The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

Policy Brief

No. 251/2024-2025

Thinking Policy Together

Enhancing Value Added Tax Performance in Kenya

By Laureen Karima

Key Highlights

Value Added Tax (VAT) has the potential to provide adequate, stable, and predictable government revenue when effectively administered. This policy brief focuses on the performance of VAT, the VAT policy, and its administration in Kenya. The key highlights include:

(i) The total tax revenue as a share of GDP in 2022/23 was16 percent, a rate below the set target of 28 per cent in the Tax Modernization Programme, despite varied tax reforms, including replacement of sales tax with VAT to achieve the set target. During the same period, VAT revenue as a share of tax revenue was 26.1 per cent. The interventions set for improving VAT revenue include expanding the tax base by improving the environment for doing business, streamlining tax administration by rationalizing VAT rates, and reviewing the tax rates, exemptions, and zero rating.

(ii) The average proportion of VAT revenue as a share of GDP between 1972/73 and 2022/23 was 6.6 per cent, a rate below the economically non-distortive rate of 10 per cent. During the same period, the proportion of VAT revenue as a share of total revenue was 24.1 per cent, a rate below the economically non-distortive rate of 40 per cent. The domestic VAT collected in 2022/23 accounted for 52 per cent of VAT revenue while import VAT accounted for 48 per cent of the total collected VAT revenue. Collection of domestic VAT in 2022/23 recorded a shortfall of Ksh 24.5 billion, the second highest after the excise tax shortfall, owing to subdued growth of the construction, transport, and manufacturing sectors because of inflated costs of input and increasing inflationary pressures.

(iii) Tax expenditures on VAT are a threat to enhanced VAT performance in Kenya. Over the 2017-2022 period, domestic VAT accounted for an average of 2.2 per cent of GDP, with expenditures on exemptions accounting for 52 per cent and those on zero rated goods at 48 per cent in that period. Tax expenditure, which is the average revenue foregone because of VAT preferential tax treatment in Kenya, was estimated at an annual average of Ksh 230.5 billion during the 2017-2022 period, representing 13.3 per cent of the total revenue raised. The interventions towards managing tax expenditure include elimination of consumption subsidies in favour of production subsidies.

iv) The VAT compliance gap has been high in Kenya at 43.0 per cent and 39.8 per cent in 2020/21 and 2021/22, respectively. The high rates are attributed to policy and administrative challenges. The government, however, seeks to reduce the compliance gap to 35 per cent in the medium term by reviewing the VAT thresholds, exemptions and zero rating, preferential and VAT rates and expanding the VAT base.

(v) In 2023, the Kenya Revenue Authority (KRA) launched the electronic tax information management system (e-TIMS), an online electronic tax invoice management system to enhance VAT compliance, minimize VAT fraud and increase VAT revenue. In July 2023, 95,732 VAT-registered taxpayers were onboarded onto e-TIMS, resulting in Ksh 272.365 billion in revenue collection. KRA expects that a comprehensive rollout and increased citizen awareness of e-TIMS would boost VAT revenue collection by 45 per cent.

(vi) The review of the standard VAT rate of 16 per cent as proposed in the 2023 Medium Term Revenue Strategy requires generating an optimal rate that promotes enhanced VAT revenue performance, private consumption, welfare gains and economic growth.

1. Introduction

The government introduced the Sales Tax Act in 1973 and implemented it in 1974 with the goal of raising government revenue. The sales tax revenue expanded to include both imported and domestically manufactured goods. In 1990, Kenya implemented Value Added Tax (VAT) following the Tax Modernization Programme (TMP) the country had been pursuing since 1986 to make its fiscal system more efficient, equitable, modern, and progressive, and eventually broaden its tax base. The TMP aimed to increase the tax revenue to GDP ratio from 22 per cent in 1986 to 24 per cent (later revised to 28% in 1992) in the mid-1990s, a target that has been elusive for Kenya's economy (Figure 1). VAT is viewed as a successful collection method because it encompasses value added to each commodity by a company across all stages of production and distribution, and systems for zero-rating or exempting goods and services and computed both output and input taxes. Consequently, VAT was expected to mobilize more revenue for the government and be the dominant tax revenue source.

