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A Review of Kenya's 2022 Tax Expenditures Report

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Executive Summary

In 2021, Kenya joined the ranks of countries producing tax expenditure reports and has now produced two annual reports. This is a significant stride toward transparency. Tax expenditures are a policy choice to forgo charging tax on certain activities in order to support specific policy objectives. They are also known as incentives or exemptions. While they are very similar to regular expenditures in the budget, they are often not as transparent as ordinary spending. Therefore, it is considered good practice for governments to produce special tax expenditure reports to clarify the cost and benefits of using these policies.

While we applaud the government's decision to report on tax expenditures, the information published must also be meaningful. Now that the government is publishing such reports and has committed to continue doing so in the National Tax Policy, it is imperative to independently assess their quality. Our analysis evaluated the 2022 tax expenditure report, using four criteria. First, we examined how transparent the report was about tax expenditures. Then we considered the extent to which the government provided an adequate analysis of tax expenditure effectiveness, efficiency, and equity.

Overall, the government shows that tax expenditures declined as a share of the economy between 2017 and 2021, but these high-level figures do not tell the whole story. First, the trend is not entirely consistent for the period: tax expenditures actually increased between 2020 and 2021 from Ksh 267 billion to Ksh 316 billion. Moreover, the apparent decline in tax expenditures is partly driven by changes in the way tax expenditures have been defined and calculated over time, and rather than by policy changes that have actually reduced tax expenditures.

Calculating the size of tax expenditures depends crucially on the benchmark used (the tax system in the absence of the tax expenditures), but the government made several changes to the way it calculates the benchmark between the two reports, leading to an apparent decline in tax expenditures that does not reflect an actual change in policy. For example, the government decided that the first 10 percent of its investment deduction should be considered part of the benchmark in 2022, rather than treated as a tax expenditure as it was in 2021. This artificially reduces the size of the corporate income tax (CIT) tax expenditure between the two years by almost half. It is true that there is no right way to define the tax system benchmark, but it is important to maintain a consistent definition to show how tax expenditures are evolving over time. If there is a need to change the benchmark, the government should provide a justification for this, and also provide alternative estimates based on different benchmarks, while clearly indicating whether changes over time are due to policy or to changes in definitions.

From a transparency angle, the 2022 report did well in some areas, but came up short in others. The report includes a definition of tax expenditures and the benchmark, the methodology adopted in estimating the tax expenditures, and total value of tax expenditures disaggregated by tax head. However, the data is too aggregated to allow for meaningful assessment of tax expenditures. The report failed to include details of policy objectives and beneficiaries of individual tax expenditures. Therefore, to enhance transparency we recommend:

i. Data should be disaggregated under each tax head to clarify the sectors and beneficiaries of each tax expenditure.
ii. The report should include policy objectives of all tax expenditures to understand their purposes.

With respect to the other principles we examined, the report lacks an evaluation of the effectiveness, efficiency and equity impacts of tax expenditures. Comprehensive information about the intended goals of tax expenditures, as well as techniques and procedures to determine if these goals are being reached, are fundamentally lacking. The report does not include any discussion of efficiency although it is important to evaluate whether tax incentives are the lowest cost way to achieve the set policy goals of increasing investment, increasing employment and reducing the tax burden for low-income earners. Similarly, whereas equitable distribution of income is reported as one of the core policy objectives of tax incentives, the report does not evaluate how the reported tax expenditures contribute to this goal. In addition, without comprehensive and disaggregated data on the beneficiaries of tax expenditures, it is impossible to review the impact of tax expenditures on equity.

While these types of analysis are not always straightforward, the government can build on good practices from other countries discussed in the report, including Rwanda, Ireland, Belgium, and Canada. When it comes to reporting disaggregated tax expenditures data, the government can follow Rwanda's example. In developing a framework to evaluate effectiveness of tax expenditures, Ireland's framework is a useful reference. Similarly, the government can borrow from Belgium's and Canada's approaches in reforming tax incentives and assessing equity impacts of tax expenditures, respectively.

To improve on its analysis, we recommend changes to the process of introducing and reporting on tax expenditures. Our main recommendations are for the government to:

i. Produce guidelines detailing the process of introducing, reviewing, and evaluating tax expenditures.
ii. Periodically assess effectiveness, efficiency and equity impacts of the most significant tax expenditures. This should include estimates efficiency, effectiveness and equity before tax expenditures are introduced, as well as after they have been in place for some time.
iii. Publish periodic information on the beneficiaries of tax expenditures, disaggregated by income, age, sector, and region to allow assessment of equity impacts of tax expenditures.

We hope that the government will consider our recommendations and that this report contributes to more nuanced discussion of tax expenditures going forward.

Contents

1. WHY DO TAX EXPENDITURES MATTER?

Tax expenditures are functionally the same as budget expenditure: they are a cost to government of pursuing policy through forgone revenues. Like all policy tools, tax expenditures can be more or less impactful, leading to more or less desirable outcomes. Given that they represent an important cost (for instance, as Oxfam reports, more than what some governments spend on health), it is important to assess their value in policy terms, just as we do with other parts of the budget. We should judge all expenditure by whether it is the most efficient, effective, and equitable use of the limited resources we have. Comprehensive assessment of tax expenditures permits meaningful policy debate about their costs and benefits among policymakers and civil society. Too often, however, tax expenditures are not subjected to serious scrutiny.

Over the years, many countries have increased transparency on expenditure budgets, but tax expenditures have historically been excluded. As many governments struggle with weak revenue systems, high debts, and a need for fiscal consolidation, there is growing interest in ensuring that tax expenditures deliver value relative to their costs, or that they be reformed or scrapped. In recent years, international agencies such as the International Monetary Fund (IMF), Organization for Economic Cooperation and Development (OECD), International Budget Partnership (IBP), and the Centre for Global Development have called upon governments to publish reports on tax expenditures to promote fiscal transparency and accountability.

As a result, more low- and middle-income countries are making progress in publishing estimates of the fiscal costs associated with these measures. The 2022 Global Tax Expenditures Database (GTED) Progress Report indicates that 97 out of 218 countries published some data on tax expenditures as of June 2022; this was an increase from 75 countries in June 2021. More recent data on GTED website shows that 106 countries now have data on tax expenditures. Additional countries that produced data on tax expenditures in 2022 include Kenya, Mongolia, Nigeria, Uganda, and North Macedonia.

Kenya has now produced two tax expenditure reports for 2021 and 2022. These were undertaken as part of the IMF Programme's structural benchmarks, though the government has recently recognized that reporting on tax expenditures is a good practice in its National Tax Policy (now in Parliament). The policy includes government commitments to review current tax expenditures and introduce a framework for granting incentives that considers the costs and benefits of the incentives and preparation of tax expenditure reports annually.

Now that the Kenya government has taken the positive step of publishing these reports, it is crucial to examine the information provided and analyse its adequacy. This paper evaluates the 2022 Tax Expenditures Report based on four criteria: (i) transparency, (ii) effectiveness, (iii) efficiency and (iv)equity. These principles are enshrined in the Kenyan Constitution as fundamental principles of public finance management and they represent core values for the Institute of Public Finance.

Transparency is the main purpose of publishing these reports in the first place: to permit an assessment of how much the country is spending on tax subsidies over time, and to determine whether we are getting a commensurate return from that spending compared to other non-tax options such as direct spending, which is already reported on in the budget. We cannot assess effectiveness, efficiency, or equity without transparency.

