

**RETHINKING THE KENYAN LAW AND POLICY ON VAT EXEMPTIONS:  
TOWARDS A THINNER EXEMPTION LIST**

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PSV Public Service Vehicle  
PULP Pretoria University Law Press  
RST Retail Sales Tax  
SAGA Semi-Autonomous Government Agencies  
SET Selective Employment Tax  
TJN Tax Justice Network  
TMP Tax Modernization Program  
ToT Turnover Tax  
UTS Unified Tax System  
VAT Value Added Tax  
VATTR Value Added Tax Tribunal Reports  
WB World Bank

**DECLARATION**

I, **Ahmed Ibrahim Ogle**, do hereby declare that this is my original work and any references made to the works of others have been properly acknowledged. This work has not been submitted to any other university, college or institution apart from the University of Nairobi.

Signed..........

Date.....22/11/2018.....

**Ahmed Ibrahim Ogle**

**G62/76076/2014**

**Supervisor's Approval**

This Dissertation has been submitted for examination with my approval as the student supervisor.

Signed..........

Date.....22.11.2018.....

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## **DEDICATION**

To my Daughter **Ishraq Ahmed Ibrahim Ogle** and my Wife **Najma Abdullahi Ahmed**.

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Lastly, I would like to thank my family members and friends for their encouragement and understanding, which in the end contributed to the successful completion of my LLM. To Mr. Ahmed Sheikh Adan for financing a huge part of my LLM school fees.

## CHAPTER ONE: INTRODUCTION

### 1.1. Background

“Governments need money. Modern governments need lots of money. How they get this money and whom they take it from are two of the most difficult political issues faced in any modern political economy” — Sven Steinmo.<sup>1</sup>

Value Added Tax has been defined as a consumption tax levied on consumers of goods and services;<sup>2</sup> it is therefore an indirect tax. There is no specific or single definition of the phrase VAT Exemption. However, Scholars and Drafters defined VAT exemption by giving a description of how it operates and its effects. For instance, Alan Schenk and Oliver Oldman define VAT Exemption from the context of exempt sale. They define it as a sale that is not subject to VAT.<sup>3</sup> Ebrill et al in their book, *Modern VAT* define VAT Exemption from a context of how VAT Exemption works and how it is structured. They argue that VAT Exemption occurs when output is untaxed and the seller cannot claim the VAT in purchases/input VAT.<sup>4</sup>

In Kenya, an attempt was made in the VAT Guide published by the Kenya Revenue Authority to define VAT Exemption. Again the definition in the VAT Guide is an operational definition. It defines VAT Exemption by referring to the list of items that are the subject of exemption and explaining its effects. This is a scheduler kind of definition.<sup>5</sup>

The Cabinet Secretary for National Treasury submitted to the National Assembly the Valued Added Tax Bill 2013 aimed at among other things addressing the challenges faced in the

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<sup>1</sup> As is quoted in, Attiya Waris, Jack Ranguma & Matti Kohonen, *Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare* (Tax Justice Network 2009) 7.

<sup>2</sup> See the definition given in VAT Theory and Background (1992), Value Added Tax Training Institute. Cf to the definition by Richard Krever, Richard Krever, ‘Designing and Drafting VAT Laws for Africa’ in Richard Krever (eds), *VAT in Africa* (Pretoria University Law Press 2008) at 13.

<sup>3</sup> Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007)19.

<sup>4</sup> Ebrill et al, *Modern VAT* (IMF 2001) 83.

<sup>5</sup> The VAT Guide: A step by step Compliance Guide to VAT in Kenya (Kenya Revenue Authority 1999) 98.



administration of tax under the VAT Act 1989.<sup>6</sup> This Bill was eventually passed and became the VAT Act 2013. It was celebrated to have among other things reduced the long list of VAT exemptions. Some of the items that were excluded from the VAT exemptions include fuel. Other items such as financial services were retained and are still part of VAT exemptions. This paper explores into the rationale for inclusion of financial services among the list of VAT exemptions and whether its inclusion has occasioned on the government of the day loss of possible revenue it would have generated if Financial Services were included within the realm of VAT taxation.

In a move that was highly celebrated by all the stakeholders, the Government of Kenya in 2010 promulgated the Constitution of Kenya.<sup>7</sup> Among many other milestones, the new constitution created two levels of Government namely the National Government and the County Governments (47 County Governments) resultantly increasing the levels of government and the government's expenditure. It was, however, expected of the drafters of the Constitution and the public finance technocrats to among other things come up with ways to rethink the revenue mobilization base to accommodate the change in the governance. By not considering the need for a change in the revenue mobilization framework, then there is a highly likelihood that the Government of the day will resort to selling of assets and debts to finance the budget deficit, options which have never been sustainable and will not work in the long run. This paper explores if by thinning the list of VAT exemptions through the exclusion of financial services, the government of the day will be in a position to raise more revenue to meet its budgetary targets.

Most countries in the world including Kenya adopted the destination principle in determining the imposition of VAT on exports and imports. This is against the availability of the alternative of using the origin principle in imposing VAT on exports and imports.<sup>8</sup> There are, however, some underlying structural and administrative problems with destination zero rating

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<sup>6</sup> See the Memorandum of Objectives in the VAT Bill 2013 at <http://www.kenyalaw.org/kl/fileadmin/pdfdownloads/bills/2013/THEVALUEADDED TAXBILL2013.pdf> (accessed on 10/11/2018)

<sup>7</sup> See Article 6, Constitution of Kenya 2010.

<sup>8</sup> Alan Schenk, *ibid*, 182.

of exports. They include, the risk of introducing significant and costly distortions<sup>9</sup> and the problem of large refunds and revenue losses occasioned by the said tax refunds.

## 1.2. Statement of the problem

VAT is part of the wider taxation regime in Kenya and was initially designed to help in widening the tax base in order for the government of the day to increase its revenue from tax.<sup>10</sup> However, this was marked by the introduction of VAT on certain goods and/or services and exemption or zero rating of some of the goods and/or services defying the whole essence of widening the tax base.<sup>11</sup> It has been estimated that the various governments from 1989 until now have lost out on the opportunity to subject some of the items that were classified under exemption to VAT taxation.<sup>12</sup> By subjecting some of the exempted items such as financial services to VAT taxation, it would have helped the government address the long lasting budget deficits.

Another problem that complicates the existing revenue mobilization framework is the introduction of two levels of government courtesy of the Constitution of Kenya 2010. The VAT Act 2013 in an attempt to increase the possible revenue from VAT excluded some items from VAT. Some of these items include fuel.<sup>13</sup> However, some items such as financial services especially those services that can be argued to be transactional such as letters of credit and forex have been retained under the list of exemptions. This creates the problem of deepening Kenya's budgetary deficits.

Further, Kenya and other small economies have been faced with the problem of blindly adopting the destination zero rating of exports. There are underlying structural and administrative problems with this approach of zero rating exports. They include, the risk of

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<sup>9</sup> See the discussion by Ebrill et al, The Modern VAT (IMF 2001).

<sup>10</sup> See the Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth where it was proposed that the Government should focus on consumption taxation as a way to enhance its revenue mobilization base.

<sup>11</sup> See the First, Second and Fifth Schedules to the VAT Act 1989 that has long lists of Rates and Exemptions. Indeed the lists of rates and exemptions run from page 38 to 91.

<sup>12</sup> See the Report by the Tax Justice Network available at <http://www.taxjusticeafrica.net/wp-content/uploads/2015/11/eac-tax-competition-report.pdf> (accessed 08/12/2015) where it is estimated that between 2003 and 2008 Kenya lost over Kshs. 24 billion from VAT exemptions.

<sup>13</sup> See the First Schedule to the Valued Added Tax Act 2013 available at [http://www.kenyalaw.org/lex/actview.xhtml?actid=No.%2035%20of%202013#part\\_XVIII](http://www.kenyalaw.org/lex/actview.xhtml?actid=No.%2035%20of%202013#part_XVIII) (accessed on 02/08/2015).

introducing significant and costly distortions<sup>14</sup> and the problem of large refunds and revenue losses occasioned by the said tax refunds.

### **1.3. Objectives of the study**

This study aims at interrogating the history of Kenya's VAT Law and the various tax reforms the government of Kenya has undertaken in order to make VAT simpler and less regressive. In particular, it focuses on the concept of exemption in Kenya's VAT Law and if indeed the approach taken by the Government of Kenya on VAT exemption has helped in addressing the very intention of coming up with exemption and whether the same policies that led to the adoption of the exemptions are sustainable under the current financial and governance climate.