However, VAT revenue performance in Kenya has been quite erratic since its inception as signaled by the VAT revenue to tax revenue ratio, VAT revenue to total revenue ratio and the VAT revenue to GDP ratio (Figure 2). The proportion of VAT revenue to total tax revenue in 1990/91, when VAT replaced sales tax, was 36.4 per cent, the highest ratio ever recorded since implementation of VAT Act, 2013. As of 2022/23, the proportion of VAT revenue to tax revenue was 26.1 per cent. The average proportion of VAT revenue to tax revenue ratio for the 1990/91 to 2022/23 period was 26.8 percent, a rate lower than the 27.1 per cent average of sales tax revenue to tax revenue during its implementation period 1972/73-1989/1990. In addition, the average VAT revenue to tax revenue ratio for Kenya over the VAT implementation period has been lower than Africa's average of 27.8 per cent in 2021.

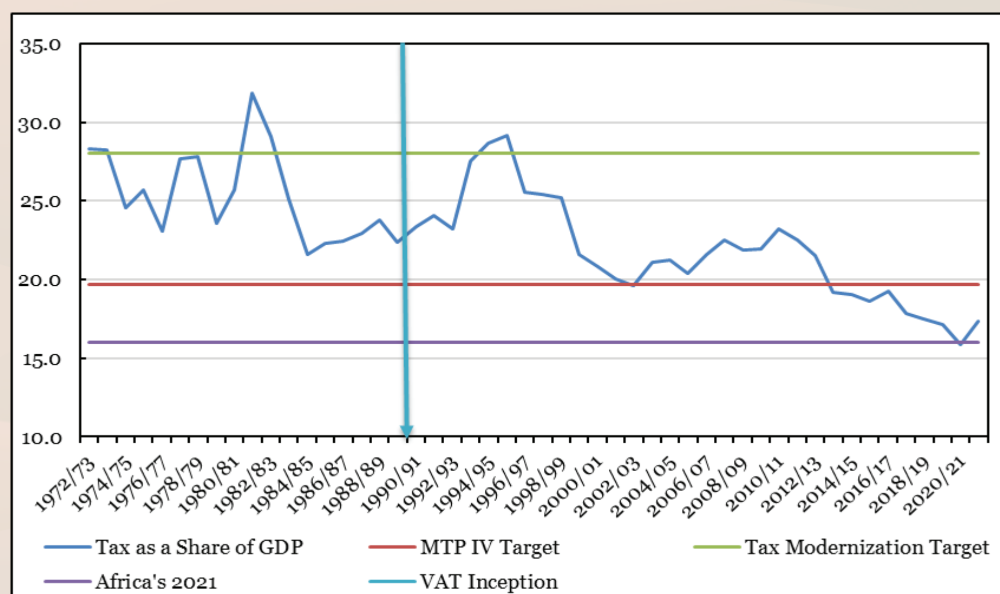
The average proportion of VAT revenue to total revenue since its inception was 24.1 per cent, a rate lower than the TMP target of 28.0 per cent. This average is also lower than the 40.0 per cent IMF minimum threshold of a less economically distortive tax. The trends in this ratio speak to the challenges facing VAT revenue mobilization, and VAT underperformance being the dominant source of revenue in not only Kenya but also Africa. According to OECD statistics 2021, VAT revenue accounted for 27.8 per cent of total revenue in Africa, trailing income tax revenue, which accounted for 37.9 per cent, a trend that is also observed in Kenya. The average proportion of VAT revenue to GDP since the 1972/73 to 2022/23 is 6.6 per cent, a rate that is below the IMF recommended threshold of above 10.0 per cent for a less economically distortive ratio.

VAT revenue in Kenya comprises both domestic and import sources, with the VAT Act, 2013 dictating the treatment of both domestic and import goods and services. Figure 3 shows the domestic and import VAT revenue mix in Kenya.

Import VAT revenue constituted an average of 49 per cent of VAT revenue since its VAT inception in Kenya while domestic VAT revenue accounted for 51 per cent of total VAT revenue. The mix in domestic VAT and import VAT revenue has been fluctuating across the years. In 2022/23, domestic VAT revenue collected accounted for 52 per cent of VAT revenue while import VAT accounted for 48 per cent of the VAT revenue collected.

