

First, it was observed that some organisations are not honest in the figures they use for purposes of depreciation, where the amount of depreciation declared is higher than the actual amount. The law does not provide a framework for how this can be mitigated. Secondly, regarding the losses that are declared by these organisations and used to offset tax payable, the government may not have the capacity to confirm with certainty that the company incurred the losses. Therefore, in case a business entity uses creative accounting, then the business benefits from the incentives illegally, yet there is no clear mechanism to mitigate. The government loses revenue that would have gone a long way in providing much-needed services.

Tax incentives and preferential tax treatment create unintended and unforeseen tax-planning opportunities. Tax planning involves businesses hiring services of tax planners to help in tax planning to take advantage of tax incentives. Thus, even without the tax incentives, the business would still be operational. Nonetheless, the moment the incentives are provided, efforts are made to take advantage of the same.

When tax incentives are offered in developing countries, they result in little additional investment; most investors would still have invested without the offer of tax incentives. When the incentives are for a specific sector, investors will try to align themselves with the sector-granted exemptions to take advantage of the incentives. There are cases where companies operating in export processing zones have completed the 10-year tax holiday to re-constitute themselves and start enjoying the 10-year tax holiday again. If this happens the government has no recourse, and it will lose much-needed revenue. In the counties, most of the tax waivers are related to land rate arrears and penalties. The counties would give waivers and again, even investors who would make to pay for arrears and penalties take advantage of the waivers as there is no clear policy that guides who qualifies and who does not qualify.

The benefits of tax incentives irregularly and illegally disadvantage the poor in society as they are not able to use the above provisions and claim for tax incentives. Secondly, failure by the government to collect tax denies them government services (Padilla, Biyani, Maranga and Quantrill, 2020). This increases the inequality between the rich and the poor in society.

4.5.2 Tax incentives policies are a result of lobbying by the wealthy in the society

The respondents indicated that some of the tax incentives given to business entities are a result of lobbying rather than being informed by facts. It was noted that lobbying requires resources and networking with the policymakers; this leaves the vulnerable who may not have the resources or the network out of the lobbying circle. A case that was noted in this regard was during the enactment of VAT 2013 which sought to rationalise VAT exemptions as part of a commitment to the IMF in return for their balance of payment assistance to Kenya. From the review of the Act, the government wanted to eliminate all exemptions on some items including basic foodstuffs and essential supplies. The inclusion of VAT on essential supplies was opposed by the public and MPs and they were exempt. However, there was a negotiation to exempt light aircraft and helicopters and their spare parts from the VAT. The argument advanced then was that failure to exempt the light aircraft and helicopters from VAT will bring some of the airport operators to halt and they may close their business. However, it can be noted that the majority of the people that use the aircrafts are rich and those who operate light aircraft and helicopters are also wealthy people. What can be concluded from this is that the airline operators could manage to lobby their case listened to and determined, while other small-scale traders could not get such a chance. In recent times (2020), the government imposed a 1 per cent turnover tax on all businesses that operate in Kenya, eliciting complaints from the business community. During this time, Kenya Airways (KQ) sought to be exempted from turnover tax, and through due process, the same was granted. Though KQ's point of argument could be correct, they were given an exemption, because they could lobby for the same. In 2022, ILAM Fahari I-Reit negotiated to be exempted from withholding tax (CMA, 2022). This leaves out those other businesses that cannot lobby to the mercy of the tax man and therefore, inequalities may go higher.

4.5.3 There is no regulation or framework approved by Parliament on the implementation of tax incentives

The implementation of tax incentives is affected through a tax guidelines/framework that was developed by the National Treasury. It should also be noted that the framework was developed by the National Treasury without oversight from Parliament. The lack of this oversight is what causes an uproar when certain business sectors get exemptions. Thus, even if tax exemption was fully justified by the fact that the authority implementing the exemption is the same that developed the

framework, the decisions may be questioned. There is a need for a framework/policy to be approved by Parliament. There should be a regulation by Parliament guiding how implementation shall be done.

The guidelines provide that implementation of tax incentives is at the Executive level only, yet the tax incentives reduce the national revenue that is approved by Parliament. As per the guidelines, the application is done through writing to the Cabinet Secretary, the National Treasury. The guidelines provide for discussion between the National Treasury and the person requesting for exemption. This discussion creates room for underhand dealings. Thus, it would be prudent if the tax incentives are subjected to a legislative process, consolidated under the tax law and their fiscal costs reviewed annually as part of a tax-expenditure review. In addition, the approval process of tax incentives may involve several stakeholders, who give their input on the tax process. As the case stands, the respondents indicated that the guidelines leave room for corruption as there is no segregation of duties.

4.5.4 Displacement of investment of small-scale investors

With tax incentives, there are risks of investment displacement of domestic investment by foreign investments or of small-scale traders by large investors. The respondents indicated that some of the big establishments like supermarkets and other market malls create employment opportunities. However, they observed that small retailers and small manufacturers are pushed out of business as they cannot compete with such big establishments. Thus, though there are jobs created, there were others that were eliminated due to the same business establishment, and therefore, just a replacement for domestic investment. Despite the displacement of domestic investment, the respondents indicated that this may exhibit inequality from the point of earning. When the persons are employed in these new establishments, they are paid a salary that is limited up to a certain level, unlike their establishment where they can increase their income through more efficient operations, thus increasing the profits. The problem is that there could be an increase in FDI with no increase in total investment in the country. It may be viewed like there was an improvement in job creation and economic activities, but in actual sense, it is a shift in employment.