#### **1.3.1. Specific Objective**

The main objective of this study is to interrogate the underlying legal, economic, social and political reasons for Kenya's approach towards VAT Exemption and to make a case for a thin list of VAT exemptions with a specific focus on the exclusion of transactional financial services from the list of VAT exemptions.

#### **1.3.2. General Objectives**

In a general sense, the study aims at establishing the nature of products and services that have been the subject matter of VAT exemption.<sup>15</sup> This is in a bid to establish the honesty or lack of it of the Government of Kenya in dealing with the regressive nature of VAT.

Secondly, this study also aims to establish the extent to which Kenya's VAT exemption conforms to the "so called" best practices in the world. These include the zero rating and exemption of exports and financial services and if the same so called best practices can be viable in the current economic and political set up in Kenya.<sup>16</sup>

The study also aims to explore and underscore the need to strike a balance between the competing interests of widening the tax base through VAT and preventing the regressive

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<sup>14</sup> See the discussion by Ebrill et al, *The Modern VAT* (IMF 2001).

<sup>15</sup> The best practice is classifying the products according to tariff numbers and these are found in the Schedules to the VAT Act.

<sup>16</sup> In order to establish the best practices in VAT exemption and zero rating, the paper explores at the various approaches developed in various countries such as the New Zealand Approach, the Australian Approach and the European Union Approach.

nature of nature of VAT in a country's taxation. In a bid to address the uniqueness of each country, the paper recommends on the best way to strike a balance between increasing the government's revenue and addressing the effects the abolition of exemption and zero rating can have on the poor households.<sup>17</sup>

The paper also aims to establish the existence or non-existence of industry lobbying in influencing the government's decision to zero rate or exempt certain items from VAT. In an attempt to bring the point home, the writer will discuss the exemption of VAT from financial services and the trend in the law and policy documents with regard to VAT and exemption.

#### **1.4. Research Questions**

This paper aims to answer the following questions. First, what was the purpose of the government of Kenya in coming up with a VAT structure that provided for a long list of exemptions? Was this viable in the context of Kenya's economic and political set up?

Second, what are the issues that inform the inclusion or exclusion of goods and services from VAT and is exemption a good approach in VAT? Reference is made to the Financial Services sector and the destination zero rating principle of exports to illustrate the policy consideration in coming up with exemptions and to explore the possibilities of subjecting some of these items within the realm of VAT.

#### **1.5. Hypotheses**

This paper posits several arguments and assumptions that underlie the history of Value-Added Tax in Kenya and on the concept of VAT exemptions. Most of these arguments and assumptions are driven from Kenya's experience with VAT and best practices.

This paper posits that the exclusion and inclusion of certain items are influenced by certain social measures as well as political measures such as the exemption of basic goods in order to cure the regressive effects of VAT (Since VAT is thought to affect the poor households as it taxes consumption).<sup>18</sup>

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<sup>17</sup> For instance, see Richard Krever, *op. cit* (n3) where he talks of how Japan is able to sustain its VAT structure due to its unique political and economic culture.

<sup>18</sup> For instance, see the capture theory discussed by Professor Richard Posner in his work; Richard Posner, "Theories of Economic Regulation" (1974) Vol. 5 No. 2 *the Bell Journal of Economics and Management Science* pp 335-358.

The paper posits argues that Kenya got its VAT partly through influence by foreign and development partners such as the World Bank and the International Monetary Fund (IMF).<sup>19</sup>

The paper also posits that the model of VAT adopted by Kenya is neither the traditional VAT model nor the modern VAT model. The classification of Kenya's model is limited to its approach towards exemption and zero rating.

Lastly, this study posits that Kenya as a developing country should adopt a VAT structure that has a standard and uniform rate with minimum exemption. This is especially the case with a two level governance system namely the national government and the county governments.<sup>20</sup> This requires the government to raise more revenue to sustain both the county governments and the national government.

### **1.6. Justification of the study**

The lack of succinct third world countries' including Kenyan literature on the law and policies of VAT exemptions Kenya points to a need to develop third world literature on VAT exemptions. This paper critically discusses and analyses the experience of Kenya with VAT exemptions and the trade-offs that informed Kenya's approach towards a VAT system that provided for a long list of exemptions.<sup>21</sup>

Few and scattered research has been done on the policy justifications of VAT exemptions, thus making this study among the few that explore the policy justifications of VAT exemptions.

The ballooning debt of the government of the day which has cast aspersions on the ability of the Government to collect sufficient tax also encouraged the writer to consider VAT exemptions and the zero rating of exports under the destination principle.

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<sup>19</sup> Susan Morse, "How Australia got a VAT" (2011) *Tax Analysts* where she discusses the influence of development partners in the enactment of VAT in developing countries like Kenya.

<sup>20</sup> See Article 6, Constitution of Kenya 2010.

<sup>21</sup> Most of the literatures on VAT in Kenya focus mainly on the tax reforms that the Government of Kenya has undertaken but fall short of the underlying considerations that informed the government's decision to provide for exemptions and zero rating in the VAT law. This study will endeavour to not only talk of the general arguments for and against exemption and zero rating but will also question the intention of the government with regard to exemptions and zero rating.

## 1.7. Theoretical Framework

This paper is anchored on the two theories of efficiency and economic regulation.

The efficiency theory in tax law concentrates on the argument that the existing tax law should promote efficient allocation of resources.<sup>22</sup> In doing this, the government should not focus on issues such as exempting certain goods/services from the purview of VAT rather it should focus on how to improve the volume of taxes it can collect from this. Since this theory makes a case for maximising taxes and this study is aimed at exploring possible revenue streams, it therefore offers a good anchoring for this paper.

Professor Richard Posner of the University of Chicago considers the theories of economic regulation in his work "Theories of Economic Regulation" and argues that several theories have been advanced to explain the observed pattern of government regulation of the economy. These include the "public interest" theory and several versions, proposed either by political scientists or by economists, of the "interest group" or "capture" theory.<sup>23</sup> For the purpose of this study, the writer will limit his focus to the capture theory as is espoused by Professor Posner. This is so as the capture theory explains one of the issues that this aims to explore and that is the influence by lobbyists and development partners in the design and formulations of the Kenyan VAT law and policies on exemptions.

According to Professor Posner, the capture theory is a "poor" term that was espoused by an odd mixture of welfare state liberals, muckrakers, Marxists, and free-market economists. According to Posner, the capture theory holds that regulation is supplied in response to the demands of interest groups struggling among themselves to maximize the incomes of their members.<sup>24</sup> The Capture Theory as discussed by Professor Posner helps in exploring the policy issues (economic, political and social) that the government considered in the enactment of the various laws and policies on VAT exemptions.

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<sup>22</sup> See Boris I. Bittker, "Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities" (1979) *Faculty Scholarship Series* Paper 2301. Available at [http://digitalcommons.law.yale.edu/fss\\_papers/2301](http://digitalcommons.law.yale.edu/fss_papers/2301)(accessed 18/11/2014)

<sup>23</sup> Richard Posner, "Theories of Economic Regulation" (1974) Vol. 5 No. 2 *the Bell Journal of Economics and Management Science* pp 335-358, at 335.

<sup>24</sup> Richard Posner, op. cit. at 336.

## 1.8. Conceptual Framework

### 1.8.1. VAT Exemption Defined

There is no specific or single definition of the phrase VAT Exemption. However, Scholars and Drafters defined VAT exemption by giving a description of how it operates and its effects. For instance, Alan Schenk and Oliver Oldman define VAT Exemption from the context of exempt sale. They define it as a sale that is not subject to VAT.<sup>25</sup> Ebrill et al in their book, *Modern VAT* define VAT Exemption from a context of how VAT Exemption works and how it is structured. They argue that VAT Exemption occurs when output is untaxed and the seller cannot claim the VAT in purchases/input VAT.<sup>26</sup>

In Kenya, an attempt was made in the VAT Guide published by the Kenya Revenue Authority to define VAT Exemption. Again the definition in the VAT Guide is an operational definition. It defines VAT Exemption by referring to the list of items that are the subject of exemption and explaining its effects. This is a scheduler kind of definition. The VAT Guide provides that persons making exempt supplies are not required to charge VAT on their supplies and cannot (though the text uses may not which I think is misleading) claim VAT on their purchases.<sup>27</sup>

From a statutory point of definition, the Sales Tax Act 1973 did not define the term Exemption. It actually did not use exemption in the Act at all but the usage of the phrase Non-Taxable goods can be argued to have meant exempt goods as the effect of exemption meant non-taxation of goods.<sup>28</sup> An attempt was made in the VAT Act 1989 to define the phrase VAT Exemption. The Value Added Tax Act 1989 defined Exempt supplies as the supplies of goods specified in the Second Schedule of the Act or supplies of services not specified in the Third Schedule of the Act.<sup>29</sup> Two things are worthy to note in this definition by Section 2 of the Value Added Tax Act 1989. First, there is similarity in the items listed in the Second Schedule of the Value Added Tax 1989 and the Second Schedule of the Sales Tax Act 1973. For instance, Tariff 01.02.10 of the Second Schedule of the Value Added Tax Act 1989 and Tariff 01.02.010 of the Second Schedule of the Sales Tax Act 1973 both provide for

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<sup>25</sup> Alan Schenk and Oliver Oldman, op. cit. 19.