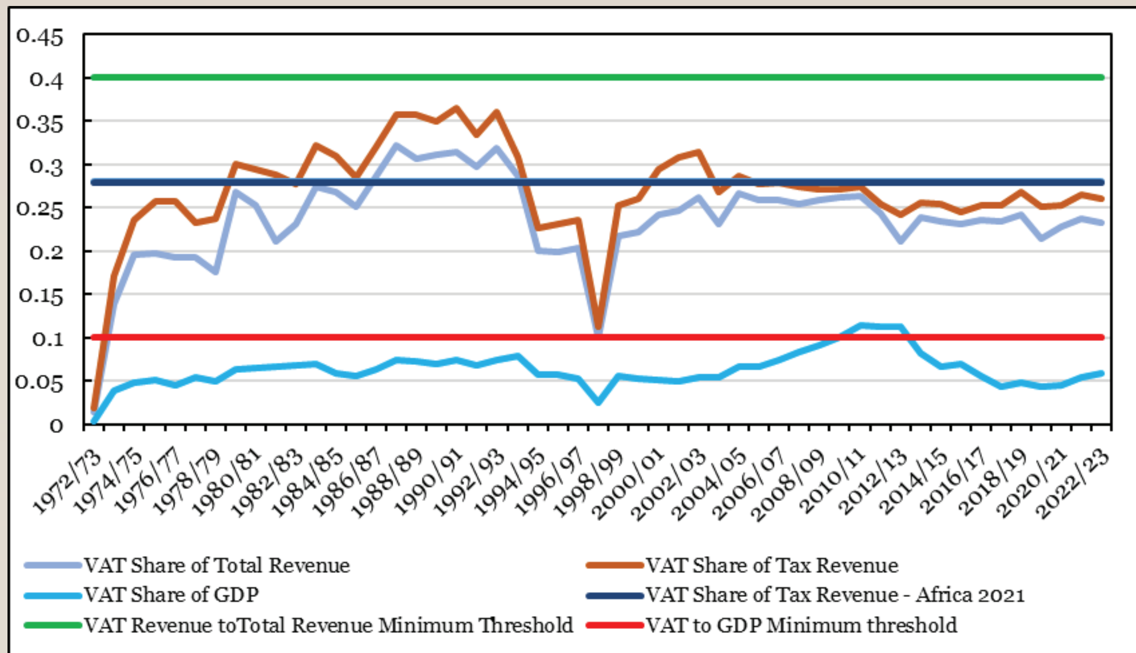
In the past, the drivers of VAT revenue performance in Kenya include the VAT policy, which includes the tax rate and the tax base, VAT administration, and the global and Kenya's macroeconomic status. To understand the VAT revenue performance, it is important to understand the elements of the policy that are being implemented, and its influence on the revenue mobilized. The objective of this policy brief is to analyze the VAT performance

Figure 1: Trends in tax revenue as a share of GDP (1972/73-2020/21)



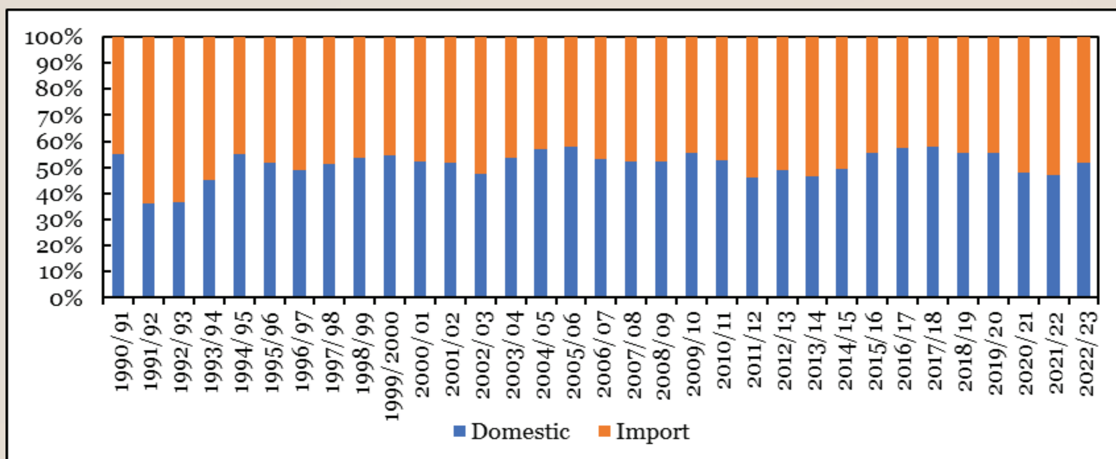
Data Source: KNBS Economic Surveys; National Treasury Quarterly Budget and OECD Revenue Statistics in Africa various issues