4.5.5 Exemption of capital gain favours the wealth in the society

Capital gains tax was first introduced in 1975 as a response to the growing demands for equity and redistribution by seeking to tax the wealthy. As per the income tax laws, capital gains tax is a tax on the profit when an asset that has increased in value is sold. It is the gain made that is taxed, not the amount of money received. Taxing capital gain is considered progressive as wealthier people are far more likely to own and trade assets that gain value (such as property, land, artwork, shares, etc.), and therefore profit when they are sold. Though the tax was popular with the public, it faced very vocal opposition from leaders and other wealthy people who had to bear the weight of the new tax. Members of Parliament who were against the tax argued that it was unfair to tax capital gains and that the tax would dissuade the holders of

capital from investing in Kenya. Due to opposition by leaders, the rate was reduced from the initial 36 per cent to 10 per cent, and a broad-based sales tax introduced to meet the growing gap in revenues. There have been reviews of this tax in Kenya, which was suspended in the mid-1980s.

Though capital gain tax was later revived, it was at a lower rate compared with the rest of the region. In Tanzania, for example, it levies a capital gains tax of 10 per cent, while Uganda taxes capital gains at the same rates as personal and corporate income tax. The rate is minimal compared with the top marginal rate of 30 per cent top rate on labour and 16 per cent payable on VAT. Though the argument for the suspension of this tax is to encourage investment, on the other hand, it has been noted that taxes are not a major consideration when it comes to investment. Thus, the country denies itself the much-needed revenue that would go a long way in meeting public needs. Giving tax incentives to those who get capital gain from their operations and taxing every other person increases the inequality gap.

The capital gain tax also faced opposition from players in the capital markets after the reintroduction of the tax in the 2014 Finance Bill. The Kenya Association of Stockbrokers and Investment banks (KASIB) threatened to suspend trading at the Nairobi Securities Exchange (NSE) until the issue was resolved. The government attempted to reach a compromise with KASIB through the introduction of a lower rate of 0.3 per cent withholding tax on gains from listed securities in the 2015 Finance Bill. Eventually, faced with the risk of losing investors and aggressive lobbying, the government gave in to the demands and through an amendment in the Finance Act exempted gains from listed securities from tax. Thus, with the lobbying, the government had to withdraw the tax.

Most of the persons who trade in the security exchange again are persons with extra funds to set aside for investment. The government on the other hand has invested its resources in ensuring the capital market is sound. Yet the persons benefiting from the security market are not willing to contribute to the government through taxation. Going by the transactions that take place in security exchange, an increase in the capital gains tax rate could go a long way to help reduce the inequality exhibited in taxing capital at a lower rate than labour. Furthermore, it would help reduce tax avoidance and evasion and the resultant erosion of the tax base. The discrepancy in the tax rates for income and capital gains encourages tax dodging by allowing corporations and individuals to re-characterise their income as capital gains and therefore benefit from the lower tax rate. For instance, wealthy individuals prefer not to receive dividends but to retain them as income. When the shares gain value due to retained dividends, they dispose of the shares and get the tax-free capital gain.

4.5.6 Incentives are not grounded on economic strategy

Respondents also indicated that tax incentives are a poor response to the economic or political problems that may exist in a country. They argued that if a country has inadequate protection of property rights, rigid employment laws, or a poorly functioning legal system, it is necessary to engage in the difficult and lengthy process of correcting these deficiencies rather than provide investors with additional tax benefits. It was noted that investors are not ready to risk their resources even with tax incentives given the above weakness.

In one county, it was indicated that property owners were reluctant to pay property rates and they had accumulated arrears out of the feeling that the county government was providing the necessary services required for urban development. Instead of the government providing the amenities to encourage disclosure and payment of the rates, they opted to give waivers to property owners. The decision to give waivers was a way of covering the government's failure instead of correcting the situation and at times because of political mileage. This is unfair treatment of citizens as not every person was to benefit from the decision. The majority lost as few property owners benefited yet the revenue forgone was substantial and would have benefited the county. The Nairobi City County Government in September 2022 granted tax exemptions to filmmakers and photographers, but no facts and figures were provided to support this.

A survey by World Bank Global Investment Competitiveness (GIC) noted that factors such as political stability and security and a business-friendly legal and regulatory environment are at the top of an investor's list when choosing where to invest, with 86 per cent of those interviewed stating the legal and regulatory environment as critical. Macroeconomic stability, the pool of skilled labour, infrastructure and low tax rates were other factors noted as important. Therefore, a country should focus on the main factors that attract investment to her. Tax features such as tax incentives can play an enabling role to help attract investment into a developing country by helping to reduce the cost of doing business. For there to be new investment, it is important for the government to have a clear policy on tax incentives, otherwise, the beneficiary of taxes may be business that would be started with or without tax incentives. A tax incentives analysis by Copenhagen Business School also concluded that tax holidays are not an effective tool for developing countries to achieve sustainable development and are more likely to undermine than facilitate growth.