A policy is deemed effective if it can be implemented, and if, when implemented, it leads to the desired impact. In the case of tax expenditures, this means asking whether a tax exemption is actually used and applied to the right things, and whether when applied, it leads to intended consequences. If, for instance, an exemption for capital investment is offered, analysis of effectiveness would entail determining if the exemption ultimately translates to more capital than if the exemption was not offered. If a tax incentive is meant to create jobs, we should be able to assess whether or not it does so. Ex ante evaluations (estimating the possible impact of reforms) are important because there must be a justification for governments to forego revenues. Governments should then take into account the impact of tax expenditures in forecasting revenue because once tax incentives have been introduced, they are difficult to eliminate. Without clear benefits that surpass the costs of tax expenditures, it would be imprudent to offer the incentives.

Efficiency assessment provides a clear understanding of whether or not tax expenditures are the least cost way of achieving desired policy goals. Such evaluation should ideally cover both direct costs in terms of revenues forgone as well as administrative costs and compliance cost incurred by taxpayers and provide insights as to whether tax expenditures duplicate or complement other government programmes.

Under the equity pillar, we recognize that tax expenditures have varying impacts and could contribute to reducing or exacerbating inequalities. For example, a tax incentive may be more beneficial to high income earners at the expense of the poor. In addition, it is important to evaluate tax expenditures in the context of the broader tax system to examine whether it makes the tax system less or more equitable. As a general principle, provisions that disproportionately benefit the poor are equitable while those that carry disproportionate benefits for the wealthy are less equitable. Measuring this is not always easy: a tax incentive to build a bridge might benefit the construction company, but also benefit lower income users of that bridge.

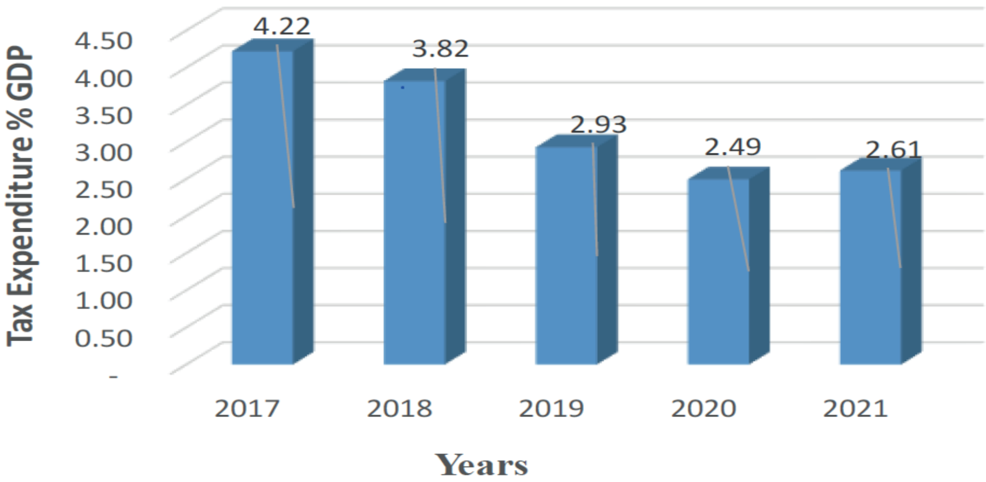
The rest of this paper is organized as follows. First, we look at the top-line findings in the government's publications. We raise some questions about how these figures are calculated, including how the benchmark tax system, a key concept in tax expenditure analysis, is defined. We then evaluate the report against our core principles of transparency, effectiveness, efficiency and equity, providing recommendations against each principle. We conclude with a call to enhance the value of these reports so that they can contribute to meaningful debate about the value of tax expenditures.

2. UNDERSTANDING THE NUMBERS: WHAT DOES THE 2022 REPORT SAY, AND HOW DID GOVERNMENT DERIVE THESE FIGURES?

Tax expenditures have been falling as a share of the economy in recent years but rose slightly in 2021. The report claims that tax expenditures have been declining over the past several years, from about 4.2 percent of GDP to about 2.6 percent of GDP between 2017 and 2021. However, tax expenditures increased between 2020 and 2021, from Ksh 267 billion (2.5 percent of GDP) to Ksh 316 billion (2.6 percent of GDP). It is not clear why this should be so, but it raises questions about whether the downward trend will continue.

The 2023/24 budget comes at a time when the economy is rebounding from COVID-19 related shocks. Although

Figure 1: Total Tax Expenditures (Precent of GDP)



Source: The National Treasury, 2022 Tax Expenditures Report

Value Added Tax (VAT) accounts for the highest share of tax expenditures, and its share is growing, compared to other taxes such as income tax. Domestic VAT and VAT on imports together accounted for about 75 percent of all tax expenditures, excise duty (10 percent) and CIT (CIT) (6 percent) in 2021. As show in Table 1, the share of VAT tax expenditures has been increasing whereas the shares of tax expenditures under the rest of the tax heads declined between 2020 and 2021.

While not reported in the 2021 report, fees and levies-related tax expenditures accounted for about 2 percent of total tax expenditures in 2021. The Miscellaneous Fees and Levies Act enacted in 2016 provides for imposition of Import Declaration Fee (IDF) and the Railway Development Levy (RDL) and is the case with other acts, some goods and services (such as raw materials, inputs imported for constructions of affordable houses) enjoy a preferential rate. Therefore, their inclusion in the 2022 report does not mirror a change in policy but rather a more comprehensive reporting on tax expenditures.

Table 1: Tax Expenditures by Revenue Head

	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
Tax Heads	Ksh Billion					Share of Total Tax Expenditure				
Personal Income Tax	3.45	3.78	4.53	4.77	5.31	0.964	1.012	1.513	1.786	1.680
Corporation Income Tax	17.09	39.29	19.38	22.56	21.64	4.776	10.519	6.472	8.446	5.707
VAT Domestic	272.42	269.36	209.40	172.54	211.09	76.131	72.115	69.928	64.598	67.609
Excise duty on imports	-	0.04	0.13	0.13	0.12	-	0.011	0.044	0.048	0.038
Excise duty (Domestic)	48.38	49.25	46.95	36.80	30.97	13.520	13.186	15.679	13.778	9.919
VAT on imports	4.880	0.002	0.001	0.001	0.002	1.364	0.001	0.000	0.000	0.001
VAT on imports (Fuel)	-	-	9.09	16.79	28.01	-	-	3.036	6.286	8.971
Import duty	11.61	11.79	9.97	11.49	13.35	3.245	3.157	3.329	4.302	4.276
Fees and Levies	-	-	-	2.02	5.55	-	-	-	0.756	1.778
Total Tax Expenditure	**357.83**	**373.51**	**299.45**	**267.10**	**316.04**	**100**	**100**	**100**	**100**	**100**

Note: * denotes projections

When we dig into the broad tax heads, we can learn a bit more about the main drivers of tax expenditure in Kenya, though the report says little about the observed trend. For corporate tax, more than half of CIT expenditures are related to plant and machinery allowance and investment deductions. Between 2020 and 2021, capital allowances on industrial building and deduction on agricultural land increased while plant and machinery allowance and investment deduction on buildings declined. A closer look at investment deductions on buildings reveals that they declined between 2018 and 2019, more than doubled between 2019 and 2020, before declining between 2020 and 2021; however, but it is not clear what caused these changes. These deductions are presumably meant to encourage greater capital investment, but the report says nothing about whether their performance is linked to investment decisions for the period under review given that there was no policy change during that period. Data from the economic survey indicates that gross fixed capital formation increased from Ksh 1.9 billion in 2019, to Ksh 2.1 billion in 2020, and Ksh 2.4 billion in 2021. However, we cannot conclude that investment deductions lead to increased capital investments, because they increased even when the tax expenditures declined.