Figure 2: Trends in VAT revenue performance in Kenya (1972/73-2022/23)



Data Source: KNBS Economic Surveys; National Treasury Quarterly Budget and OECD Revenue Statistics in Africa, various issues

Figure 3: Trends in VAT revenue performance in Kenya (1990/91-2022/23)



Data Source: KNBS (Various), Economic Survey

trends in different VAT regimes, assess the effectiveness of the current VAT tax policy in revenue generation, and provide policy recommendations to address the identified gaps.

2. Factors Influencing VAT Revenue Performance in Kenya

2.1 VAT Policy and Legislative Framework

The VAT Act, 2013, which replaced the previous VAT Act of 1989, governs VAT in Kenya. The VAT system is designed to impose a tax on the value added to goods and services at each stage of production or distribution, with the ultimate burden borne by the final consumer (tax base). To be eligible for VAT registration, businesses should have an annual turnover exceeding a specified threshold (currently Ksh 5 million). Voluntary registration is also allowed for businesses below the threshold. Treatment of both domestic and imported goods and services is captured in terms of the definition of items subject to VAT and the rate applied.

The VAT Act applies a standard VAT rate in Kenya that is currently set at 16 per cent, with certain goods and services subject to a zero rate or are exempted from VAT altogether, signaling existence of multiple VAT rates. Zero-rated supplies include selected agricultural inputs, and certain machinery and equipment. VAT exemptions are on specific categories, such as projects financed by development partners, persons with privileges and

immunities, supplies to armed security forces, raw farm produce, live animals, fish, poultry, medicaments, financial services, educational services, and goods imported by persons living with disabilities. The Act provides that all VAT exemptions with VAT zero rating are for exported goods, passenger transportation, taxable services by carriers, and land transportation for destinations outside Kenya.

In 2013, the VAT Act underwent a major review, leading to a new structural design aimed at modernizing the law, reducing zero-rating and exemption of goods, and increasing revenue through tax expenditure reduction and aligning with international best practices. The Finance Act, 2023, also led to further modifications by introducing the latest items to the zero-rate list, including electrical buses, motorcycles, bicycles, liquefied petroleum gas, and inbound international sea freight.

Despite the VAT Act, 2013 being pronounced on the modalities of the policy in place, several challenges face VAT revenue performance. The challenges attributed to this policy will be discussed in the section that follows.

2.1.1 Issues linked to VAT policy

(i) The existence of multiple VAT rates in Kenya contravenes global best practices, which advocate for a single tax rate as a condition for optimal VAT revenue collection, besides the advantage of eliminating distortions in consumption and production decisions and lowering the risk of revenue leakages through fractional VAT collection and preferential tax treatments (tax expenditures). The government is gradually moving towards a single rate, with recent reductions to two rates following elimination of 8 per cent tax on petroleum products in the Finance Act, 2023. However, it remains uncertain whether the economy will fully benefit from a single rate due to the negligible gains associated with the elimination of the 8 per cent on petroleum products, which saw the VAT rates reduced from three to two.

(ii) To raise VAT revenue performance, the 2023 Medium Term Revenue Strategy for the medium term points at reviewing the VAT rate for the medium term to support funding of the major plans of the government. Given Kenya's rate is the lowest within the East African Community, rationalization is imminent. Theory, however, posits that an increase in the VAT standard rate may not translate to enhanced VAT revenue performance, since this may not favour optimal interactions between the rate and the consumption base. Furthermore, uncertainty on the VAT productivity of the prevailing standard rate lingers. An increase in VAT rate for Kenya may not conform to the tax productivity principle, which posits that a lower tax rate generates low revenue, and a higher rate generates higher revenue given its low VAT performance despite a higher prevailing rate.