4.5.7 Tax incentives lack clarity on the level of contribution by those exempted from tax

The law provides for investment allowance to encourage investment, job creation, technology transfer and employment among others. However, the laws are silent on the minimum investment required, a minimum shareholder requirement and no minimum requirement for the proportion of local people employed. Therefore, a company may be enjoying the tax incentives, yet the objective of creating employment

and technology transfer is not achieved. This denies the government the much-needed revenue without benefits to the country. In Kiambu County, it was noted that some industries have been set up and who enjoy capital allowance deductions. The leadership of the county was not convinced that the benefits from these industries in terms of job creation were equivalent to the allowances they were enjoying. This emanated from the fact that some industries are highly automated such that though the investment is enormous, the human resources required was low. The leadership of Kiambu viewed that it was losing and thus denying the common citizen benefit he or she would have received if taxes were paid in full.

4.5.8 Risk of firms transforming into new entities special zone

For an investor to qualify for tax incentives in the special economic zones and export processing zones, there are set criteria, with some of the tax incentives running for a specific period. For example, companies operating in the Export Processing Zone enjoy tax holidays for the first ten years. There are, however, no measures in place to prevent an entity that completes the 10-year tax holiday from winding up and registering afresh, thereby continuously benefitting from the tax holiday. The owners and investors in the EPZ again may be the elite who can have their organisations in the zones.

An investor thus may enjoy tax incentives beyond the maximum period through transforming the business entity. This is against the principle of fairness in taxation and denies the government the much-needed revenue to provide services to the vulnerable.

4.5.9 The threshold for some incentives is out of reach for small enterprises

Currently, the Income Tax Act provides for a deduction of 100 per cent of the cost of the equipment for investment in the construction of industrial buildings or the installation of machinery and equipment in a building. Construction of a building for an amount of more than KShs 250 million outside Nairobi and Mombasa is entitled to an investment deduction. This incentive was intended to boost investment and manufacturing outside the Central Business District. Going by this requirement of KShs 250 million leaves out the majority of the citizens enjoying the incentives as few can afford this. Another incentive out of reach by the common person was the Business Laws Amendment Act, 2020 in March 2020 that provided for investment deduction of 150 per cent where a person incurs capital expenditure of at least KShs 5 billion on the construction of bulk storage and handling facilities for supporting the Standard Gauge Railway (SGR) operations.

Respondents were of the view that smaller investors in the stated areas would have benefited from the incentives if the threshold was lower. Leaving out smaller investors in such tax incentives just makes the inequality gap wider.

4.5.10 Incentives are redundant in terms of location

The incentives to decongest the cities have not borne fruits as investors consider other factors other than the tax incentives. From the study, there are no factories that can be indicated to have been started outside the cities, solely due to tax incentives. These incentives therefore become redundant as far as the intended objective is concerned. On the other hand of redundancy, the incentive has been utilised by other players who ought not to. The objective of the incentive was to encourage manufacturing companies to set up businesses outside the cities and therefore enjoy the taxes. However, there is another business by nature whose operations can only be established in rural areas such as agro-processing manufacturing companies such as tea factories. Thus, whether there were incentives or not, they were still to be established in the rural areas. However, the fact is though there are incentives, they still claim the same and therefore deny the government the much-needed revenue. These incentives, therefore, are doing more harm than good as there is no correlation between the tax incentive and decongesting the cities, yet those who ought to be paying tax are not paying. The tax incentives were not adding value to investment, and they were making the government lose revenue.

The World Bank (2014) noted that a country like Burundi which is among the poorest countries globally is still seen as providing tax incentives that are not necessary. Burundi ranks 180th out of 186 countries in terms of the Human Development Index, whilst nearly 64.9 per cent of the population live below the poverty line. With this kind of poverty, the government is not able to provide basic public services and the people who suffer most are the vulnerable in the society. With the country providing incentives despite its poverty levels, a survey by IMF on tax incentives indicated that 77 per cent of the tax incentives were redundant, meaning they were unnecessary, thus depriving the country of much needed revenue.

4.5.11 Investors engaging in transfer pricing schemes

Investors have been found to avoid tax burdens through transfer pricing. The unfortunate part is that this usually happens by organisations well established to a certain level and they have different related entities. Small enterprises that belong to the small investors may not be able to do this due to their nature of operations and mere size. This is against the principles of taxation; it is unethical and advances inequality as small businesses cannot be able to transfer pricing pay tax in full.

4.5.12 Discretionary powers which are prone to abuse at the expense

As per the EPZ Act, export processing zones are areas designated for the manufacture of exports. Kenya introduced the EPZs in 1990 as part of the Export Development Programme. Businesses operating in the export processing zones are treated as being outside the customs territory of Kenya as far as taxes are concerned, which entitles companies operating in the EPZs to numerous tax benefits. However, when

it comes to the qualification of a company, the EPZ Authority is granted powers to determine which entity qualifies to operate in the EPZ territory. The law provides wide discretionary power to the EPZ authority. In the same vein, the law does not provide the minimum level of investment or minimum local shareholding requirement as provided in the law.

The Special Economic Zones Act 2015 introduced special economic zones (SEZs) in Kenya. An SEZ is defined as a designated area where 'business-enabling' policies, different land uses, and infrastructure and utilities are provided, and shares many similarities with an EPZ. SEZs cover a wider range of sectors, including livestock zones, business service parks, science and technology parks, information communication parks, agricultural parks and tourist and recreational zones. With what qualifies as SEZ, it is much easier to meet the entry requirement of an SEZ. It should be noted again that SEZ Authority has wide discretionary powers to determine which entity qualifies to be an SEZ. These discretionary powers by EPZ and SEZ authorities create room for corruption and taxpayers indicated that these powers are at times abused by the authorities.