<sup>26</sup> Ebrill et al, *Modern VAT*, op. cit. 83.

<sup>27</sup> The VAT Guide, op. cit. 98.

<sup>28</sup> See the Second Schedule of the Sales Tax Act 1973.

<sup>29</sup> Section 2, Value Added Tax 1989.

the exemption and non-taxation of pure-bred breeding animals, bovine respectively. Again if you look at the other Tariffs, you will find similarity in almost all the items listed there. Secondly, the definition by Section 2 of the Value Added Tax 1989 introduces a new angle to the definition of VAT Exemption. This is by defining VAT exemption as services not listed in the Third Schedule of the Act. The problem with this approach is that it opens a Pandora's Box as to what services are subject to exemption.

So what are the effects of VAT exemption? The potential effects of VAT exemptions can be explained from three perspectives. The first perspective is the effect on the taxpayer. This effect has been widely discussed both by scholars and drafters of VAT Law and Policies. The effect of VAT exemption on the taxpayer is that the taxpayer will not charge taxes on their supplies and cannot claim credit for their purchases. This effect of VAT Exemption applies in most of the countries that have modern VAT and have a credit based VAT. Even the Japanese system of VAT namely Japanese Consumption Tax (CT) denies input credit on purchases that are exempt from tax such as medical related services.<sup>30</sup> This effect has far reaching consequences on a country's economy. Ebrill et al in their book, *Modern VAT* discuss the various consequences that can arise out of VAT Exemption and denial of input credits. They argue that denial of input credit as a result of VAT exemption leads to a distorted input choice as this goes against the very feature of VAT namely preservation of undistorted production.<sup>31</sup> They also argued that denial of input credits as a result of VAT exemption creates the incentive to self-supply and this has the potential of leading to tax avoidance and subsequent loss of revenue by the Government. The second perspective to the effects of VAT Exemption is its constraints on the ability of the government to raise more revenue. It has been argued by scholars and drafters of VAT law and policies that a long list of exemptions in a country's VAT law to satisfy political goals is not sustainable and may work against the very reason for the adoption of a broad based VAT system.<sup>32</sup> The effect of VAT Exemption on a country's fiscal goals is the apparent reduction in the revenue capacity of the Government of the day. The last perspective on the effects of VAT Exemption is its importance in addressing issues of socio-economic rights. This is more so with the promulgation of the Constitution of Kenya 2010 which under Chapter Four provides for socio-economic rights.<sup>33</sup> One of the arguments for VAT exemption is that it reduces the costs

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<sup>30</sup> Alan Schenk and Oliver Oldman, op. cit. 68.

<sup>31</sup> Ebrill et al, op. cit. 86.

<sup>32</sup> See Alan Schenk and Oliver Oldman, ibid. 71.

<sup>33</sup> See Article 43, Constitution of Kenya 2010.



of essentials such as basic food, education and housing. As to whether the exemption of VAT on these essentials has led to the achievement of the aforementioned socio-economic goals is not the purpose of this paper and will require a whole study on Tax incentives and the achievement of socio-economic rights.

### **1.9. Research Methodology**

The study utilizes desk based research in reviewing literature on VAT exemptions. Literature reviewed include online and hard copy materials on the subjects of VAT. The literature reviewed have been mainly obtained from the University of Nairobi School of Law Library, books and materials the writer borrowed from Professor Eshiwani's personal library, online sources and government documents and laws obtained from the website of the Kenya Law Report. Where it was necessary, publications and briefs by leading newspapers and the Institute of Certified Public Accountants were also reviewed.

### **1.10. Literature Review**

This paper explores and interrogates the Finance Acts from 1990 to 2013, VAT Acts from 1989 to 2013 and all tax policies that touch on VAT in Kenya. On top of that, the study reviews books; journal articles and reports both hardcopy and electronic sources in order to make an analytical analysis on the laws and policies of VAT exemptions.

Susan Morse looks at how Australia got its VAT law and argues that most of the countries that have VAT/GST (Goods and Services Tax) were influenced by external pressures coming from development partners such as preconditions for institutional membership and financial support from organisations like the World Bank and the IMF.<sup>34</sup> Morse strongly argues that most developing countries including Kenya have had IMF influence in the enactment of their VAT laws. However, the writer did not explore whether or not such external influence in the enactment of a country's law helped in bridging the gap in the budget deficits facing those countries.

Ian Dickson, a former senior advisor to the Minister for Finance of New Zealand also looks at the historical and policy perspective of New Zealand's choice of GST.<sup>35</sup> He argues that certain stakeholders played a critical role in the enactment of New Zealand's GST law. Of

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<sup>34</sup> Susan Morse, "How Australia got a VAT" (2011), op.cit.

<sup>35</sup> Ian Dickson, 'The New Zealand GST Policy Choice: An historical and policy perspective' in David White and Richard Krever (eds), *GST in Retrospect and Prospect* (Thompson Brookers 2007).

importance are the Treasury that represented the Government's political and economic manifesto and on the other was the Inland Revenue Department as well as lobby groups. Similarly, the writer falls short to consider the design and formulation of tax laws in countries that gained independence and had no expertise in taxation and tax laws.

Cecil Morden, a chief economist and tax expert in South Africa also looks at South Africa's VAT history.<sup>36</sup> He argues that South Africa introduced a value added tax system on September 30, 1991 and that this system of tax (VAT) was preceded by a one-stage sales tax that was in place from 1978 to 1991.<sup>37</sup> Cecil Morden in his works also talks about the efficiency principles in VAT and argues that VAT should be kept as simple and efficient as it is intended.<sup>38</sup> While the explanation by the author on South Africa's enactment of VAT is helpful, he does not offer policy explanations that justify the adoption of VAT exemptions in countries that are faced with the problem of huge budget deficits.

Stephen Karingi and Bernadette Wanjala of the United Nations Economic Commission for Africa (UNECA) and Kenya Institute for Public Policy Research and Analysis (KIPPRA) respectively discuss the tax reform experience in Kenya and in their paper they argued that Kenya introduced Sales Tax in the 1972/1973 Fiscal year in an attempt to address the fiscal crisis Kenya was undergoing namely the oil crisis and the ballooning balance of payment deficits.<sup>39</sup> They argue that the sales tax helped the government to set the stage in the early 1980s for the government's policy change of relying more on indirect taxes as a major source of development finance aimed at increasing savings and investments and reduction of reliance on direct taxes.<sup>40</sup> The writers, however, did not address the question of whether or not the approach adopted satisfied the need for more revenue mobilisation from VAT.

Nada Eissa and William Jack also discuss the policy and administrative issues that came with Kenya's tax reforms. In their paper titled *Tax Reform in Kenya: Policy and Administrative Issues*, they argue that Kenya has undergone more or less continual tax reforms over the last two decades and part of these reforms include the introduction of VAT which they argue is a

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<sup>36</sup> Cecil Morden, 'Fifteen Years of Value Added Tax in South Africa (1991-2006)' in David White and Richard Krever (eds), *GST in Retrospect and Prospect* (Thompson Brookers 2007).

<sup>37</sup> Cecil Morden, *ibid*.

<sup>38</sup> Cecil Morden, *ibid* at 550.

<sup>39</sup> Bernadette Wanjala and Stephen Karingi (2005), "Tax Reform Experience in Kenya" Tax Policy Unit, Nairobi, Kenya: KIPPRA at 2.

<sup>40</sup> Bernadette Wanjala and Stephen Karingi (2005), *ibid*.

modern tax system.<sup>41</sup> However, the two writers do not discuss how Kenya's VAT system was modern and the trade-offs that informed a VAT structure that had long lists of exemptions and the literature does not address the recent reforms under the VAT Act 2013.