Turning to VAT, exemptions and zero-rating in financial and insurance services, information and communication, and manufacturing were the biggest drivers of tax expenditure under the exempt list, though it is not entirely clear what is included here. No further analysis is given of the value of these tax expenditures. However, transportation and storage, manufacturing, and electricity, oil, gas, steam, and air conditioning supply account for the largest shares of tax expenditures under the zero-rated list. The report notes that growth in VAT Tax expenditures is attributable to economic recovery post COVID-19 pandemic (not necessarily increase in exempt/zero-rated items). It is worth noting that most VAT relief seems to be focused more on industrial policy than on providing relief to ordinary citizens. There is also no clear rationale for some exemptions such as air conditioning supply.

Table 2: Plant and machinery tax expenditures consistently account for more than half of total CIT tax expenditures

	2017	2018	2019	2020	2021
	Ksh Million				
Plant and machinery allowance	8,721.57	14,002.18	12,594.46	13,820.49	12,284.68
Investment deductioon on building	2,755.10	3,153.29	2,072.21	4,559.22	3,489.20
Capital allowance on industrial building	4,870.88	4,532.80	4,073.78	3,839.97	5,346.56
Deduction oon agricultural land	737.77	598.80	639.41	345.09	516.38
Total CIT Expenditures	17,085.32	22,287.07	19,379.86	22,564.77	21,636.81
Nominal GDP	8,483,396.00	9,340,307.00	10,237,727.00	10,716,034.00	12,098,200.00
Total CIT% of GDP	0.20	0.24	0.19	0.21	0.18

Source: The National Treasury 2022 Tax Expenditures Report

Under Excise Duty, locally assembled motorcycles and motor vehicles accounted for the highest tax expenditures share; exemption from excise duty for these items was geared towards supporting the local production of motorcycles and motor vehicles. This seems to be supporting local assembly of motor vehicles; the number of locally assembled motor vehicles increased by 29.3 percent between 2020 and 2021. However, the 9,989 locally assembled vehicles is modest compared to 126,415 imported vehicles in 2021.

In summary, the data show that as a share of GDP, total tax expenditures have gradually declined but the trend is varied across different tax heads. Domestic VAT tax expenditures increased in 2021 and remains the biggest contributor to total tax expenditures. CIT, VAT on imported fuel, and domestic excise duty also are a significant source of tax expenditures. However, the report fails to provide disaggregated data on tax expenditures to give a clear picture on specific items that are responsible for revenue losses. It also fails to provide a clear indication of the strategy behind the figures. For example, why does Kenya's approach focus so heavily on VAT relative to CIT? What strategic priorities are we pursuing as a country through this distribution and trend in our tax expenditures?

2.1 How are these numbers derived?

While these topline figures are useful, their value depends on how they were calculated and how realistic they are. Evaluating tax expenditures is somewhat more complex than evaluating budget expenditure because we must first decide what to include or exclude. Unlike a spending budget, where every expenditure item is an act of will to spend money, a tax expenditure is a decision not to collect a tax. But to define this, we need some standard against which to measure our decisions, otherwise there is no logical limit to what might count as a tax expenditure. For example, the government does not tax the air we breathe. Does that mean that there is a tax expenditure on air? Obviously not. Tax expenditures must be relative to what we take to be "normal" taxation. The way that this is usually determined is to decide on what the "benchmark" tax system is, and then look for deviations from it.

There are three approaches to defining tax expenditures and the benchmark tax system: the reference tax law, conceptual, and the expenditure subsidy approach. The reference tax law takes a country's tax system as the starting point of defining the benchmark and defines a tax expenditure as an explicit concession that departs from the applicable tax provision. The conceptual approach defines a normative benchmark tax system guided by a theoretical concept of comprehensive income or consumption that provides guidance on how policy should be defined, irrespective of whether the benchmark corresponds to the existing tax law. The last approach is the expenditure subsidy approach where the government only costs tax incentives that are clearly analogous to an expenditure subsidy.

The government used the tax law approach to define tax expenditures and the benchmark tax system. It defines tax expenditures as *"tax foregone due to explicit concession that departs from what is considered as a generally applicable tax provision under the existing tax law and is meant to achieve a specific socio-economic outcome"* and a benchmark as *"a baseline against which a tax expenditure is recognized as a standard tax treatment at international standard or in Kenya and not conferring preferential treatment to particular group of taxpayers."* These definitions are consistent with OECD's and IMF's definition of tax expenditures and a benchmark. Under each tax head, the report defines different components of a benchmark including the tax base, tax unit, and tax rate, for respective tax heads.[i] For example under CIT, the tax base is the taxable income of legal persons, the tax unit is a corporate, and the benchmark tax rate is 30 percent (previously 30 percent for resident and 37.5 percent for non-resident corporates). However, some information on the benchmark is unclear. For instance, the report states that *"only the major structural elements of each tax category are considered as part of the benchmark tax system."* What does this mean?

The government changed the way it assesses the benchmark between the 2021 and 2022 reports. leading to artificial changes in the level of tax expenditures that are not related to policy changes, but only to a change in definitions. For example, the 2022 report considers 10 percent rate of deduction as the benchmark for investment deduction while the 2021 reported treated all investment deductions as tax expenditures. In other words, the government is considering a 10 percent deduction to be a standard part of the tax system, and only considering additional deductions beyond 10 percent as a tax expenditure. The government explains this shift by stating that investment deductions are an international best practice and only a proportion (in the case of the 2022 tax expenditures report, 15 percent) of the investment deductions should be treated as tax expenditures. As a result, the reported tax expenditures in 2021 report nearly halved in 2022 (the reported 2020 investment deductions tax expenditures were Ksh 8.6 billion in the 2021 report, this reduced to Ksh 4.6 billion in the 2022 report) without any change in policy.

Similarly, wear and tear deductions were reported as tax expenditures in 2021 but became part of the benchmark in the 2022 report under CIT. The report also excludes major exemptions associated with investment schemes like the export processing zones, reduced taxes for public listings, reduced taxes for local vehicle manufacturing, or indefinite loss carry provisions for businesses under CIT. All of these are considered part of the benchmark. Regardless of whether the government is technically correct to include these incentives in the benchmark, the effect of this decision is to remove many important incentives from the analysis and to create a misleading sense that tax expenditures are declining more than they are.

The same can be seen if we turn to VAT. For example, zero rating/exemptions on mosquito nets, education services, hearing aids, mobile phone services, betting and gaming, hiring of airplanes, and so on are considered part of the benchmark and their costs are not treated as tax expenditures. The same applies to exemptions on exported goods and services. Zero-rated supplies for export were considered as part of the benchmark in the 2022 report but considered tax expenditures in the 2021 report. These adjustments automatically lead to lower tax expenditure figures without changes in law. Reported zero-rated supplies related tax expenditures for 2020 reduced from Ksh 151.7 billion to Ksh 85.7 billion as result of the change in the definition of the benchmark.