4.5.13 Disproportionate treatment of taxpayers

On SEZ, respondents were of the view that businesses in these areas received many favours compared to other businesses which were economically unfair. Important to note is that SEZs operate in a favourable environment as they have business-enabling policies such as infrastructure, which have been developed using taxpayer's money. Though the purpose of the zones was to spur economic growth, there is discrimination against some businesspersons. As a way of attracting foreign direct investment, the government, through the Finance Act (2017) amended the Income Tax Act to exempt and introduce lower rates of withholding taxes on various payments made in the special economic zones to foreign investors. The amendments eliminated withholding taxes on dividends paid to investors from companies operating from the economic free zones. Withholding tax payments in special economic zones in the form of interest was reduced from 15 per cent to 5 per cent and management and professional services from 20 per cent to 5 per cent while royalties were reduced from 15 percent to 5 per cent. The respondents were of the view that the exemptions were just too much. If the intention was to attract investments, there were other input support during establishment that would have been given to the investor rather than generous tax waivers.

The other concern with the exemption was that the exemptions did not have a limit in terms of amounts and therefore, the volume of profits made by the company does not matter. The argument by the respondents is that SEZ can be provided with enabling business environment, but then they pay the tax that will be used to develop infrastructure and provide public services to the other parts of the country. Again, not every citizen can qualify to invest in SEZ and especially the vulnerable. This widens the inequality gap.

Despite the enactment of the Special Economic Zones Act, 2015 and the establishment of SEZ and the government setting aside funds to provide for the infrastructure in SEZ, the same zones are not operational to date. The government also established and resourced the SEZ Authority to facilitate the development of SEZ. As it is understandable that there is need for an office to spearhead the government agenda, it is taking long to realise the results from SEZ, yet resources have already been committed. Respondents argued that some of these resources would have been better if channelled to other areas of government operations to spur growth.

4.5.14 Lack of parliament oversight on double taxation treaty

Double taxation agreements are meant to bring several benefits to the country. However, if not well structured, they can create more problems than benefits. As per the Income Tax Act, the Cabinet Secretary to the National Treasury has the power to declare by way of notice any agreement or arrangements entered into by the Government of Kenya with any other country, with a view of affording relief from double taxation. Through this provision, Kenya has entered into several double tax agreements with various countries.

Leaving the development and negotiation of tax treaties to the expertise of the National Treasury where they are also implementers, exposes it to abuse. The negotiation of the tax treaties between the developing world and the developed world sometimes has been found to favour the developed country. Where the treaties are negotiated without oversight, the same may be negotiated at the whims of the Executive, as tax treaties are not included in the Treaty Making and Ratification Act, which provides for parliamentary oversight of treaties. This leaves room for abuse, as the Executive may opt to have Kenya negotiate and ratify treaties with countries that offer them or their fellow elite strategic advantages.

4.5.15 Lack of cost-benefit analysis for tax incentives

It was noted that there has been no cost-benefit analysis of the tax incentives granted both at the national and at the county level. It was noted that there is no evidence to indicate that granting of tax exemption was informed by cost-benefit analysis. With granting of the exemption, again, there is no evidence of monitoring of the tax incentive, and thus their effectiveness is not assessed. With cost-benefit analysis, the government would be able to assess the effectiveness of tax incentives. The analysis can also help to understand the impact of the incentives on poor people and vulnerable groups. This is the reason why several respondents and previous studies have indicated that several tax incentives are redundant, yet they have not been removed as should be the case.

4.5.16 Inefficiency in administration of tax incentives leading to erosion of tax base

The provision of tax incentives in the government policy allows those who qualify for the same to claim. The issue of erosion of the tax base was raised especially where there is no efficiency in the administration of the tax incentive. Tax incentives are non-discretionally but can be discretionary where a government official is left with the decision on whether an investor qualifies for tax exemption or not. With such discussion, there is a risk of corruption where transactions that do not qualify for incentives are included. Secondly, for investors to qualify for tax incentives, they are the ones who provide the necessary information to the government. At times, the information could be inaccurate and/or inflated in favour of the investor and this at times goes unnoticed by the person approving the incentive.

Investors go further to engage tax planners who guide them on how to take advantage of the various tax provisions through tax avoidance. In the long run, it was noted, this erodes the tax base and affects the final tax revenue to the government.

This finding agreed with other scholars who indicated that in Kenya, tax incentives are numerous and inefficient because the structures put in place to govern their implementation are weak and ineffective (Tax Justice Network Africa and ActionAid International, 2012). The framework that dictates the criteria for defining and termination of beneficiary of tax incentives are neither open nor inclusive as demanded by the role and prudent public finance management. This makes it unclear to what extent these preferential tax treatments have contributed to the investment and the creation of employment in a country. Provision of the incentives is surrounded by limited transparency and therefore it has never been clear how those who benefit formal tax incentives are identified.