Joachim Englisch also considers the EU perspective on VAT exemptions in his paper titled *EU Perspective on VAT Exemptions* and discusses the legal issues associated with exempt supplies with special emphasis on the Constitutional requirements for equality. He also discusses the arguments for and against exemptions from constitutional and economic perspectives.<sup>42</sup> Of relevance to this paper is the Constitution of Kenya 2010 that provides for equality and freedom from discrimination and the requirement that no law may exclude a state officer from payment of tax by reasons of the office they occupy and the nature of the work they do.<sup>43</sup>

To bring the discussion closer to home, the writer relies on the work of Gabriel Kitenga where he provides insights into the history of Kenya's VAT law in his book titled *Introduction to Tax Law*.<sup>44</sup> However, the writings by the author does not address the recent reforms in VAT after the enactment of the 2010 constitution and just mentions the concept of VAT exemptions with little focus on the policy and legal justifications of VAT exemptions.

Another critical and important literature that the writer relies on is case law. A number of cases especially from the UK and the European Court of Justice (ECJ) have played a critical role in enhancing the literature on VAT exemption and zero rating. A number of cases discussed in the Value-Added Tax Tribunal Report, 1994 and the cases of *Talacre Beach Caravans Sales Limited v Customs and Excise Commissioner*<sup>45</sup> as well as the case of *Canterbury Hockey Club and Canterbury Ladies Hockey Club v the Commissioner of HMRC*<sup>46</sup> are important literature that the writer reviews in this paper. These cases have among other things contributed to the interpretation by tax tribunals of exemption items that were not clearly provided for in the exemption list. However, these cases do not proffer

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<sup>41</sup> Nada Eissa and William Jack, (2009), "Tax Reform in Kenya: Policy and Administrative Issues," *Initiative for Policy Dialogue*, Georgetown University at 1.

<sup>42</sup> Joachim Englisch, (2011), "EU Perspective on VAT Exemptions," *Oxford University Centre for Business Taxation Working paper series 11/11* available at <http://www.sbs.ox.ac.uk/ideas-impact/tax/publications/working-papers/eu-perspectives-vat-exemptions> (accessed 03/09/2015)

<sup>43</sup> Article 27 of the Constitution of Kenya 2010 provides for the equality and freedom from discrimination and states that every person is equal before the law and has the right to equal protection and benefit of the law. Article 210(3) of the Constitution of Kenya 2010 also states that no law may exclude a state officer from payment of tax by reason of the office they occupy or the nature of work they do.

<sup>44</sup> Gabriel Kitenga, *Introduction to Tax Law* (Law Africa Publishers 2010).

<sup>45</sup> [2004] EWHC 165 (Ch).

<sup>46</sup> (2008) ECR

guidelines on how a country with scheduler system of taxation should approach items that are generalized under a specific industry such as financial services.

Ebrill et al in their book *the Modern VAT* discuss the concept of destination zero rating of exports. They justify this best practice on the basis of excluding exemption as the alternative to zero rating.<sup>47</sup> Equally Peter Gottfried also discusses destination zero rating of exports as one of the best practices of Value Added Tax.<sup>48</sup> They both justify this destination zero rating principle of exports on the basis of the avoidance of the distortion effect of VAT.<sup>49</sup> However, the same authors in the same literature acknowledge that for small economies the destination zero rating principle may not be the better alternative.<sup>50</sup> Although the explanations by the writers are useful in explaining the destination zero rating principle, they are, however, generalist and fail to differentiate between small economies and developed economies.

### **1.11. Chapter Breakdown**

Chapter 1 of the study covers the introduction.

Chapter 2 of the study explores and discusses the history of VAT in the world in Kenya in particular. This historical analysis is important as it discusses the shift in policy and the tax reforms undertaken and examines whether the same have been successful.

Chapter 3 of the study examines and explores VAT exemption generally, the scope of VAT exemption, VAT exemption of financial services and attempts to examine the destination zero rating principle with a view to adopt an exemption oriented destination principle of exports.

Chapter 4 concludes that there is need to rethink the VAT exemption of Financial Services and the destination zero rating of exports and makes recommendations though far reaching are useful in allowing the government to raise more revenue and save on tax refunds.

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<sup>47</sup> Ebrill et al, *The Modern VAT* (IMF 2001) 86.

<sup>48</sup> Peter Gottfried et al "Exemption versus zero rating. A hidden problem of VAT" (1991) Vol. 46, *Journal of Public Economics* 326

<sup>49</sup> Ebril et al and Gottfried et al, *ibid*.

<sup>50</sup> See Peter Gottfried et al, *ibid* 326 where they acknowledge that revenue performance arising out of VAT exemption in small countries exceeded zero rating by approximately 20 percent. This includes the zero rating of exports.

## CHAPTER TWO: THE HISTORY AND RISE OF VAT IN KENYA

### 2.1. Introduction

Chapter Two discusses the history of VAT Law globally with a focus on Kenya's experience in the rise and spread of VAT. This chapter is divided into five parts. The first part of this chapter covers the history and rise of VAT globally with focus on certain geographical areas and how they shaped the rise and spread of VAT in those regions. In this part, the writer discusses the history of VAT in the world. This discussion enables the readers to acknowledge the trend in tax reforms in Kenya. The United Kingdom of Great Britain and North Ireland being the colonial masters of Kenya will also be considered in Chapter Two. Part two of this chapter discusses the rise and spread of VAT in the UK. The third part of this chapter discusses the history and rise of VAT Law in Kenya. This part will in particular look at the pre-VAT era in Kenya. The Sales Tax Act and its salient features and why Kenya thought it was more proper to have VAT and do away with the Sales Tax. Part three of this chapter will also discuss the First VAT Act in Kenya namely the Value Added Tax, Chapter 476 of the Laws of Kenya which was enacted in the year 1989 and commenced on the First of January 1990. It will be inevitable to discuss the salient features of this Act as it formed the bedrock of the rise and spread of VAT in Kenya. The fourth part of this Chapter will discuss the role played by development partners in the rise of spread of VAT globally and Kenya in particular. In Part four, I will look at the roles played specifically by the World Bank (WB) and the International Monetary Fund (IMF). It is also worth noting and curiosity arising that one of the best books if not the best on VAT Law and practice namely *Modern VAT* has been published by the International Monetary Fund (IMF). The fifth part of this Chapter will discuss the eventual enactment of the VAT Act 2013 after almost two and half decades of having one VAT Law. What really makes the VAT Act 2013 different from the VAT Act 1989? What are its salient features and how does it reflect the policy of the Government of the day? Lastly, the chapter concludes by having a conclusion on the assumptions and research questions laid out in this Chapter.

As a kick start, what was the purpose of the government of Kenya in coming up with a VAT structure that provided for a long list of exemptions? Was this viable in the context of Kenya's economic and political set up? The Chapter also investigates the assumption that Kenya's VAT Law was as a result of influence by development partners such as the International Monetary Fund (IMF) and the World Bank (WB).

## 2.2. The History and Rise of Value-Added Tax in the World

There is no agreement or settled literature on where VAT originated from.<sup>51</sup> However, what is common among the scholars of VAT is the attribution of the concept of VAT to two persons.<sup>52</sup> The first person is Professor Thomas Adams, an American economist, whose work is credited for the introduction of VAT in the US State of Michigan.<sup>53</sup> Some of the authoritative scholars on VAT Law and practice have mentioned the role played by Professor Adams of the US albeit in a passing statement.<sup>54</sup> Ebrill et al argue that Professor Adams suggested the invoice credit method in the calculation of VAT.<sup>55</sup> The second person is the German Businessman Welhelm Von Siemens whose writings shaped the concept of VAT in German and in the European Union.<sup>56</sup> The difference between the two scholars in their conceptualisation of VAT was their approach towards VAT. Thomas Adams viewed VAT as an alternative to the business income tax in the US.<sup>57</sup> This in my opinion was shaped by the constant struggle in the US to have a federal system of Consumption Tax, a struggle that has persisted until today.<sup>58</sup> In the case of Welhem Von Siemens, he viewed it as an improvement on the sales tax. The approach by Welhelm was an innovation on how to improve the sales tax and did not present itself as an initiative to replace the existing fiscal policy.<sup>59</sup> Again this reflected the trend in how Europe was much ahead of the US in the development of Consumption tax.

VAT as a form of tax is generally considered to be a modern tax.<sup>60</sup> This is because the VAT as a system of taxation developed slowly from the year 1920 in France.<sup>61</sup> The introduction of Value Added as an independent form of taxation was preceded by excise tax on alcohol and tobacco, sales tax and Turnover Tax (ToT).<sup>62</sup>

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<sup>51</sup> See Kathryn James, *The VAT Reader* (Tax Analysts 2001) 15

<sup>52</sup> See Kathryn James, *ibid* and Richard Krever, *Designing and Drafting VAT Laws for Africa* in Richard Krever (eds), *VAT in Africa* (Pretoria University Law Press 2008)

<sup>53</sup> *Ibid*.