Because there is always likely to be some disagreement about what constitutes the benchmark tax system, the government ought to maintain a consistent benchmark. Whenever changes are made to the benchmark, the government should make extra efforts to be transparent about their impact. Going forward, we recommend that the government should do three things differently with respect to its benchmark. First, it should **provide a justification** for including certain items in the benchmark. Second, it should **provide alternative estimates** of total tax expenditure based on an analysis of how sensitive its numbers are to inclusions and exclusions. Third, it should **clearly identify in each report changes in tax expenditure levels** since the last report and whether they are caused by changes in policy or the definition of the benchmark.

[i] The benchmark also includes some provisions in bilateral agreements where there is a preferential tax relative to the general regime, this is considered a TE. In addition, regional and international agreements are part of a benchmark tax system

3. EVALUATING THE REPORT: TRANSPARENCY

In assessing transparency, this analysis examines the extent to which the 2022 tax expenditure report provide comprehensive information about tax expenditures in Kenya. An ideal tax expenditure report should include:

i. A comprehensive definition of tax expenditures and benchmark tax system including the tax base, tax unit, tax rate, and duration of the tax expenditure.
ii. Policy objectives of tax expenditures
iii. Types of tax expenditures such as exemptions, tax credits, reduced tax rates or tax deferrals and their estimated shares to total tax expenditures
iv. Beneficiaries of tax expenditures, and
v. Methodology used in estimating the cost of tax expenditures.
vi. Tax expenditures by category (such as personal income tax, corporate income tax, excise duties, custom duties, value-added tax (VAT), etc) and sectors
vii. Total value of tax expenditures

3.1 Definition of the tax expenditures and the benchmark tax system

The 2022 tax expenditures report includes a definition of a benchmark including the tax base, rate and unit but there are cases where we could not tell what is part of the benchmark and what is not. For example, there is a lack of clarity in definition of the benchmark under some of the tax heads (does the report consider personal relief as tax expenditure under PIT or not?).

3.2 Policy objectives of tax expenditures

The 2022 tax expenditures report lists the general policy goals of tax incentives. Among these, it mentions: to spur economic growth, increase investments, create employment, and lower the cost of living. The report also includes policy objectives under some tax heads. For example, the policy objectives of tax incentives under PIT are to encourage savings, home ownership

Table 3: Inclusions and exclusions from the 2022 Tax Expenditures Report

Content of Report	Included (✓ Yes, ✗ No)
i. A comprehensive definition of the benchmark tax system including the tax base, tax unit, tax rate, and duration of the tax expenditure.	✓
ii. Definition of tax expenditures	✓
iii. Policy objectives of tax expenditures	✓
iv. Types of tax expenditures such as exemptions, tax credits, reduced tax rates or tax deferrals and their estimated shares to total tax expenditures	✗
v. Beneficiaries of tax expenditures	✗
vi. Methodology used in estimating the cost of tax expenditures.	✓
vii.Tax expenditures by category (such as personal income tax, corporate income tax, excise duties, custom duties, value-added tax (VAT), etc) and sectors	✓
viii. Total value of tax expenditures	✓

and reduce the tax burden. However, we observe that these policy objectives are very broad, and are prone to abuse. They do not explain specific policy choices. This limits the usefulness of the report in evaluating whether the tax expenditures have been meeting their intended policy goals. Moreover, beyond listing the policy goals of the incentives, the report fails to provide any further information or analysis on the extent to which the incentives have contributed to or achieved their policy goals.

3.3 Methodology used in estimating tax expenditures

The 2022 tax expenditures report used the 'revenue foregone' methodology to estimate tax expenditures under each tax head. The 'revenue foregone' is the most common approach in estimating tax expenditures and is recommended by the IMF. In this approach, a deviation from the defined benchmark tax base and rate is considered a tax expenditure. Annex III of the report clearly explains that it uses the revenue foregone approach and goes further to explain the specific methodology it adapted for some of the tax heads. It however does not include explanatory notes on methodology under CIT and there are no indications why these were excluded.

The report also recognizes some limitations in its methodology in estimating the cost of some tax expenditures (such as mortgage interest deductions, homeowners saving plan and for exempted incomes) which is a good practice. The report notes that with detailed individual data, future reports could use micro-simulations to estimate these tax expenditures more accurately. Nonetheless, it is not clear from Annex III of the report how the new methodology would differ from the current methodology.

3.4 Tax expenditures by category and total value of tax expenditures

The report includes sufficient details on the revenues foregone under each tax head and the total tax expenditures for the period 2017 to 2021 but does not disaggregate data on tax expenditures by mechanism (see figure two below) such as exemptions, tax credits, reduced tax rates or tax deferrals and their estimated shares to total tax expenditures. There are different criteria for classifying tax expenditures including mechanism by which they are provided (for example exemptions, tax credits, reduced tax rates or tax deferrals); the type of tax that they relate to (such as VAT, CIT, PIT, and so on); and by their policy objective (for example fostering investment and employment and encourage home ownership). The report only classifies tax expenditures by type of tax which is inadequate. More comprehensive reporting would include additional classifications as Redonda (2016) proposes (see figure 2 below).

Figure 2: Classification of tax expenditures

Category	Criterium	Examples
Mechanism for delivery	The mechanism through which the TE is granted	Exemption, deductiion, credit, relief, tax-free threshold, deferral
Type of tax	The particular tax base to which the TE is applied	PIT, CIT, VAT
Budget category	The budgetary heading to which the TE is attributed	By function such as education, health, fuel and energy
Policy objective	The specific policy objective for which the TE was designed	Making work pay, housing, innovation
Beneficiary	The agent or entity that benefits from the TE	A (group of) consumer(s), producer(s), region(s)
Size	The magnitude of the TE in terms of its costs (e.g. revenue forgone)	Absolute terms (e.g. in dollars), % of GDP, % of total tax revenue

Source: Redonda (2016)

3.5 Beneficiaries of tax expenditures

The report does not include any specific information on who the ultimate beneficiaries of tax expenditures are. Looking at CIT, the report provides tax expenditures by sector but does not have information on the beneficiaries (such as the number of firms) of the tax reliefs. Under PIT, our expectation is disaggregation of tax expenditures by income groups to allow further analysis on equity, efficiency, and effectiveness.