4.5.17 Disaggregated management of tax incentives increasing administration cost

The various tax legislations that are involved in tax incentives create confusion in the administration of the tax. This compromises the principles of simplicity, fairness and efficiency given the fact that they complicate the tax system by creating horizontal inequities and distorting production efficiency. In the long run, the country may forgo revenue that could have been spent more productively or used in other ways. The economic advantage of tax incentives must be evaluated in terms of their ability to achieve clear goals in ways that are both effective and efficient, relative to alternative policies, both tax and non-tax, which could achieve the same objectives.

In the administration of the tax, it was noted in some cases, different bodies are involved in the process of granting tax incentives. For example, for one to qualify to be in SEZ, the approval comes from the SEZ Authority and exemptions relating to health must go through the Ministry of Health. Where various ministries are involved, they may not coordinate their incentive measures (tax and non-tax) with each other or the Kenya Revenue Authority, with the result that incentives may overlap, be

inconsistent or even work at cross-purposes. The process of granting the incentives requires more resources without direct benefit on the same (James and Van Parys, 2009; Abbas and Klemm, 2013).

Different tax incentives are anchored in different legislations. Due to the numerous incentives, it comes with administrative issues where administering the taxes comes with costs. Tax incentives, therefore, impose a significant administrative burden, and must therefore be more than marginally effective to cover the costs of implementing them and produce a net overall benefit. It should be noted that tax incentives can be put into discretionary regimes, which depend upon case-by-case evaluations, and non-discretionary regimes, which grant incentives to whatever company meets clearly stated requirements. A discretionary regime is difficult to administer, leading to delays and causing uncertainty for investors, which can even increase the overall cost of investing in some countries. The administrative cost is met by the government while there are other costs of the forgone revenue (De Mooij and Ederveen, 2008). Discretion in tax exemption creates room for corruption and this is detrimental to the processes of developing competitive markets and sound policymaking.

From the foregoing, tax incentives violate the principle of simplicity in tax administration and therefore requires extra enforcement. The government, therefore, ends up spending more taxpayers' funds to monitor those who are not paying any tax. This will be fruitful only if their strict criteria ensure that only those who deserve tax incentives are the ones who are given the incentives. Unfortunately, there are "free riders" who take advantage of the incentives and they avoid taxation, yet the government spends money to monitor the same. Even worse, the greater the complexity of the tax incentive regime, the higher the potential enforcement and compliance costs, and mostly, when there are incentives, the tax matter becomes complex. Due to limited resources, revenue authorities seek to use their limited administrative resources to improve tax collection, and therefore prefer auditing fully taxable firms rather than those firms operating under a tax holiday arrangement. Thus, any malpractices in tax collection under these establishments may go unnoticed.

4.5.18 Domestic firms restructuring as foreign investors

The respondents also observed that where tax incentives are given to attract FDI, some organisations transfer ownership, through mergers and acquisitions, or if the domestic investment is 'round tripped', through a foreign entity to take advantage of the tax incentive. However, most owners of the companies are local persons, especially in the construction industry. Through such arrangements, the government loses tax revenue. These concerns are in line with the case of Latin American, Caribbean and African countries between 1985 and 2004 where there was an increase in FDI. However, the FDI inflows did not increase total investment, nor did they increase economic growth. This suggests the restructuring of domestic to foreign companies (Klemm and Van Parys, 2012). During this study, respondents from the counties cited the construction industry as one sector that this was prone to these dynamics. Unfortunately, most of the players in the industry are wealthy.

4.5.19 Information on tax incentives is not accessible

For fairness in access to tax incentives, information on tax incentives should be made available to taxpayers. It was noted that the information is not easily comprehensible by some of the expected beneficiaries. A case in point is tax exemptions for Persons with Disabilities. It was noted that several of them were not aware of the tax incentives on their income.

4.5.20 There is no monitoring and evaluation by the government to ensure they continue to serve their original purpose

Tax incentives have been used for the long term to achieve certain objectives. The success of any policy direction can also be known if there is monitoring and evaluation after the implementation of the policy. Despite the implementation of tax incentives for a long time, the government has still failed to carry out an analysis of the costs and benefits in a national context to support government decision making going forward. At the same time, the data collected on granted tax incentives is limited in terms of qualifying investments made, direct and indirect benefits to the economy and the cost of these tax incentives in terms of foregone revenue.

In terms of cost revenue, it has been noted that there are investors who benefit from tax incentives, yet they ought not to have benefited. Thus, revenue cost in this case, includes all the tax forgone from the project that would have been implemented even if there were no tax incentives and those who lost revenue by taxable firms who improperly claim incentives or shift income from related taxable firms to those qualifying for favourable tax treatment. Policymakers should seek to target tax incentives that will help achieve the greatest possible benefits for the lowest cost. The ideal scenario would be to offer tax incentives only to those investors at the margin who would invest elsewhere for the tax incentives. Offering tax incentives to those investors whose decisions to invest are not affected by the proposed tax benefit merely results in a transfer to the investor from the host government without any gain.

4.5.21 Land rates and rent arrears waivers in counties benefit few individuals

This was raised as a major concern by the respondents in the counties such as Homabay, Machakos, Kitui, Kwale and Nairobi. The purpose of waiver of tax arrears is to encourage those who had defaulted to declare their properties, pay the outstanding rate and continue paying land rates going forward. The concern is that majority of the persons who own properties are wealthy people and therefore the issues of inability to pay should not arise. Also raised is that some of these properties are developed and thus generate income. In that case, it is just that the owners are not willing to pay what is due to the government. On the developed properties that are generating rental income, the tenants are the low-income earners in the society

or people who are running a business in these establishments. With the waiver of the land rates arrears, the gap between the rich and the poor is widened.