(iii) Revenue losses associated with exemptions, zero rating and other preferential taxes constitute tax expenditures. The trends in tax expenditures in Kenya have been worrying over the past six years. Domestic VAT expenditures in Kenya averaged Ksh 230.5 billion (representing 13.3% share of VAT expenditure in total revenue) between 2017 and 2022, and Ksh 248.3 billion (representing 10.7% share of VAT expenditure in total revenue) in 2022 (Figure 4). The declining proportions of VAT expenditure to total revenue ratio reflects government efforts to rationalize exemptions and zero rating. However, more effort is needed to lower the VAT revenue leakages. Exemption-based tax expenditures accounted for 52 per cent of tax expenditures, while zero-rated expenditures accounted for 48 per cent. In 2022, tax exemptions accounted for 52 per cent of the year's tax expenditure, while zero-rated revenue was 48 per cent.

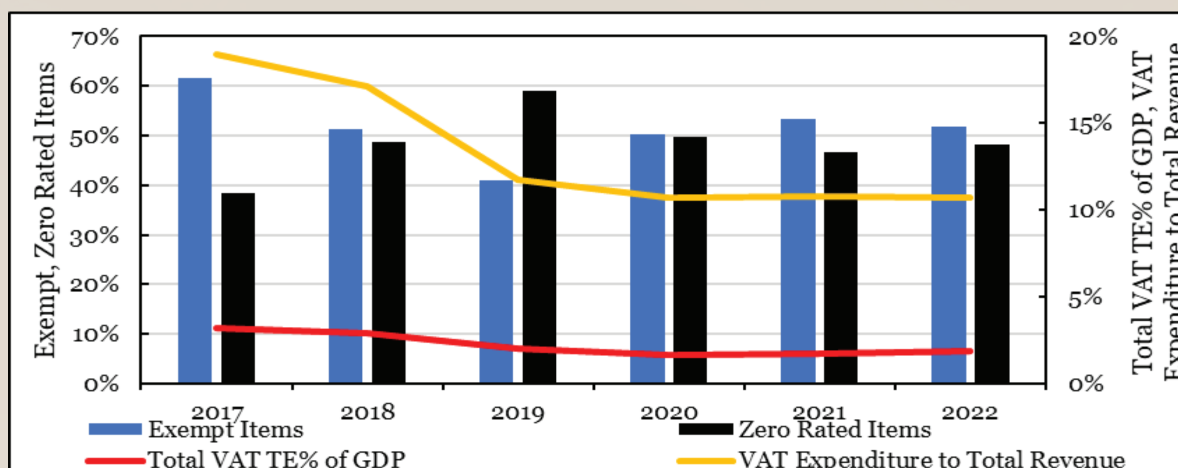
(iv) Domestic VAT expenditures have implications on VAT revenue collected. Although the VAT expenditure as a share of GDP declined from 2017, the proportion of zero-rated supplies and exempt supplies as a share of private consumption recorded a growth from 10.5 and 14.7 per cent, respectively, in 2021 to 18.1 and 17.8 per cent, respectively, in 2022. Furthermore, the government through the Finance Act, 2023 made additions to the zero-list item, triggering concerns on the potential impact of such items on the net VAT revenue losses that are likely to be associated with the preferential domestic VAT practices.

(v) The unit of taxation in the VAT tax system is the final consumption of taxable goods and services, which forms the proxy base. Since its inception, the range of VAT taxable goods and services has been periodically reviewed through Finance Acts to cover varying goods and services. The Finance Act, 2023, for instance, further expanded the base to include insurance and education services. Although these efforts are aimed at raising VAT revenue through expansion of the base, welfare concerns rock these initiatives.

The VAT base also includes goods and services from hard-to-tax sectors, including the large agricultural, informal sector (whose employment accounts for 83% of total labour force), and the digital economy. Despite the agriculture sector contributing to about 21.2 per cent of GDP in 2022, its contribution to VAT revenue remained less than 3 per cent. This is an indication that the contributions to VAT revenue from agriculture and the expanding informal sectors have been quite low, partly due to poor record-keeping and cash-based transactions, leading to lower levels of VAT revenue.