3.6 Policy objectives of tax expenditures

The report also fails to include sufficient details on the policy objectives of various tax exemptions. Some of the listed objectives of tax expenditures are promoting investment, increase employment and encourage home ownership. These objectives are very broad. As Redonda (2016) notes, this is a common practice among developing countries, but clear definition of policy objectives is critical in understanding whether or not tax expenditures contribute to broader economic objectives. The Addis Tax Initiative Post-2020 Monitoring Framework recommends inclusion of a detailed description of tax expenditures' policy objectives. It would also be useful to include a clear rationale for each tax expenditures. Rwanda's tax expenditures reports illustrate how this can be achieved.[ii]

3.7 Recommendations for improving transparency of the report

Tax expenditures should be disaggregated under each tax head to clarify the sectors and beneficiaries of each TE. The 2022 tax expenditures report provides sufficient detail on the cost of tax expenditures in Kenya by estimating the 'revenue foregone' under each tax head. Nonetheless, the data provided is too aggregated. Ultimately, every tax expenditure is a policy choice, and we need to evaluate them individually, not only as a whole. Future reports should include:

i. The mechanism for delivery for example exemptions, deductions, tax relief et cetera.
ii. A breakdown of tax expenditures by sector for each tax head,
iii. Beneficiaries such as number of firms,
iv. Policy impacts of tax expenditures such as estimated incremental investments because of tax incentives,
v. Government function/ budget category such as health, education etc
vi. Policy justification of each tax expenditure

Figure 3: Rwanda provides a rationale for each tax head in its tax expenditures reports

#	Provision	TE estimate (Rwf bn)			Rationale/description
		2018/19	2019/20	2020/21	
1	VAT exemption for financial services	15.85	13.53	25.51	Intended to increase affordability of a sensitive product. Exemptions are applied by many countries because of difficulties in applying VAT to this sector.
2	VAT exemption for supplies for health-related purposes	6.30	10.53	16.91	Increasing affordability of a sensitive product. Excludes TE on public healthcare provision.
3	VAT exemption for information, communications and Technology equipment	18.93	16.82	16.28	Encourage use of modern ICT equipment and technologies.
4	VAT exemption for educational materials, services and equipment	9.75	13.48	15.57	Increasing affordability of a sensitive product. Excludes TE on public sector education.

ii https://www.canada.ca/en/department-finance/services/publicationsfederal-tax-expenditures/2022/part-8.html

There is no need to reinvent the wheel: Kenya can draw on experiences from other countries to prepare its report. Rwanda's report for FY 2020/21 includes a comprehensive definition of benchmark under each tax head, reference laws, and the tax expenditures data is disaggregated at the sector level. The report includes historical data and a rationale for each tax relief is provided alongside a cost estimate and sufficient details of the methodology and the attendant limitations. Canada's tax expenditures report exemplifies how countries can estimate the impact of tax expenditure on different categories of taxpayers.

Include policy objectives of all tax expenditures. The 2022 tax expenditures report only mentions general policy objectives of preferential tax measures, though there is some implicit discussion of the purpose of exemptions under CIT. Tax expenditures, like budget spending, should have clear objectives, such as increasing capital outlays in some sectors, increasing disposable income of low-income households, and so on. It is impossible to assess whether tax expenditures have an impact in the absence of defined objectives. The practice in Kenya of defining objectives very broadly is detrimental to understanding how tax expenditures contribute to broader economic goals. The government by reporting on objectives can use this information to ensure consistency across policy tools and avoid redundancy.

4. ASSESSING EFFECTIVENESS

A comprehensive assessment of tax expenditures is critical to evaluating whether they provide value for money and whether the government should reform tax expenditures or do away with them altogether. The 2022 tax expenditures report lists the policy goals of tax incentives among them to spur economic growth, increase investments, create employment, and lower the cost of living. These policy objectives are very broad. As we saw in the last section, the report fails to disaggregate data on tax expenditures by specific policy objective, making it impossible to assess their efficacy. And the report itself makes no effort to estimate the effectiveness of tax expenditures against policy goals.

The report attempts to relate some tax expenditures with growth in the manufacturing sector and increase in employment. The report explains that the manufacturing sector accounted for about 18 percent of total VAT tax expenditures in 2021. Data from the Economic Survey show that formal employment in the sector also grew, but by just under 5 percent, while the manufacturing sector's contribution to GDP actually declined, from 7.8 percent to 7.6 percent between 2021 and 2022. These figures do not tell us conclusively whether incentives worked or not, but they certainly suggest a need for more analysis to quantify the extent to which tax incentives in the manufacturing sector are effective. In particular, the government must indicate what it expects to result from an incentive: when tax incentives of X percent are offered, what level of employment growth in manufacturing do we anticipate? Such estimates must take into account factors such as the rate of substitution between factors of production when incentives affect relative costs (e.g., if an incentive makes capital cheaper, to what extent will employment be dampened as producers shift toward using more capital than labor?).

Notably, many important incentives are considered part of the benchmark in the report and are therefore not discussed at all. For example, the 2022 tax expenditures report considers incentives in Export Processing Zones (EPZ), Special Economic Zones (SEZs) as part of the benchmark. However, these incentives are very costly. Conservative estimates by Africa Centre for People, Institutions and Society (ACEPIS) indicates that the government relinquished approximately Ksh 20 billion in corporate income tax that the companies in EPZs would have paid between 2011 and 2019 . In giving these tax incentives, the government cites a broad goal of increasing exports and employment, but various analysts have raised doubts about their efficacy.

While granting tax incentives to promote investment is common in countries around the world, evidence suggests that their effectiveness in attracting incremental investments—above and beyond the level that would have been reached had no incentives been granted—is often questionable. A World Bank survey established that 93 percent of investors in East Africa would have invested even if tax incentives were not offered. As tax incentives can be abused by existing enterprises disguised as new ones through nominal reorganization, their revenue costs can be high. Moreover, foreign investors, the primary target of most tax incentives, base their decision to enter a country on a whole host of factors (such as natural resources, political stability, transparent regulatory systems, infrastructure, a skilled workforce), of which tax incentives are frequently far from being the most important one. In addition, tax incentives are not an end in and of themselves but are a net reduction in cost of operations which can then compensate for other factors that are important for investors but may be lacking in country. Therefore, their impact on investment is not obvious.

Ideally, we would expect to see data on tax expenditures broken down by their specific policy goals and how they have contributed to these

goals such as increased investment, employment, and home ownership. That way, it would be possible to determine if the tax incentives indeed contributed to achieving the specified policy goals. Some indication of how to measure whether these purposes are being achieved would be the second step. Even if the government is not yet able to make a full assessment of impact, it should lay out a road map for doing so in the future by collecting certain forms of data. At a minimum, more information could be provided about who receives or uses tax expenditures: how many corporations benefit from a particular exemption, and an estimate of the value in real terms of these exemptions for that set of actors. For example, the tax expenditures report highlights increased investment as a core objective of incentives under CIT. However, without some of form of evaluation, we cannot tell whether investments have actually increased as a result of tax incentives.

Without an evaluation framework that defines how to measure their impact we cannot evaluate if these tax incentives are indeed effective. Such frameworks do exist, however, and Kenya can learn from countries such as Ireland, whose ex-ante evaluation framework includes key questions such as: what the objectives of tax expenditures are, what market failure are they addressing, are tax expenditures the best approach to the market failure, what are the anticipated economic impacts, and what is their projected cost. Similarly, Ireland's ex-post evaluation assesses whether tax expenditures are still relevant, the actual cost and impact of tax expenditures and whether they have been efficient. Ireland's assessments vary in scope and frequency; for tax expenditures greater than Euro 50, a full cost benefit analysis (CBA) is conducted including identifying methods and data requirements for ex post CBA, which is done after three years.