According to the County Governments Waiver Administration Act, the waiver is offered after approval of the County Executive Committee Member for Finance after consultation with the Governor. The Act gives room for negotiation between the county government and investors and this gives room for underhand dealing at the expense of the government. This reduces the revenue for the counties.

4.5.22 There are no estimates of the costs of tax incentives

Sometimes, even when the tax incentives succeed in attracting investment, the costs of the incentives may exceed the benefits derived from the new investment as there could be other costs like social and environmental costs arising because of granting the incentives. Though this may not be easier to substantiate, there is a way of estimating the costs and benefits of tax incentives. One way of achieving this is by doing a cost-benefit analysis to estimate the cost in terms of forgone revenue and/or direct financial subsidies for each job created. This may not give an accurate picture for example the value of a job created may be difficult to quantify as there are other factors apart from salary.

In assessing the performance of tax incentive schemes, the objectives are to determine the amount of incremental investment resulting from tax incentives and the costs and benefits associated with attracting that investment. Therefore, to determine the cost is by one, the amount of investment that would have been made without the tax incentive programme. Secondly, is the amount of leakage from the tax base due to taxpayers improperly claiming the tax incentives or shifting income from taxable to related tax-exempt or lower-taxed entities. Lastly is the tax revenue gained from the activities undertaken after the incentive expires, of taxpayers who were granted a tax incentive or from those activities generating other sources of tax revenue.

4.5.23 Tax waivers counties shifting business to other counties

As noted, there is no collaboration in fiscal measures at the counties and therefore, one county may provide a tax waiver that affects the neighbouring county, and this leads to income inequality. The case was noted where one county would waive charges and businesspeople and citizens would move to where there are no charges. A case that was noted is Isiolo town where one part is in Isiolo County and the other is in Meru County. When Meru County is not charging parking fees on some days, motorists would park on the side of Meru County and would conduct business on that side. This disadvantaged the residents of Isiolo County. This was also happening in counties in SEKEM.

5 RECOMMENDATIONS

This section provides the conclusion from the study and offers recommendations that will help improve tax incentives.

5.1 Conclusion

The purpose of this study was to produce a comparative analysis report of the existing tax incentives and decision-making processes across the seven economic blocs in Kenya and where relevant, the East African Community (EAC) region to transpose learnings from neighbouring countries. From the findings, the following can be concluded:

- i. There is no comprehensive national tax policy resulting in weakness in the tax administration process.
- ii. Though tax incentives may have increased the FDI in the country or investment in countries, there is no analysis of the benefits against the revenue lost. Therefore, it cannot be conclusively confirmed whether the net effect is positive or negative.
- iii. The decision to provide tax incentives is not fully participative and all those who are affected should be involved in the processes. This results in tax incentive policies that are not favourable to all taxpayers.
- iv. The decision-making processes of developing the tax incentives policies are not backed up with facts and figures to justify the need for the incentives.
- v. There are no mechanisms to review the tax incentives policies to enhance or remove them in the future.
- vi. There is no mechanism in place to evaluate the impact of tax incentives after the implementations.
- vii. Tax incentives/waivers across the counties cause economic disruption in the neighbouring counties.
- viii. Tax incentives policies are not fool proof and therefore create room for corruption.
- ix. The implementation of tax incentives allows for discretion by the officers granting the incentives and this gives room for corruption.
- x. There are no tight criteria for evaluating the information provided by the investors claiming the tax incentives and this gives room for claimants to provide false information.
- xi. Most of the tax incentives are accessible to the rich compared to those that are enjoyed by the vulnerable in society. This is against the principle of fairness in taxation and increases the inequality between the rich and the poor.

- xii. Tax incentives advance income inequality in agreement with the New Growth Theory that indicated that tax incentives have minimal effect or no effect on the growth of the economy.
- xiii. The economic blocs have not put mechanisms in place that will help them collaborate in the tax collection process and administration of waivers.

5.2 Recommendations

From the findings of this study, it can be observed tax incentives have advanced inequality among the underprivileged. This study, therefore, recommends as follows:

5.2.1 The government should develop a tax incentive implementation framework

Most of the illegalities that happen in tax incentives administration are a result of a lack of comprehensive national tax policy that guides tax administration including tax incentives. Therefore, the national government and county governments should, through a consultative process, develop a framework for tax incentives administration that helps in upholding transparency in granting tax exemptions. As recommended by the OECD's Task Force on Tax and Development there is need for a more effective global transparency framework for tax incentives for investment with the idea of promoting transparency in decision-making processes, increasing the information available on costs and benefits, limiting discretion and increasing accountability.

The government should establish a framework for the conclusion of tax treaties, amend the Treaty Making and Ratification Act to bring tax treaties within the oversight of Parliament, and invest in the training of tax treaty negotiator.

5.2.2 Tax incentive decisions be evidence-based on economic, social and environmental impact assessments

Incentives should only be granted following clear, evidence-based economic, social and environmental impact assessments to avoid granting incentives that are not adding value to the economy. Offering incentives should be about achieving the long-term ambitions of a country, to support sustainable and inclusive economic growth. Businesses and civil society want to see tax incentives offered when there is a clear economic and social need to build a lasting presence in a country, which will contribute to prosperity long after the initial project or investment.