Although the VAT Act has pronounced itself on a wide range of issues, it has not kept up with the various structural changes in the economy. For instance, formalizing the informal economy has been slow with provisions on the digital economy yet to be well established. The optimality of the standard VAT rate and

Figure 4: VAT expenditures, exemptions and zero-rated expenditure proportions (%) (2017-2022)



Data Source: National Treasury Tax Expenditure Reports (Various issues)

its effect on the VAT base are not yet clear as signaled with dwindling VAT revenue in the wake of expansion of the VAT base.

2.2 Tax Administration

Tax administration entails the process of managing and enforcing tax laws and regulations within the country. It includes assessment, collection, enforcement, litigation, publication and statistical gathering functions under the various tax laws or conventions. The key players in tax administration include the Kenya Revenue Authority, National Treasury, National Assembly, Judiciary, and Tax Appeal Tribunal.

Given how critical VAT administration is in enhancing VAT revenue collection, the government reviews administrative measures annually through the Finance Acts. Recently, KRA aligned itself with the use of technology to better streamline VAT administration. This includes introduction of the electronic tax invoice (now supported by the Finance Bill 2024), achieved through the implementation of the Tax Invoice Management System (TIMS) to curb revenue leakages. Other technological interventions include the use of scanners on cargo, enhancements of i-Tax such as integration with Telcos, applying e-TIMS for VAT registration, and Integrated Customs Management System (iCMS); improved efficiency in the management of tax refunds; improved taxpayer audits and implemented specific measures to boost voluntary compliance and essentially enhance VAT revenue performance. This strategy by KRA to enhance tax compliance by leveraging on modern digital infrastructure aims at providing flexible tax solutions aligned with evolving business needs.

Despite the efforts of the National Treasury and KRA in instituting administrative measures, VAT administration still faces various gaps as explained below.

2.2.1 Issues linked to VAT administration in Kenya

Tax systems for VAT collection in low-income countries are often less transparent than those in industrialized economies, thus reducing accountability. These systems often lag in global tax policy design, particularly in revenue protection against tax avoidance or evasion tactics. Inadequate monitoring of VAT taxpayer compliance, complexities due to inadequate organizational structures, and deficiencies in information technology hinder countries from collecting more revenue.

Kenya faces the following VAT administrative challenges:

(i) Illicit trade is the largest challenge to VAT revenue mobilization. According to the World Bank, illicit trade has grown seven times more rapidly than legal trade since the 1990s. The Anti-Counterfeit Authority (ACA) 2020 National Baseline Survey findings indicate that illicit trade in Kenya escalated to Ksh 826 billion in 2018, marking a 14 per cent surge from Ksh 726 billion in 2017. The tax agency does not capture these transactions in the formal sector operations.

(ii) Compliance tax levels are quite low, with the VAT compliance gap in 2020/21 being at 43 per cent and 39.8 per cent in 2021/22. This manifests in the filing and payment of tax returns and is mostly attributed to the complexity and technicality of tax laws and procedures, taxpayer apathy, the high cost of compliance, inadequate information sharing among national and county agencies on VAT businesses and transactions that ensure VAT remittance, KRA physical absence in most parts of the country, and inadequate tax education, making it difficult for taxpayers to file and pay value added taxes.

(iii) The high number of unregistered VAT taxpayers is attributed to significant levels of informal

sector economic activity, complex registration process, high compliance costs, and weak enforcement and compliance mechanisms. The proposal in the Finance Bill, 2024 to raise VAT registration threshold to Ksh 8 million from Ksh 5 million is likely to strain the efforts put in place to facilitate registration of potential VAT taxpayers.

(iv) Limited collaboration and information sharing between county, national and international institutions on VAT matters limits enhanced VAT performance. Information on VAT registration status, VAT transactions and payments, payment information, compliance records and audit findings are critical in enhancing compliance and enforcement for VAT performance. However, inadequate exchange of information because of limited collaborations hampers compliance and eventually improvement of VAT revenue performance.