4.1 Overall assessment of Effectiveness

Overall, the report lacks an evaluation of the effectiveness of tax expenditures. Comprehensive information about the intended goals of tax expenditures, as well as techniques and procedures to determine if these goals are being reached, are fundamentally lacking. Achieving the desired objectives in the use of tax expenditures requires institutionalized (as opposed to ad hoc) evaluations for informed decision making, which in some countries (such as Germany and Netherlands) is a legal requirement. We also acknowledge that it may not be feasible to conduct in-depth annual evaluations of tax expenditures, but periodic evaluations should be achievable (in the Netherlands, evaluations are carried out every four to seven years). There are existing evaluation frameworks and guiding notes on evaluating the effectiveness of tax expenditures. For instance, the IMF proposes the questions below to assess the effectiveness of tax expenditures:

i. What are the intended benefits of the program, and who are the intended beneficiaries?
ii. Do most eligible taxpayers claim the tax expenditure? If not, what prevents them from doing so?
iii. What are potential indirect benefits?
iv. Would the desired behaviour also occur in the absence of the expenditure?
v. What is the potential for displacement effects?[iii]

4.2 Recommendations for improving effectiveness

Produce a guideline detailing process of introducing, reviewing, and evaluating tax expenditures. We recognize that decisions on the introduction and review of tax relief measures may be outside the scope of a tax expenditures report, nonetheless, the government should document and publish information on process of introducing, reviewing, and evaluating tax expenditures. This can be done in a separate document as is the practice in Ireland.[iv]

Conduct periodic assessment of effectiveness of the most significant tax expenditures. For a start, an evaluation of Kenya's tax expenditures could attempt to answer some of the questions on evaluating tax expenditures

[iii] An example of displacement effect is an increase in investment or employment in one sector may also result in a corresponding decrease in another sector.

[iv] Ireland in the Medium-Term Economic Strategy 2014-2020 ("the MTES") established a number of tax expenditure principles. The MTES indicates that tax expenditures could be used in limited circumstances where there is demonstrable market failure and a tax-based incentive is more efficient than a direct expenditure intervention. The MTES also stipulated that tax expenditures be time-bound, with higher-cost expenditures subject to ex ante evaluation, and that tax expenditures be reviewed on a regular basis.

Box 1: Ireland's Evaluation of Effectiveness of the R&D Tax Credit

Ireland's National Research and Innovation Strategy prioritizes research and innovation in addressing societal, economic, and environmental challenges. The government of Ireland therefore funds R&D directly and indirectly through tax credits. Corporations offset their qualifying R&D tax credit against their corporation tax liabilities.

Ireland evaluates its Research and Development (R&D) tax expenditures by assessing whether there is value for money, whether the additional R&D spending would have taken place without the tax credit and whether there is increased employment and demand for higher education as a result of the tax credit.

The Revenue Commissioners collect detailed data on R&D activities that can be used to evaluate the impact of these R&D tax expenditures. The data includes information on claimants (SMEs and large companies) and the cost of the credit disaggregated by sector. This allows greater transparency in tax expenditures reporting.

In the 2022 assessment of R&D, Ireland hypothesized that a decline in the cost of R&D as a result of the tax credits should lead firms to allocate more resources to R&D, thereby increasing the level of R&D. The evaluation combined desk research to compare R&D approaches across different countries, economic analysis, and qualitative analysis of responses from a public consultation process. However, due to insufficient data points, the econometric model did not produce robust results. A 2016 review used a different approach (difference-in-difference) and established that each euro of foregone revenue generated an additional €2.4 in R&D spending.

The 2022 evaluation supplemented the quantitative analysis with information from public consultations that included questions on key factors that influence R&D decisions and the impact of the tax credit on these decisions. The consultation included specific questions to SMEs who are less likely to claim the tax credit due to the associated administrative burden. The respondents highlighted qualitative benefits of the tax credit (such as knowledge development and retention) and the need to ease some requirements for SMEs in claiming the R&D tax credit.

Ireland's Ministry of Finance analysis supported retention of the tax credit because it has significant spill-over effects on employment and higher education.

Source: Ireland's 2022 Tax Expenditures Report

that the IMF proposes in its 2022 report (cited above) covering the most significant tax expenditures and progressively work towards periodic assessments for all tax expenditures. This is in line with the National Tax Policy that commits to implementation of a centralized monitoring and evaluation framework for tax incentives.

5. ASSESSING EFFICIENCY

The 2022 tax expenditures report does not provide any assessment of efficiency. In order to assess the principle of efficiency, it is imperative to define the broad approaches/ elements of an efficient tax expenditure. The IMF, OECD, United Nations, and World Bank define efficiency of tax expenditures to mean that tax expenditures meet their objectives at low social costs including loss of revenue. In line with this definition, the goal of tax incentives should always be to support activities that would not take place without the tax incentive. Evaluation of efficiency of tax expenditures is also important to quantify indirect costs that rise from tax incentives. For example, if only foreign investors enjoy a certain incentive, then local firms may use a foreign conduit to invest. Similarly, if a tax incentive targets new firms only, then investors might set up new companies to enjoy preferential taxation for new firms. As with tax policy more generally, optimal tax expenditures should not lead taxpayers to undertake activities that are not economically viable only to avoid paying tax. Administrative and compliance costs also arise in administering tax incentives and in taxpayers meeting various compliance requirements, and these should also be evaluated especially in the context of developing countries where there is limited administrative capacity.

Kenya's 2022 tax expenditures report does not contain any solid discussion of effectiveness. The report mentions that rationalization of tax expenditures would eliminate redundant tax expenditures while retaining those that promote investments and social protection. But this general mention of rationalizing tax expenditures does not indicate that the government uses evidence in designing tax expenditures. The report further indicates that on advice from the World Bank it has removed some tax incentives because they did not yield the expected results, such as lowering prices or increasing supply of some products. While some inefficient incentives may have been removed, there is no analysis showing that the incentives currently in place are efficient. The report mentions the need for an elaborate monitoring and evaluation framework on the impact of tax expenditures in the economy but does not provide further details of when or how this framework would be developed.

Evaluation of efficacy of tax incentives should also look at their impact on other sectors in resource allocations. By design, tax incentives disadvantage those investments that have no incentives, which may result in higher investments in areas that enjoy tax incentives. The result may be movement of labour from non-incentivised to incentivised investments because firms enjoying tax incentives may offer higher wages. Such a scenario may distort allocation of resources among different sectors and in turn may negatively affect economic growth if the privileged sectors are not ultimately viable.

Some countries provide good examples of how to evaluate efficiency of tax expenditures that are entrenched in their tax expenditures evaluation frameworks. Ireland, Germany and Netherlands have evaluation frameworks that provide for regular review of tax expenditures, desired policy objectives of tax expenditures, and whether a tax expenditure are the most appropriate policy alternative compared to other policy instruments. Ireland's evaluation framework is largely aligned to the OECD approach, where tax expenditures are limited to cases where there is clear market failure[v] and where tax incentives

[v] Ireland defines market failure as *"a situation where an imperfection in the market mechanism prevents the achievement of economic efficiency. It is often represented in situations where supply and demand do not balance at a price that would apply in a well-functioning market. Market failures can occur in the presence of positive or negative externalities, monopoly presence, information asymmetries, or the existence of public goods".*

would be more effective than direct spending. For example, businesses tend to under-invest in Research and Development (R&D). A government would therefore give tax incentives to encourage more R&D spending and is justified because of the likely positive externalities on the rest of the economy. Similarly, it may be more efficient to zero-rate basic commodities compared to running a cash transfer programme targeting low-income earners because the later would have higher administrative costs.