<sup>54</sup> Ebrill et al, *The Modern VAT* (IMF 2001) 4.

<sup>55</sup> Ebrill et al, *ibid* at 5.

<sup>56</sup> Kathryn James, *ibid* at 15.

<sup>57</sup> Thomas S. Adams, "Fundamental Problems of Federal Income Taxation," *Quarterly Journal of Economics* 35 (4)

<sup>58</sup> See Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach* (Cambridge University Press 2007) 2.

<sup>59</sup> See Kathryn James, *ibid*.

<sup>60</sup> See Ebrill et al, *op. cit.* 4.

<sup>61</sup> *Ibid*. 4.

<sup>62</sup> *Ibid*.

The First form of Value Added Tax was introduced in France in 1948.<sup>63</sup> The pre-1948 activities on the rise of VAT were mere proposal that didn't see the light of the day. Value Added Tax in France was as well put in to practice in 1954 by Maurice Laure, the then joint director of tax authority of France.<sup>64</sup> Ebrill et al argue that the 1948 system introduced in France was a Value Added Tax which I beg to differ as their reference to the limit of the application of the VAT to the manufacturing stage makes it a sales tax. However, their reference to VAT may loosely be translated to include the sales tax as there is no discussion of sales tax in their serialisation of the rise and spread of VAT. France has popularised the VAT system by giving two reasons.<sup>65</sup> First, the Value Added Tax is imposed on each stage of value addition unlike the sales tax and hence no scope of cascading valued added tax. Secondly, they argued that it affects everyone and hence enhances equality among all the French nationals. The rise and spread of VAT in France informed and influenced the development of Value Added Tax in Europe. This was also facilitated and fast tracked by the adoption of Value Added Tax by Denmark. As of 1969, the European Union nations including Switzerland and Norway had a developed system of VAT and there were about five countries that had the same.<sup>66</sup> This number increased to twelve by the year 1979 and by 2001 Seventeen countries of the European Union including Switzerland and Norway had developed systems of VAT.

The rise and spread of Value Added Tax in Asia was influenced by Japan. Japan in its endeavours to have VAT has been characterised by episode and movie like trend of VAT adoption. Some scholars like Alan Schenk describe the Japanese trend as "some tremble on the brink, while others leave only to return, eventually the attraction appears irresistible."<sup>67</sup> Japan was first introduced to the Value Added Tax system by the Shoup Mission, a group of Seven American Economists who spent four months examining Japanese Public finance, in 1949.<sup>68</sup> A law implementing the VAT system was enacted in 1950 but this failed as the system was unpopular among the business people.<sup>69</sup> A moratorium was passed subsequent to

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<sup>63</sup> See Ebrill et al and Alan Schenk & Oliver Oldman, *ibid*.

<sup>64</sup> Content Team, Economy Watch, at <http://www.economywatch.com/business-and-economy/france.html> (14/09/2015)

<sup>65</sup> *Ibid*.

<sup>66</sup> See Ebrill et al, at 6.

<sup>67</sup> Alan Schenk & Oliver Oldman, *op. cit.* 1.

<sup>68</sup> See Ebrill et al, *ibid* and Beyer, Vicki and Ishimura, Koji (1993) "The Progress of the Japanese National Consumption Tax," *Revenue Law Journal*: Vol. 3: Iss. 2, Article 3. Available at: <http://epublications.bond.edu.au/rlj/vol3/iss2/3> (10/09/2016).

<sup>69</sup> *Ibid*.

this to suspend the implementation of the new VAT system.<sup>70</sup> This continued to be in effect up to 1954 when the VAT was repealed.<sup>71</sup> In the 1970s Japan faced deficit problems in its budget and this led to a review of its tax structure.<sup>72</sup> Again the re-introduction of VAT became inevitable notwithstanding continued resistance by the business people.<sup>73</sup> The Government of the day had no option but to pursue the adoption and implementation of the VAT system. However, in order to do this the Government undertook substantial awareness programs to make the system at home with the Japanese business community. The 1987 Government led by Yasuhiro Nakasone implemented the various proposals on tax reforms and came up with a broad based credit VAT at 5%. This again did not go well with the people and saw the withdrawal of the VAT and the voting out of Yasuhiro's Government. The successive Government led by Noboru Takeshita started off with a request to the tax Advisory Commission to come up with proposals to sort out the problem of budget deficit and balancing of the taxation of income, consumption tax and property taxation.<sup>74</sup> After careful consideration of the likely political ramifications and giving in to the demands by businessmen, Japan enacted another broad based value added tax with some of the salient features being VAT on services, low rate VAT and exemptions on some of the commodities.<sup>75</sup> As can be seen from the Japan experience on VAT, VAT is and has really been a reason to topple the Government of the day and this has been the trend from France to Africa. By 2001 the Asia and Pacific Region had only eighteen countries that implemented a broad based VAT system.<sup>76</sup>

### **2.3. The Rise and Spread of VAT in the United Kingdom**

The United Kingdom being the colonial masters of Kenya, it is inevitable to discuss the rise and spread of VAT in the UK. The rise and spread of VAT in the UK can be summarised by giving two contributing factors.<sup>77</sup> First is the agenda of the Conservative Party that was to replace the purchase tax and Selective Employment Tax (SET) to a Value Added Tax. The argument espoused by the Government of the day and the proponents of Value Added Tax touched along the lines of its equality nature and how it was cross-cutting. The second factor

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<sup>70</sup> Ibid.

<sup>71</sup> Ibid.

<sup>72</sup> Ibid.

<sup>73</sup> Ibid.

<sup>74</sup> Beyer, Vicki and Ishimura, Koji (1993), op. cit.

<sup>75</sup> Ibid (n25).

<sup>76</sup> Ebrill et al, op. cit. 6.

<sup>77</sup> Warren, Neil (1993) "The UK Experience with VAT," *Revenue Law Journal*: Vol. 3: Iss. 2, Article 1. Available at: <http://epublications.bond.edu.au/rlj/vol3/iss2/1> at 75 & 76 (accessed 10/09/2016).



that contributed to the rise and spread of Value Added Tax in the UK is the EU Directive 1967 that required any new entrant to the European Community to adopt a Value Added Tax system.

The introduction of Value Added Tax in the UK was preceded by various policy papers and preparatory works by the Government of the day to make the new system at home with the people and the businessmen.<sup>78</sup> At first, the UK Government released a white paper in 1972 which laid the basis for the introduction of a Value Added Tax through the Finance Act of 1972/1973.<sup>79</sup> In the said white paper the Government indicated its intentions to introduce a Value Added Tax Act in 1973 and invited the public to submit their comments and contribution to the proposed VAT Law. This led to the introduction of a Value Added Tax in 1973 which was characterised by a starting rate of 10% and zero-rating of most of the essentials such as food, water, power and fuel.<sup>80</sup>

There were various arguments for and against VAT in the UK. Even though this is not the focus of this paper, I nevertheless find it a bit relevant to mention the main arguments for and against the introduction of VAT in the UK. The first argument espoused was how less distortionary the system was.<sup>81</sup> This is an argument that was as well used to popularise the Value Added Tax system in Japan. The second main argument for VAT in UK was the buoyancy revenue effect of VAT in the UK. It was argued that a broad based VAT would assure the UK Government of relatively stable revenue.

Some of the arguments against the introduction of VAT in the UK included the argument that a Valued Added Tax in the UK will distort prices and lead to price inflation.<sup>82</sup> This argument was however countered by the introduction of a low rate of 10% and zero-rating of most essentials.<sup>83</sup> It was also argued that the value Added Tax in the UK would be a bad idea as it will lead to higher administrative and compliance costs.<sup>84</sup>

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<sup>78</sup> Warren, Neil (1993), *ibid.*

<sup>79</sup> Warren, Neil, *ibid.*

<sup>80</sup> Warren, Neil (1993), *ibid* (n28) 75.

<sup>81</sup> See Warren, Neil (1993), *ibid.* 76.

<sup>82</sup> James, Simon & Alley, Clinton (2008) "Successful tax reform: the experience of value added tax in the United Kingdom and goods and services tax in New Zealand" available at <https://mpa.ub.uni-muenchen.de/19858/> (10/09/2016).