There is a need to consider other factors such as social, environmental, fiscal and exacerbation of inequalities including gender inequality and benefits. The government should ensure that any tax incentive has the same limit in terms of amount or period. Tax incentives that are specific and limited in scope and time and those that are targeted incentives are more likely to be efficient and effective. After the grant, the same should be recorded in national budget expenditure, monitored and evaluated against their stated objectives, and withdrawn or revised accordingly.

5.2.3 Provide tax incentives for investment through tax laws only

Tax incentives are currently provided in different legislations such as Income Tax Act, Exercise Duty Act and VAT Act among others. The criteria for determining whether one qualifies to enjoy tax incentives again is provided by laws governing investment, for example, export processing zones, special economic zones and the National Treasury. Due to this, the extent of tax incentives granted and even the monitoring of the same may be a challenge for the government. There is a need to have consolidated legislation that guides the qualification of tax incentives.

5.2.4 Monitoring and evaluation of tax incentives granted

The government should always carry out a cost-benefit analysis of the tax incentives that are proposed to be granted. This will help the authorities to make evidence-based decisions when reviewing tax incentives. This will ensure that the tax granted will add value to the economy rather than have negative effects on the economy.

Incentives should be subject to ongoing monitoring and evaluation by the government to ensure that they continue to serve their original purpose. Where the incentives fail to meet their main objective, the policy should be reviewed to remove the incentives.

5.2.5 Publish and publicize the beneficiaries of tax incentives

The Constitution of Kenya and other laws governing the administration of tax incentives indicates that all beneficiaries of tax incentives should be published and publicised. This should be executed and communicated publicly through a regularly updated statement with the justification of why the exemption was granted.

5.2.6 Consolidate all tax incentives for investment under the Authority or one government body, where possible

The tax incentives should be managed by one body and not different bodies as it is currently. For export processing zones, it is EPZ Authority, for Special Economic Zones, it is SEZ Authority, for aid-funded projects, it is the National Treasury while for investment allowance it is the Commissioner of Income Tax. When granting of incentives is spread among many players, it increases the risk of corruption and rent seeking.

5.2.7 Evaluate to weed out redundant tax incentives

It was indicated that tax incentives are not a priority to some investors and therefore, whether there are incentives or not, they will still invest. Thus, the incentives may not be adding value to the economy, yet the government is losing revenue as investors are still claiming the incentives. Through cost-benefit analysis, redundant tax incentives should be removed. This will minimise cases where a tax incentive that is not serving any purpose is still available for investors.

5.2.8 Include minimum requirement for investors granted tax incentives

Tax incentives are given with certain objectives such as job creation, technology transfers and investment. However, the law does not specify the minimum requirements for an organisation to continue enjoying tax incentives. For example, the companies operating in EPZ enjoy tax holidays for 10 years. There are no parameters like the minimum number of local employees the organisations should employ for it to continue enjoying the tax holiday.

5.2.9 Need for co-operation by regional economic blocs

Regional economic blocs should critically examine collaboration in investment promotion; one which requires member counties to protect cross-county border investments and returns to investors of other member counties within their territories. Specifically, the member counties are urged to ensure non-discrimination of investors in the other member counties, by according to them treatment no less favourable than that accorded in similar circumstances to the residents of those member counties or third parties.

5.2.10 Investment policy and strategy frameworks

REBs urgently need investment policy and strategy frameworks that should include model agreements (MoUs) for adoption by county governments; model legislation to guide the institutionalisation and general administration of the REB, and mechanisms for public participation in the operations of the REB. Such policy and strategy frameworks should be based on existing laws and legislation, as well as member counties' regimes for investment facilitation and promotion. Under this, the counties should ensure that regional blocs and member counties would be required to gradually remove all the restrictions to investment in the respective blocs. The member counties will have to take measures to promote the free flow of capital, skilled labour, professionals and technology. However, the policy should be well thought through not to discriminate against citizens of the counties that are poor economically.

5.2.11 Enlightening the taxpayers

From the study, it was noted that majority of the taxpayers were not conversant with different tax provisions. To have maximum co-operation from the taxpayers, the government should put in place sensitisation programmes for the taxpayers especially on tax incentives.

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APPENDIX I: INTERVIEW GUIDE

Transparency International Kenya

Dear Respondent

Transparency International Kenya is carrying out a research on tax incentives driving economic inequality across the regional economic blocs in Kenya. The research is to provide a comparative analysis report of the existing tax incentives and decision-making processes across the Seven Economic Blocs in Kenya and where relevant, the East Africa Community (EAC) region to transpose learnings from neighbouring countries. The organisation has engaged Dr. Richard M Kiai (the Consultant) to undertake the survey on its behalf.

The consultant has undertaken background on the subject matter and from the studies, he has identified your organization as one of the Key Players in the area. This is therefore to request your participation in the study. The study will be guided by a questionnaire and I request your full participation. The feedback provided in this study will be purely used for this study and the confidentiality of the respondents is hereby guaranteed.

KEY DEFINITION OF TERMS

Tax - means all types of taxes and revenue streams such as PAYE, VAT, Corporate Tax, Exercise duty, custom duty, levies, fees, land rent, cess, permits, etc.