The IMF has published some guidelines on how to evaluate tax expenditures and indicates that annual evaluations of tax expenditures is both infeasible and unnecessary, but it is important for countries to evaluations their tax expenditures periodically. A good approach would be to conduct thematic evaluations where tax expenditures with the same policy objectives are evaluated together. Evidence from evaluation would be useful in streamlining tax expenditures with similar objectives and to eliminate redundant tax expenditures. Nonetheless, evaluations before introduction of tax expenditures, such as that carried out by Belgium on car taxes (see Box 2) would be critical in providing a justification for a tax expenditure and its alignment with broader economic goals.

Box 2: Tax Expenditure reforms: Ex Ante evaluation of the reform of company car taxation in Belgium

Belgium's Law on Fiscal and Social Greening of Mobility enacted in 2021 eliminated corporation tax deductibility for all company cars except those with zero carbon dioxide (CO2). The goal of the law was to encourage transition to all-electric company car fleet. This law was designed to address a negative externality of green-house gases (market failure) from use of non-electric company cars by limiting tax expenditures to electric cars that do not emit these gases.

Belgium's Federal Planning Bureau estimated the policy impact of the new law on fleet composition and revenues; this was achieved by comparing two scenarios using a model that the Bureau developed. Key findings from the model included:

i. The tax reform accelerates the electrification of the company car fleet.
ii. The accelerated electrification of the company car fleet leads to a decrease in tax revenues from the ownership and use of company cars compared to a scenario without reform.
iii. The accelerated electrification of the company car fleet leads to higher corporate tax revenues compared to a scenario without reform.
iv. The accelerated electrification of the company car fleet has a net positive impact on public finances compared to a scenario without reform.
v. The accelerated electrification of the company car fleet leads to an accelerated reduction in CO2 emissions compared to a scenario without reform.

This assessment simulated the possible policy outcomes of reforming an existing tax deduction; Kenya could follow a similar approach in reforming tax expenditures.

Source: Franckx (2022)[23]

5.1 Overall Assessment of efficiency

Kenya's tax expenditures report does not include any discussion of efficiency. It is important to evaluate whether tax incentives are the lowest cost way to achieve the goals of reducing the cost of capital and to encourage investment, support development expenditure, and ease the cost of living for the vulnerable in society, among others.

5.2 Recommendations for improving efficiency

The government should conduct regular review of tax expenditures, starting from the most significant. The National Tax Policy rightfully recognizes that some tax incentives and exemptions are economically inefficient and indicates that the government will develop guidelines and regularly review the cost and benefits of the tax expenditures. An evaluation should go beyond looking at the obvious cost of revenue foregone to a deeper analysis that looks at administrative and compliance costs and potential impacts of tax expenditures on other sectors of the economy. These evaluations provide evidence to inform design of tax expenditures, so that they reduce these costs thereby increasing their efficiency.

6. ASSESSING EQUITY

As mentioned earlier on in this report, governments use tax systems to achieve policy objectives through such measures as preferential rates, exemptions, deductions, deferrals, and tax credits. These measures are designed to serve different purposes: some of these measures are aimed at cushioning citizens from high cost of living while others aim at promoting investments (including foreign direct investment), stimulating employment, and encouraging savings. Assessing the impact of tax incentives on income distribution helps determine whether tax incentives enhance equity or not.

Good tax systems redistribute wealth and raise revenues to fund provision of public goods and services; this makes taxation one of the most effective avenues for governments to reduce inequality. Taxing profits, especially large multinational corporations, is one of the most progressive taxes because it raises revenue that governments can use to fund pro-poor expenditure including health and education. Conversely and as Oxfam argues, when corporations do not pay a fair share of their taxes, governments tend to either cut back on spending including social spending or increase the incidence of some taxes (for example VAT) to make up for the foregone revenues. This has a negative impact on equity because a majority of poor people depend on public services.

Evaluating equity is important, but not straightforward. Consider PIT. The benchmark for personal income tax (PIT) is remuneration paid to an individual and tax expenditures under this tax head include reliefs to encourage savings, home ownership and reduce the tax burden. Personal relief accounts for 80 percent of tax expenditures under PIT, with both low-income earners and high-income earners benefitting from this provision. While such relief accounts for a higher share of income for lower income earners, making it progressive, it also provides a benefit to higher income earners that they may not need.

Higher income earners probably benefit disproportionately from mortgage relief and insurance relief. The report does not discuss the equity implications of these exemptions, but some basic analysis suggests that these provisions are unlikely to benefit lower income workers. The Income Tax Act provides for insurance relief on premiums paid for education policies, health policies or life insurance. Data from the Insurance Regulatory Authority (IRA) indicates that only 24 percent of Kenyans used insurance services in 2021. The main reason for not having insurance was the high cost of insurance premiums. This implies that only a small number of high-income earners can benefit from the insurance relief, contributing to an inequitable tax system. Equity is not the only goal of the tax system, but each of these exemptions should be assessed for their equity implications alongside other policy objectives, such as increasing insurance coverage or homeownership.

Investment deductions tend to be regressive due to their tendency to disproportionately benefit higher-income individuals and corporations with larger investments, exacerbating income inequality. The government considers a 10% reduction on investment under corporate taxes to be part of the benchmark, which means it is not even part of the equity conversation about tax expenditures, though this may well be regressive. Beyond 10 percent, as discussed earlier, further deductions are considered tax expenditures. The amount of investment required to benefit from these deductions is also out of reach for the poor. For example, firms enjoy 150 percent investment deductions for capital expenditures on building and/or machinery exceeding Ksh. 200 million if the investment is outside Nairobi. Only a handful of wealthier Kenyans can raise such an investment amount. Of course, it is obvious that these kinds of incentives are targeting large investors; the question is whether they can be justified, given their equity implications.

While some degree of inequity is inevitable, such deductions should have a net positive impact on society. This may occur if the incentives lead to investments that benefit the country as a whole, and/or if they lead to trickle down through more job formation for lower income workers. Reported data shows that both investment and employment have been on the rise. Commercial banks and other financial institutions approved Ksh 465 billion in credit to fund manufacturing projects in 2021, an increase from Ksh 367 approved in 2020. Similarly, Kenya Investment Authority (KenInvest) registered 30 proposed industrial projects with a capital cost of Ksh 7.4 billion in 2021 compared to 21 valued at Ksh 4.9 billion registered in 2020. Private sector formal employment grew modestly by 6.7 percent in 2021. However, the 2022 tax expenditures report does not have any kind of analysis of the role that tax incentives have played in these trends, or whether this has benefited low income earners.

Most tax expenditures relate to domestic VAT in the 2022 tax expenditures report. But, because the government includes many exemptions/zero-rated items in the benchmark tax system, it is difficult to determine the equity implications of the VAT regime. On the other hand, there is no further breakdown of VAT to understand who benefits from the remaining exemptions and zero-rating: that is, while Annex 1 in the report gives us information about what is part of the benchmark, no comparable table describes the items that are actually tax expenditures.

6.1 Overall Assessment of Equity

The National Treasury identifies more equitable distribution of income as a core policy objective of tax incentives but does not evaluate how the reported tax expenditures contribute to this goal. Lack of comprehensive data on the beneficiaries of tax expenditures limited our review of equity.