<sup>83</sup> *Ibid* (n33).

<sup>84</sup> *Ibid.*

The history, rise and spread of Value Added Tax in the UK is one that has only persisted for less than half a century and the UK has since its introduction of Value Added Tax enacted only three VAT Acts namely the 1973 VAT Act, the 1983 VAT Act and the 1994 Act.<sup>85</sup> The rate has relatively stayed at 10% and the latest rate being at 17.5%.<sup>86</sup>

#### **2.4. The Rise and Spread of VAT in Kenya**

The rise and spread of VAT in Kenya has been characterised by the same experience other countries have gone through in their pursuit to adopt a Value Added Tax system and is a modern cum recent form of tax.<sup>87</sup> The Kenyan pattern has been adoption of a Sales Tax and subsequent replacement with a Value Added Tax System. <sup>88</sup>The experience of Kenya is a reflection of the pattern undertaken by developing economies.<sup>89</sup>

In this part, I will discuss the pre-VAT system that Kenya had namely the Sales Tax represented by the Sales Tax Act 1973, the Value Added Tax Act 1989 Chapter 476 of the Laws of Kenya and the various amendments incorporating up to 2012 and as well the VAT Act 2013 and the amendments incorporating up to the 2014/2015 fiscal year.

##### **2.4.1. The Pre-VAT Era in Kenya**

The Pre-VAT era in Kenya can be discussed in two levels. First, the era before the introduction of the Sales Tax. The second level is after the introduction of the Sales Tax and before the commencement of the Value Added Tax Act 1989.

The Pre-Sales Tax era in Kenya's history of VAT Law is that time between the attainment of independence (1963) and the year 1973. During this period, Mr. Mwai Kibaki acted as the Finance Minister between 1969 and 1981.<sup>90</sup>This is relevant as it is this period that Kenya progressed from a system of no-tax on consumption to a system of renewed and desire to

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<sup>85</sup> See the UK Government's main legislation website, <http://www.legislation.gov.uk/all?title=Value%20Added%20Tax%20Act> (10/09/2016)

<sup>86</sup> Section 2, Value Added Tax 1994 available at <http://www.legislation.gov.uk/all?title=Value%20Added%20Tax%20Act> (10/09/2016)

<sup>87</sup> See Nada Eissa and William Jack (2009), "Tax Reform in Kenya: Policy and Administrative Issues," *Initiative for Policy Dialogue*, 1.

<sup>88</sup> See the Sales Tax Act Chapter 476 of the Laws of Kenya which was later replaced with the Value Added Tax Act Chapter 476 of the Laws of Kenya (the two Acts bearing the same Chapter number namely Chapter 476).

<sup>89</sup> See Ebrill et al, op. cit. 5.

<sup>90</sup> See the National Treasury website on Kenya's former Finance Ministers at <http://www.treasury.go.ke/aboutus/former-finance-ministers.html> (10/09/2016).

have an effective and broad-based system of consumption taxation. Of relevance is his training in economics and public finance.<sup>91</sup>

During the period of Pre-Sales Tax, Kenya's economic system can be described as a rudimentary economic system of a Government that didn't have proper economic plan hence the little focus it gave to taxation and public finance matters.<sup>92</sup> This can be attributed to a small population that didn't put so much pressure on the available resources. Additionally, scholars have also argued that prior to the 1970 and upon attainment of independence Kenya's economy has been growing at an average rate of 6% and hence the economy was faring well.<sup>93</sup> However, this was scheduled to change as the early 1970s oil crisis had severe fiscal consequences on oil importing countries such as Kenya. This prompted the Government of the day to think of a way to address the deficit in Kenya's budget as more imports meant a negative balance of payment. This led to the enactment of the Sales Tax Act in the 1972/1973 Fiscal year.<sup>94</sup>

The enactment of the Sales Tax Act led to a complete change in the policy of the Government of the day namely more reliance on indirect taxes as the continued growth of industries meant more consumption and hence a broader based tax if the Government focused on the taxation of consumption.

The short title to the Sales Tax Act 1973 read as follows: -

“An Act of Parliament to impose a sales tax on certain manufactured goods produced in, or imported into, Kenya; and for matters connected therewith and incidental thereto.”

The Sales Tax Act Chapter 476 of the Laws of Kenya was proposed in the 1972/1973 Budget Statement by the then Finance Minister Mr. Mwai Kibaki.<sup>95</sup> The Act came into commencement on the 1<sup>st</sup> Day of May 1973. In the following paragraphs, I will give a brief outline of salient features of the Sales Tax Act 1973.

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<sup>91</sup> See Mr. Kibaki's profile at <http://www.thefamouspeople.com/profiles/mwai-kibaki-5812.php> (10/09/2016).

<sup>92</sup> See Bernadette Wanjala and Stephen Karingi (2005), "Tax Reform Experience in Kenya" Tax Policy Unit, Nairobi, Kenya: KIPPRA 2.

<sup>93</sup> Wanjala and Karingi (2005) *ibid*.

<sup>94</sup> Wanjala & Karingi, *op. cit*.

<sup>95</sup> <http://www.treasury.go.ke/aboutus/former-finance-ministers.html> (10/09/2016).

The Sales Tax Act 1973 as the name indicates and as was provided in the Short Title to the Act was primarily for the taxation of sales. Sales Tax can be defined as an indirect tax that is imposed at a single or multiple stages of production or distribution.<sup>96</sup> In the case of Kenya, the Sales Tax was a single stage tax imposed at the manufacturing level.<sup>97</sup>

The Sales Tax Act had Thirteen Main Parts (Part I to Part XIII) and Two Schedules (First Schedule provided for the rates and the Second Schedule provided for the non-taxable supplies).

Part I of the Act covered the Preliminary. It provided for the short title and the interpretation section. Part II touched on the administration of Sales Tax and provided among other things the commissioner of sales and other officers as well as their powers in the enforcement of the sales tax. Part III of the Act provided for the Charge to Tax. Of relevance to this paper are Sections Five and Six. Section Five is the charging section and the most important section of any piece of tax legislation as it lays the basis for the goods and services to be taxed. It provided for the tax base as sales tax on manufactured goods and imports as well as distribution of goods by a person who is a manufacturer but did not manufacture them. Section Six provided for who should pay the tax and lists the payers as manufacturers and importers.

Part IV of the Act provided for the registration of manufacturers and the exemption from registration by the Minister. The part provided for two forms of Registration.<sup>98</sup> First, voluntary registration by taxpayers who can manufacture goods to the tune of Kenya Shillings Two Hundred Thousand or expect to manufacture goods whose total value will be Kenya Shillings Two Hundred Thousand in the succeeding period of twelve months. The second form of registration is registration by the commissioner. It gave the commissioner the power to register any person he/she believed was eligible for registration. The registration for sales tax was to be evidenced by the issuance of a Sales Tax Registration Certificate. A practice that is no longer followed and for administrative convenience, it is now sufficient for one to just have a KRA PIN where they can list all their tax obligations.

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<sup>96</sup> Alan Schenk & Oliver Oldman, *op. cit.*

<sup>97</sup> See Section 8 and Part IV, Sales Tax Act 1973.

<sup>98</sup> See Section 9, Sales Tax Act 1973.

Part V of the Act provided for invoices, records and returns. It provided inter alia the duty to keep proper records and the filing of returns before the last day of the following months.<sup>99</sup> This would later change to the twentieth day of the following month.<sup>100</sup>

Part VI of Act provided for the collection and recovery of the tax. It provided among other things, the penalty for late payment and the penalty was to be at the rate of two percent per month on the unpaid tax.<sup>101</sup> The part also provided for collection of tax by distraint. This meant that the Commissioner could get hold of the goods of the person who didn't pay the tax and hire agents to recover the money from them.

Part VII of the Act provided for the remission, rebate and refund of tax. On the issue of remission, the Act gave the Minister of Finance the power to publish order for the remission of certain taxes on the ground of public interest. However, should an event happen that will reverse the remission order, then the tax would become due.

On refund claims, the Part provided that if a person upon successful written application to the commissioner satisfied the commissioner that he/she is eligible for refund then the commissioner was obligated to refund the claim so lodged by the taxpayer. The Act provided for five grounds to make a taxpayer eligible for refund.<sup>102</sup> First, if the taxpayer manufactures/imports goods and has paid tax in respect of those goods and the importation/manufacture was solely for export. Secondly, where a manufacturer sells goods to another registered manufacturer and the second proves that the good have been used for export, the first manufacturer was to be entitled to refund. Thirdly, where a taxpayer imports goods and tax has been paid in respect of those goods and he/she goes ahead and sells them to a registered manufacturer who in turn exports them. Fourthly, where any tax has been paid in error. Lastly, where in the opinion of the Minister, it is in the public interest to do so. It was also a requirement that a taxpayer should file for the refund claim within a period of one year upon the satisfaction of the aforementioned grounds.