(v) Tax refunds in developing economies are characterized by backlogs in verification of refunds, processing and payment of refunds, challenges in legal interpretation and changes in VAT status of their supplies. Furthermore, non-conformity to the 30-day period for processing of refunds and 24-month period for actual compensation render the compensation process slow.

(vi) VAT disputes in Kenya have been on the rise occasioned by the high number of cases at the Tax Appeal Tribunals and in court. These cases lock revenue over a prolonged period, thus lowering VAT revenue performance.

3. Enhancing VAT Performance in Kenya

The optimal performance of VAT revenue in a country's fiscal space impacts total tax revenue and revenue targets, as VAT revenue is the second-most dominant tax revenue stream after income tax. Despite VAT rate increases, financial gains have been low, with low performance attributed to low expenditures and difficulties in administering the Value Added Tax Act, 2013, particularly in the informal sector. To improve the VAT revenue performance, the government can pursue varied measures to enhance the efficiency and effectiveness of the tax structure and tax administration.

3.1 Strategies to Improve VAT Policy for Enhanced Revenue Collection

(i) Transitioning to a single rate has the advantages of reducing complexity, minimizing errors in tax reporting, and sealing loopholes for tax evasion or fraud. Simplifying the tax system enhances compliance by simplifying taxes, procedures, and structures. Although it takes away the advantage of exemptions and zero rates on basic commodities and services, a single VAT rate coupled with social cash transfer programmes remains the effective way for correcting the regressive effects of VAT.

(ii) Reviewing the VAT rate in Kenya, as a Medium Term Revenue Strategy, is a significant policy decision that warrants careful consideration, especially regarding its potential impact on VAT revenue performance, and on welfare and consumption patterns. While an adjustment on VAT rate to align Kenya's standard rate with neighbouring countries, this may alter consumption patterns while disproportionately impacting lower income groups and influencing inflationary pressures. It is thus important for the government to weigh through advanced research on the potential benefits against the potential negative impacts on reviews made to the standard VAT rate and particularly the impact on low-income individuals and overall economic growth.

(iii) Government to provide a legal framework for introducing VAT incentives and a monitoring and evaluation tool for assessing the effectiveness of incentive regimes to safeguard the consumption base. Curbing exemptions can also simplify the tax system while increasing revenue by broadening the tax base. Countries incur a sizable loss of revenue through ill-designed exemptions, and other VAT incentives that fail to attract investment. Furthermore, discretionary exemptions create potential for corruption. Also, VAT exemptions and zero-rating could be reviewed and streamlined regularly to reduce tax expenditure and, therefore, support the policy objectives. While doing so, conformity to international best practices and aligning the exempted and zero-rated goods and services with the destination principle is key.

(iv) The government can explore alternative measures to broaden the VAT tax base, besides education and insurance which contribute to societal well-being and economic development. Charging VAT on these services may disproportionately burden lower-income individuals who rely on them for access to education and financial protection. To correct such anomalies, the government while applying VAT may implement a voucher system or subsidies to cover the VAT incurred on educational expenses, thus offsetting the VAT burden on education. This approach ensures that education remains affordable while allowing the government to collect VAT revenue. Expanding consumption tax base to capture informal economic activities is critical in increasing VAT revenue in hard-to-tax sectors such as agriculture and informal and digital sectors.

3.2 Strategies to Improve VAT Administration for Enhanced Revenue Collection

(i) Strengthening enforcement mechanisms to crack down on illicit trade activities, including

smuggling, counterfeiting, and tax evasion remains a key priority for the government to tap into the parallel market. This may involve increasing surveillance at borders, improving collaboration between law enforcement agencies, and implementing tougher penalties for offenders to ensure all goods into the country are recorded and vatable goods are taxed to boost VAT revenue generation.

(ii) Enhancing compliance takes on varied measures, including continuously expanding the use of modern technology in VAT services, issuing clarifying guidelines, and revising administrative procedures regularly; flexibility and skilled personnel in handling taxpayers; enhanced visibility of tax administration nationwide; and implementing risk-based verification programmes should be prioritized.