6.2 Recommendations for improving Equity

The government should publish information on the beneficiaries of tax expenditures, disaggregated by income, age, sector, and region to allow assessment of equity impacts of tax expenditures. Although equity is a crucial aspect to consider during the evaluation of a tax expenditure,

Table 4: Some of the items that are either exempt or zero-rated make the benchmark generally progressive, but there are many questions

Item	Progressive/Regressive
Domestic supply of listed agricultural inputs, including fertilizers	Progressive
Specified financial & insurance services	Regressive
Education services	Regressive[vi]
Sale, renting, leasing, hiring, letting of land or residential premises	Regressive
Medical, veterinary, dental, ambulance and nursing services	Progressive
Materials, articles, equipment and motor vehicles specially designed for the sole use by disabled and physically handicapped persons	Progressive
Betting, gaming and lotteries services	Regressive
Hiring, leasing and chartering of aircrafts, aeroplanes, and space crafts, excluding helicopters	Regressive
Taxable goods for emergency relief purposes	Progressive
Goods imported by passengers arriving from places outside Kenya	Regressive

[vi] While higher education subsidies make education affordable for low-income earners, they also benefit students with the ability to pay. In some countries with free higher education only those from advantaged families access it, making these subsidies regressive. Link.

obtaining or accessing data regarding the distributional effects—specifically, identifying those who gain and those who do not—is often challenging, especially for special concessions granted through indirect taxes like VAT. In the absence of this data, consumer surveys data can be used to estimate the impact of different tax expenditures on different income groups.

Evaluate equity implications of tax expenditures within the context of the overall tax system. Beyond looking at the equity implications of individual tax expenditures, we need to look at them in the context of the overall tax system. If VAT as a whole is progressive/regressive, and tax expenditures represent a small fraction of the VAT system, then a focus on equity might demand that we look not just at tax expenditures, but at the larger picture. Therefore, the government should also include in its report an assessment of the size of tax expenditures relative to the total revenue for each type of tax and the overall distribution or incidence of that tax (clarifying whether this includes or does not include the exemptions). The tax expenditures report does not include any analysis of this kind; Kenya can learn from Canada in analysing the equity impacts of tax expenditures.

Box 3: Canada's analysis of impacts of tax expenditure on gender and diversity

The Canadian Gender Budgeting Act, 2018 mandates the Ministry of Finance to make publicly available an analysis of the impacts of tax expenditures on gender and diversity. In line with this legal requirement, Canada's 2020 tax expenditures report includes an analysis of the impacts of tax expenditures on persons with disabilities. The Canadian government gives tax relief to Canadians with disabilities and their care givers because they incur expenses that reduce their ability to pay taxes.

Using Canadian Survey on Disability (CSD) data on people with disability and data on individuals that benefit from tax expenditures, the Ministry of Finance analyzed tax-related factors including: specific personal information, like the location of taxation, sources of income before taxation (such as employment, investments, capital gains, and transfers), various tax measures that allow the calculation of after-tax income for individuals, and claims of tax expenditures designed to offer specific support to persons with disabilities and their caregivers to determine the impact of tax expenditures on persons with disability.

The analysis revealed that different tax expenditures have varied impacts on reducing pre-tax income inequalities between persons with and without disabilities. The analysis also identified the most beneficial tax expenditures; Canada Workers Benefit supplement (CWB-sup.), Disability Tax Credit (DTC) and Non-taxation of workers' compensation (WC) benefits and non-taxation of social assistance (SA) benefits. The analysis also indicates that the progressive structure of PIT plays a significant redistributive role towards persons with disabilities.

Source: Canada's 2023 Report on Federal Tax Expenditures [vii]

7. CONCLUSION

Publication of a tax expenditures report is critical for transparency and can facilitate evaluation of the effectiveness, efficiency and equity of tax expenditures. Tax expenditure reporting is a good practice although details of these reports vary from country to country. Production of these reports is critical for transparency on the use of the tax system in achieving specific policy goals. Quality tax expenditures reports are important in supporting policy discourse and support government's efforts to reduce inefficiencies and inequities in public finance.

While we applaud the production of a regular tax expenditure report in Kenya, in its current form the report is inadequate to support a critical review of the country's use of tax exemptions. Kenya produced her maiden report in 2021 noting that tax expenditure reporting is an international best practice. While this is commendable, our review of the 2022 tax expenditures report demonstrates that the report is inadequate for a comprehensive assessment of tax expenditures in Kenya through the lens of transparency, equity, effectiveness, and efficiency.

Although the tax expenditures report adopts a benchmark system, it is inconsistent and opaque. The World Bank in a working paper recognizes that definition of a benchmark tax system as a key building block in tax expenditures reporting but also recognizes it as the trickiest. Defining a benchmark is very crucial because revenue foregone is estimated against the defined benchmark system. Kenya, like many other countries, follows the legal approach in defining the benchmark but changes in the definition of the benchmark between the 2021 and 2022 report do not inspire confidence in government's estimates of the revenue foregone. Many important exemptions are moved into the benchmark as well, which means that they are not part of the debate over tax expenditures, despite their cost and centrality to policy. Going forward, the government should provide a justification for including or excluding some items from the benchmark, provide alternative estimates whenever there are changes in the benchmark, and explain changes in tax expenditures over years.

The report is not as transparent as it could be as it fails to provide disaggregated data under each tax head to clarify beneficiaries and policy objectives of each tax incentive. The reported tax expenditures data is highly aggregated, so the public does not have sufficient information on who the ultimate beneficiaries of tax expenditures are. Inadequate details limit the kind of analysis that can be done, including assessment of the equity impact of tax expenditures. This does not mean that beneficiaries should be identified as individuals or companies, but beneficiaries can be analysed at the level of economic sectors or by income groups. Secondly, it would be important to report on revenue lost under each measure (preferential rates, exemptions, deductions, deferrals, and tax credits) as opposed to reporting an aggregate number under each tax head when different measures have different impacts.

Thirdly, the government does not assess efficiency or effectiveness of tax expenditures, nor their impacts on equity. Despite the recognition that evaluations of these principles are important, there is no such evaluation in the report or elsewhere. There is a generic mention of government's intention to review the existing preferential tax provisions with a view to rationalize them and retain tax expenditures that support investment and those geared towards social protection. When tackling the issue of tax expenditures, we need a nuanced approach that looks at specific types of tax expenditures, their purpose and their value, rather than making general statements about the need to reduce or eliminate them. Nonetheless, to the best of our knowledge the government does not have an evaluation framework to judge which tax expenditures to retain, and which ones should be eliminated. Our review did not identify specific best practice among developing countries, but highlighted examples of extensive evaluation frameworks developed by some countries such as Ireland, Netherlands, and Germany.

Finally, civil society organizations have long questioned the efficacy and cost associated with tax expenditures but they have tended to lump all tax incentives together into one basket, without considering their intended policy goals. For example, a tax incentive provided to a foreign investor is a form of tax expenditure, if it is a deviation from the tax code in place. But that incentive is provided to stimulate foreign investment. Many tax expenditures are also deviations from the tax code but are not incentives for investment. For example, an exemption from VAT on basic goods is usually intended to reduce the burden of taxation on lower-income consumers, not to increase investment. Both types of tax expenditure may be challenged, but not necessarily on the same grounds. This differentiation is important and civic actors should conduct a differentiated analysis in order to most effectively influence government policy. We hope that this report contributes to more nuanced discussion of tax expenditures going forward.

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