Parts VIII to XIII provided for the various precautionary and dispute resolution mechanism in the administration of sales tax.

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<sup>99</sup> Sections 12 and 13, Sales Tax 1973.

<sup>100</sup> Section 19, value Added Tax 2013.

<sup>101</sup> Section 16, Sales Tax Act 1973.

<sup>102</sup> Section 25, Sales Tax Act 1973.

The First Schedule to the Sales Tax Act 1973 provided for the rates of tax. The Schedule provided for a highest rate of 400% and a lowest rate of 35%. The 400% rate was on the importation of motor vehicles that were not Public Service Vehicles (PSVs) and exceeded 2,250 cubic centimetres. This reflected the policy of the Government of the day to punish luxury products. Basic and essential foods were taxed at the rate of 35%.

The Second Schedule to the Act provided for the non-taxable goods. It had fifty-seven pages of products that were not supposed to be subjected to the Sales Tax. They ranged from animal products, dried vegetables, pyrethrum, chemical products and the list is endless.<sup>103</sup> The exclusion of the product listed in the Second Schedule from the realm of sales tax can be explained from two perspectives. First, the influence by development partners such as the World Bank and the International Monetary Fund, and the adoption of best practices in the adoption of Kenya's sales tax.<sup>104</sup> Secondly, the exclusion of a large portion of products from the realm of sales can also be explained from an administrative convenience and compliance perspective. Considering how under-staffed and less trained the revenue officials were, it would have been difficult at worse futile for the Government of the day to have had a long list of products subjected to the sales tax. This was more so since the adoption of the sales tax was a more recent thing and hence the Government should have trodden carefully in its implementation of the sales tax.

#### **2.4.2. The Shift from Sales Tax to Value Added Tax**

As was the case in countries such as the United Kingdom and most of the other European Union countries, Kenya's path to the adoption of a value added tax system was characterised by a replacement of sales tax with value added tax.

There are various reasons to explain the shift from sales tax to Value Added Tax but before I discuss this, it is important to examine the difference(s) between Sales Tax and Value Added Tax.

Sales Tax is a one stage consumption tax that can be imposed either at the manufacturing/import stage or at the retail stage.<sup>105</sup> In the case of Kenya it has been defined

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<sup>103</sup> For more on the non-taxable products, see the Second Schedule of the Sales Tax Act 1973.

<sup>104</sup> See Ebrill et al (2001), op. cit.

<sup>105</sup> See Robert Carrol & Alan Viard, *Progressive Consumption Taxation* (American Enterprise Institute for Public Policy Research 2012)

as a tax on locally manufactured and imported goods which accrued upon their sale or importation into Kenya.<sup>106</sup>

Value Added Tax on the other hand has been defined as a form multi-stage imposed on goods and services and is collected at each stage of production.<sup>107</sup> A more detailed definition of Value Added Tax is offered by Ebrill et al in their book *Modern VAT* where they define it as a tax on consumption which is charged at all stages of production, but with a provision to offset taxes paid initially on the purchase of goods and services.<sup>108</sup> In an attempt to provide definiteness and clarity in the definition of VAT, Ebrill et al acknowledge the diverse approaches to the definition and adoption of VAT by various countries such as China and Russia, they offered the below definition:-

“A broad-based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs-except perhaps on capital goods-against that due on outputs.”

Robert Carroll and Alan Viard argue that VAT is a modification of the sales tax and that because of its modification and recency, it has been widely adopted by around 145 countries and has been considered the superior form of consumption taxation.<sup>109</sup> They argue that VAT like retail sales tax (RST) applies to goods and services sold to consumers. The difference is that VAT is collected at every stage of production and/or distribution whereas the sales tax is collected at the final stage where the goods and/or services are sold to the consumers.

The argument as to which form of consumption tax is more superior than the other can be summarised in the words of Zodrow as is quoted in Ebrill et al, *Modern VAT*: -

“.... although .... Some of the advantages of VAT have been exaggerated by its proponents, it seems difficult to argue that the VAT is not on balance superior to the standard RST.”<sup>110</sup>

Ebrill et al in their book *Modern VAT* argue that very few RSTs can be set at rates higher than 10% whereas few VATs are set at rates lower than 10%.

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<sup>106</sup> Section 2 of the Sales Tax Act 1973 and Kenya Revenue Authority (1999), the VAT Guide: A step by step Compliance Guide to VAT in Kenya

<sup>107</sup> See Alan Schenk and Oliver Oldman, *op. cit.* 23

<sup>108</sup> Ebrill et al, *op. cit.*

<sup>109</sup> Robert Carrol & Alan Viard, *op. cit.*

<sup>110</sup> Ebrill; et at, *op. cit.*

It is therefore evident from the above analysis that Sales Tax can be beneficial where one needs to have simplicity in taxation and can depend on other sources for revenue mobilization. Value Added Tax is on the other hand preferable for economies that need to raise more revenue.

The reasons and policy considerations in the shift from a Sales Tax to a Value Added Tax are diverse. One of the reasons for the adoption of VAT and shift from a sales tax to VAT in the UK was the requirement by the member states of the European Union for all new entrants.<sup>111</sup> It was therefore incumbent for the United Kingdom to adopt Value Added Tax for it to be allowed to join the European Union. It is also argued that VAT is more suited than the sales tax as it prevents trade distortions associated with cascading indirect taxes.<sup>112</sup>

Some countries especially developing economies shifted from the sales tax to the Value Added as a result of their Tax Modernization Programme (TMP). The TMP aimed at achieving two goals.<sup>113</sup> First it aimed at increasing the tax base and hence broadening the revenue of the Government of the day. Secondly it aimed at simplifying the administration and compliance with the tax. As to whether this was achieved or not, will be known by the conclusion of this Chapter.

Lastly, the main reason and policy consideration for the shift from sales tax to VAT was its perceived ability to raise more revenue than the sales tax. Ebrill et al consider this policy consideration in their book *Modern VAT*.<sup>114</sup> In Kenya the then Finance Minister Professor George Saitoti in his Budget Speech of 1989/1990 Fiscal Year to Parliament argued that the adoption of Value Added Tax will lead to more revenues for the Government.

Ebrill et al in their book *Modern VAT* did an analysis of the revenue difference between VAT and its predecessor Sales Tax in eight African countries including Kenya and reported that Kenya had an increase in its VAT revenue against GDP at 0.8% compared to Gabon which had the highest at 3%.<sup>115</sup>

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<sup>111</sup> Alan Schenk and Oliver Oldman, *op. cit.* 17.

<sup>112</sup> Ebrill et al, *ibid.*

<sup>113</sup> Wanjala & Karingi, *op. cit.* 8.

<sup>114</sup> Ebrill et al, *op. cit.* 25.

<sup>115</sup> Ebrill et al, *ibid.* 26.



Country	Benin	Burkina Faso	Gabon	Guinea	Kenya	Togo	Uganda	Zambia
% of GDP Increment	2.0	0.9	3.0	1.0	0.8	0.2	1.0	0.9

Source: Ebrill et al, *Modern VAT* (IMF 2001)

In the case of Kenya, two policy considerations were behind the adoption of VAT and the shift from sales tax to VAT. First, the Tax Modernization Programme (TMP) which was reflected in the Sessional paper No, 1 of 1986 on Economic Management for Renewed Growth and advocated for effective taxation on consumption.<sup>116</sup> The second policy consideration was the need to raise more revenue which was reflected in the budget speech for the 1989/1990 fiscal year. This led to the adoption of the Value Added Tax Act 1989 Chapter 476 of the Laws of Kenya.

### 2.4.3. The Adoption of the VAT Act 1989

As discussed earlier, the need to raise more revenue among other considerations led to the enactment of the VAT Act 1989.

In the year 1989, the Parliament of Kenya passed the Value Added Tax Chapter 476 of the Laws of Kenya which was later assented to by the President and came into force on the first day of January 1990.

Having discussed the Sales Tax Act in detail, I will discuss the salient features of the Value Added Tax Act 1989 by discussing the main areas that were important in the adoption of a value added tax system.