(iii) The tax administration unit could enhance mechanisms for registration of existing unregistered VAT users and potential VAT users. Leveraging on technology to facilitate registration and categorizing of registered users into economic sectors is critical for enhanced VAT administration. In July 2023, 95,732 VAT-registered taxpayers were onboarded, onto the recently introduced e-TIMS, resulting in Ksh 272.365 billion in revenue collection. A comprehensive rollout and increased citizen awareness is envisaged to boost VAT revenue collection by 45 per cent.

(iv) The government can enhance collaborations and partnerships to strengthen VAT revenue mobilization efforts and information sharing for compliance and enforcement of laws regarding VAT-related offenses to minimize VAT revenue leakages. Kenya, alongside enacting the Tax Procedures Act 2015, entered into an agreement by signing the Convention on Mutual Administrative Assistance in Tax Matters (CMAATM) on 8th February 2016 to enhance collaboration among nations in addressing tax evasion, avoidance, and other forms of non-compliance. This platform facilitates the exchange of information, mutual assistance in tax recovery, service of legal documents, and joint tax audits among signatories to the Convention. Additionally, the KRA collaborated with the Directorate of Criminal Investigations (DCI) to crack down on tax evaders within the country, with the DCI providing personnel to assist KRA in its investigations.

(v) The Alternative Dispute Resolution framework introduced in 2015 through the Tax Procedures Act, No. 29 of 2015 and backed by the 2010 Constitution provides taxpayers with a credible, transparent, and customer-friendly process that removes perception about unfairness and effectively resolves VAT disputes. Dispute resolution services, however, should be made accessible to all, and the average period of resolution of the disputes further shortened to enable standardized and speedy resolutions.

In summary, continuous review and enhancement of VAT policy and administration are necessary to align with the evolving economic landscapes and international best practices. The reforms and efforts undertaken by the government and tax authorities to address operational gaps within the VAT system are positive steps toward optimizing VAT revenue collection. However, the cost of living and welfare of the nation remains key in pursuing the development agenda.

References

A review of Kenya Finance Act, 2023. https://www.grantthornton.co.ke/globalassets/1.-member-firms/kenya/insights/pdf/finance-act-2023_analysis-by-grant-thornton.pdf accessed September 5, 2023.

Addison, T. and Levin, J. (2012), The determinants of tax revenue in Sub-Saharan Africa.

Ahlerup, P., Baskaran, T. and Bigsten, A. (2015), "Tax innovations and public revenues in Sub-Saharan Africa". *The Journal of Development Studies,* 51(6): 689-706

Asirigwa, D. A. (2011), The determinants of value added tax revenue in Kenya (Doctoral dissertation).

Keen, M. and Smith, S. (2006). "VAT fraud and evasion: What do we know and what can be done?" *National Tax Journal*, 59(4), 861-887.

National Tax Policy, June 2022. https://www.treasury.go.ke/wp-content/uploads/2022/07/DRAFT-NATIONAL-TAX-POLICY-16.06.-2022-.pdf accessed September 5, 2023.

Tax Reform Experience in Kenya; Kenya Institute for Public Policy Research and Analysis KIPPRA Working Paper No. 13 December 2005.

Terefe, K.D. and Teera, J. (2018), "Determinants of tax revenue in East African countries: An application of multivariate panel data cointegration analysis". *Journal of Economics and International Finance*, 10(11): 134-155.

The Medium-Term Revenue Strategy (An Approach of Enhancing Domestic Revenue) FY 2024/25- 2026/27: https://www.treasury.go.ke/wp-content/uploads/2023/09/Draft-MTRS-Final.pdf; accessed 12 November 2023.

Wawire, N. (2017), "Determinants of value added tax revenue in Kenya". *Journal of Economics Library,* 4(3): 322-344.

About KIPPRA Policy Briefs

KIPPRA Policy Briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

KIPPRA acknowledges generous support from the Government of Kenya and Development partners who have continued to support the Institute's activities over the years.

For More Information Contact:

Kenya Institute for Public Policy Research and Analysis
Bishops Road, Bishops Garden Towers
P.O. Box 56445-00200, Nairobi
Tel: 2719933/4, Cell: 0736712724, 0724256078
Email:admin@kippra.or.ke
Website: http://www.kippra.or.ke
@KIPPRAKenya