Tax incentive /waiver– Tax incentives are special provisions that allow for exemption from tax, reduced rates of taxes, tax deductions on expenditure, tax credits, or deferral of tax liability. Tax exemptions take many forms and include tax holidays, zero rating or exemption from VAT and exemption from customs rates.

Tax Incentives/waiver Objective – Encouraging investment in the economy, Foreign Direct Investments and Local Investments

Economic Blocs - These are county economic blocs that include Frontier Counties Development Council (FCDC); North Rift Economic Bloc (NOREB); Lake Region Economic Bloc (LREB); Jumuia ya Kaunti za Pwani; South Eastern Kenya Economic Bloc; and Mt. Kenya and Aberdares Region Economic Bloc

Section I: Questionnaire

A. Demographic of the respondent

- i. Kindly indicate the sector of your organization
- ii. Contact Person: Name
Email:
Telephone Number:.....
- iii. Kindly indicate your position in the organization
 - a) CEO []
 - b) Senior Manager []
 - c) Technical person []
 - d) Other []
 - a) Kindly indicate your gender
 - b) Male []
 - c) Female []
 - d) Other []
- iv. Kindly indicate how long you have been in the organization
 - a) Less than 2 years []
 - b) 2 to 5 years []
 - c) 5 to 10 years []
 - d) 11 to 15 years []
 - e) Over 15 years []

B. Implementation of Tax Incentives

The government grants various tax incentives. The study would wish to get your view on implementation of tax incentives.

a) Governance and Rule of law

The issues here are that tax incentives should be provided through tax laws only and ratification of tax incentives policies should be through a law-making body / parliament.

- i. Do you think the legal basis for tax incentives is effective and efficient?

- ii. In your opinion, do the tax incentives achieve the intended objective?

- iii. Are tax incentives provided through individual agreements or general legal provisions?

- iv. What is the implication of incentives to the tax payers?

- v. Are incentives equitable among different categories of taxpayers?

b) Transparency

In this section, issues here include the public availability of laws and regulations related to investment incentives, publication of a list of incentives, public statement of principles and policy objectives underpinning incentives regime and disclosure of the largest beneficiaries of investment incentives.

- i. Is there an investment attraction strategy or another document, which outlines policy objectives and strategy behind incentives in place?

- ii. Is the process for reform/change of the incentives regime outlined in the Law? Or what necessitates a change of TI laws

- iii. Are there opportunities for public participation on incentives by interested parties to voice their concerns? and how elaborate is this or are the threshold of public participation adequate to inform incentives policies?
- iv. Does administration of incentives create loopholes for corruption since there is room for negotiation between the tax incentives beneficiaries and administering authority?

- v. What is the influence of tax incentives on inequality between the rich and the poor? Does it minimize or widen the gap?

c) Efficient administration

Issues under this heading include the transparent and non-discretionary administration of investment incentives, consolidation of all tax incentives under a single government authority, coordination mechanisms among authorities responsible for investment incentives, and risk-based audits of incentives beneficiaries.

- i. Are all tax incentives granted automatically through self-declaration by the taxpayer without the need for a signature, decision, certificate from any government officials?

- ii. Are applications for incentives reviewed based on clear pre-defined published criteria?

- iii. Are there timelines for each step of the approval identified and service standards published?

- iv. Is a negative decision subject to appeal before a higher administrative authority or the courts of the country?

- v. Is the information submitted sufficient for the revenue administration to carry out a cost-benefit analysis?

- vi. Are investors receiving a tax incentive required to file a tax return/statement indicating the incentives?

vii. Does availability of incentives a major consideration while making investment decision? Explain

viii. Is there a relationship between tax incentives and more productivity, more jobs, more FDI more profits, more goods?

ix. Does availability of incentives a major consideration while making investment decision? Explain

d) Incentives reviews

Issues in this section include statements and publication of costs of tax expenditures, reviews of continuance of existing investment incentives based on cost-benefit analysis and systematic collection of data to underpin effectiveness assessment.

i. Is cost-benefit analysis performed for each type of investment incentives ex post by analysing a sample of beneficiaries (after an incentive has been granted automatically)?

ii. Are behavioural responses to incentives by investors taken into consideration (e.g. through motivation surveys)?

iii. Are the reviews carried out regularly (at the same frequency)?

iv. Are criteria and results of the reviews made publicly available?

v. Where does the government fail in tax incentives administration?

vi. How can the current legal/institutional framework on tax incentives be improved in the future.

vii. Are there monitoring mechanisms on those given tax incentives?

“Thank you. We value your contribution, and we look forward to engaging you further in this study “



APPENDIX II: Target population for key informants

- i. National Treasury
- ii. Kenya Revenue Authority – Through National Treasury
- iii. Capital Market Authority
- iv. Institute of Public Accountants of Kenya
- v. Kenya Association of Manufacturers
- vi. National Taxpayers' Association
- vii. Export Processing Zones Authority
- viii. Kenya Private Sector Alliance
- ix. Commercial Banks
- x. Kenya Bureau of Statistics
- xi. Topwise Tax Agents
- xii. Auditors
- xiii. Tax Justice Network-Africa
- xiv. ActionAid International (AAI)
- xv. Oxfam International
- xvi. Frontier Counties Secretariat
- xvii. Mt Kenya and Aberdares Region Economic Bloc
- xviii. South Eastern Economic Bloc
- xix. Lake Region Economic Block
- xx. Kenya Bankers association



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