The Value Added Tax System adopted by Kenya was a credit based VAT.<sup>117</sup> This is the most prevalent form of Value Added Tax and relies on a tax-against-a tax methodology.<sup>118</sup> To bring the description by Alan Schenk and Oliver Oldman closer home, this method entails a calculation system where one takes the VAT on purchases (popularly known as VAT on inputs/input VAT) and subtracts it from the VAT on Sales (VAT on outputs/output VAT).

<sup>116</sup> Government of Kenya, *Sessional paper No. 1 of 1986 on Economic Management for Renewed Growth* (Government Printer 1986) 28.

<sup>117</sup> See Wanjala & Karingi, op. cit.

<sup>118</sup> See the discussion by Alan Schenk & Oliver Oldman, op. cit. 38.

For instance, if say Mr. A sells Vatable goods worth Kenya shillings One Hundred (100) inclusive of VAT and purchased the same goods at Kenya Shillings Sixty (60), then to calculate the VAT payable using the credit invoice method, the below working applies: -

VAT on Sales equals to  $16/116 \times 100 =$  Approximately Kshs. Fourteen (14);

VAT on purchases equals to  $16/116 \times 60 =$  Approximately Kshs. Eight (8);

Therefore, VAT payable equals to  $14 \text{ minus } 8 =$  Kshs. 6

Of much importance and worth mentioning about the VAT Act 1989 is the issue of rate. The VAT Act 1989 was introduced with fifteen rates having the standard rate at 17%, the highest being 210 % and the lowest rate being levied at 5%.<sup>119</sup> The high number of rates came at a time when Kenya was still babysitting its Tax Modernization and against a background of reforming the high number of rates. The high number of rates can be explained from a point of confusion. It has been argued and is as well evident from the approach taken by the Government of Kenya that because of the push and desire to have an effective taxation of consumption which culminated into the adoption of the Value Added Tax, there was multiplicity in the taxation of some items which were subjected to both excise tax and the new VAT system.<sup>120</sup> It is indeed true that Kenya underwent difficulties in administering this new VAT system at the transition stage and this as I will show in the table below led to a substantive reduction in the number of rates and within a period of four fiscal years, Kenya had only four VAT rates.<sup>121</sup>

<b>Fiscal Year</b>	<b>Number of VAT Rates</b>	<b>Standard Rate</b>	<b>Highest Rate</b>
1989/1990	15	17	210
1990/1991	9	18	150
1991/1992	8	18	100
1992/1993	6	18	50

<sup>119</sup> See the First Schedule of the VAT Act 1989 (1993 Revised Edition).

<sup>120</sup> See Nada Eissa and William Jack, op. cit. 12.

<sup>121</sup> For more on the reduction of the VAT rates, see the VAT Act 1989 and the VAT Act 1989 (1994 Revised Edition which had only 4 rates with the highest being at 40%)

1993/1994	4	18	40
1994/1995	4	18	30
1995/1996	4	15	25
1996/1997	3	15	15
1997/1998	3	17	17
1998/1999	4	16	16
1999/2000	4	15	15
2000/2001	4	18	18
2001/2002	4	18	18
2002/2003	4	18	18
2003/2004	3	16	16
2004/2005	2	16	16

Source: Nada Eissa and William Jack (2009), "Tax Reform in Kenya: Policy and Administrative Issues," *Initiative for Policy Dialogue*. 12 & 13.

From the above a number of points are worth being noted. First, there has been a constant reduction in the highest rate all the way from the 210% to 16%. This can be attributed to the need to bring more taxpayers on board and as well reduce the rate of tax evasion.<sup>122</sup> As to whether this was achieved or not is not the purpose of this study. Secondly, the trend in the simplicity and predictability of the rate can also be done from a regime point of analysis. As can be seen from the data in the above table, it is covering for a period wherein we had two Governments. The first Government covered in the data is the Moi regime which ran from 1989 to 2002. The second Government is the Kibaki regime which ran from 2003 to 2005. From the data it is evident that during Moi's regime there had been fluctuations in the rate leading to a lack of prediction in the VAT rates. This had the likely effect of high level of non-compliance as well as tax evasion. During the Kibaki's regime Kenya saw sharp rise in the confidence of development partners on the future of Kenya and part of this included the

<sup>122</sup> Nada Eissa & William Jack, op. cit. 12.

policies adopted one of them being tax reforms that led to a substantial increase in the rate of compliance.<sup>123</sup> From the data above the Kibaki era was characterised by constant and reliable rates in Kenya's VAT rates where the highest has been at 16%.

The VAT Act 1989 from a general analysis was not any different from the Sales Tax Act of 1973. This is because, the layout of the VAT Act and the Sales Tax Act were almost the same. For instance, the VAT Act 1989 had Fourteen Parts and the Sales Tax Act had Thirteen Parts and they were similar in thirteen parts and this therefore meant that structurally and by layout, the VAT Act 1989 was a copy paste of the Sales Tax Act 1973. The difference between the two laws can be said to be along the issues of zero rating, the rates of tax and the introduction of input credit/claim.

Section 8 of the Value Added Tax Act 1989 provided for zero rating. It stated that where a taxable person supplies goods or services classified under Schedule Five as subject zero percent (0%) then no tax shall be charged on that supply of goods or services. The Fifth Schedule of the VAT Act 1989 provided for seven categories of items that shall be subjected to zero percent. First, the exportation of goods or services; second, the supply of goods or taxable services to designated foreign aid funded capital investment projects where the agreement specifically provides for tax exemption and that the supplies are acquired prior to payment of taxes; third, the supply of goods and services to an Export Processing Zone; fourth, the supply of goods and services to persons specified in the Eighth Schedule such as the President, the Armed Forces, Diplomats and Foreign Missions among others; fifth category, ship stores supplied to international sea and air carriers; sixth, the supply of goods and services to exporters under conditions to be prescribed by the Commissioner; and lastly, the various items listed under Part B of the Fifth Schedule such as milk, animal products, vaccines for both human and animals, fertilizers among others.<sup>124</sup> The policy considerations by the Government of the day in subjecting the aforementioned products to zero percent can be classified into two. First is the adoption of best practices in the treatment of certain sector. For instance, it is considered as a best practice to subject exports to zero percent.<sup>125</sup> Second is the development level of the Government of the day and its reliance on either foreign aid. This explains the zero rating of supplies to diplomats and foreign missions as well as foreign

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<sup>123</sup> See the analysis of Kenya's development potential by the Foundation for Sustainable Development at <http://www.fsdinternational.org/country/kenya/devissues> (accessed on 15/09/2016).

<sup>124</sup> The Fifth Schedule and Eighth Schedule, VAT Act 1989.

<sup>125</sup> See Ebrill et al, op. cit.

funded projects. Lastly, the political and socio-economic considerations of the Government of the day. In this case, the zero rating of basic and essentials such as milk and wheat is a reflection of the political and socio-economic considerations of the Government as taxing them may make the Government of the day unpopular or even lead to inflation.<sup>126</sup>

There have been various amendments to the Value Added Tax 1989 through the Finance Acts of 1990/1991 up to and until the enactment of the VAT Act 2013. The chronology of amendments was discussed by various writers but this is not the focus of this study.<sup>127</sup> However, my focus is on the main amendments introduced to the VAT Act 1989. For instance, the inclusion of restaurant services within the realm of the VAT was introduced through the Finance Act of 1991 and came into force on the first day of January 1992. It taxed restaurant services at 10% and other subsequent amendments led to taxing it at 5% and later standardising it at 16% which stood up to the enactment of the VAT Act 2013. Similarly, the VAT Act 1989 had a long list of exemptions under the Second Schedule of the Act. For instance, the Finance Act of 1994 amended the list of exemptions by including a new list of items under the Seventh Schedule of the Finance Act 1994 which amendments were reflected in the VAT Act 1989 (1995 Revised Edition). The new list included rock salt, aviation spirit (gasoline), kerosene, jet fuel, other spirit fuel, motor vehicles sold by registered persons where input taxes were not allowed and motor vehicles sold by un-registered persons where no input taxes were allowed.<sup>128</sup> This new list of exemptions in my view is a reflection of industry lobbying and the desire to make it possible for Kenyans to purchase motor vehicles (sellers of second hand vehicles) and to stabilise the economy (in the case of exempting the fuel).<sup>129</sup>

The other most important amendment to the VAT Act 1989 was the inclusion of certain services whether or not they met the threshold within the realm of Vatable services. This new list of taxable services was provided under the Eighth Schedule of the Finance Act 1994.

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<sup>126</sup> See the case of Japan and how the Government of Yasuhiro was voted by the Japanese people, see Beyer, Vicki and Ishimura, Koji (1993) "The Progress of the Japanese National Consumption Tax," *Revenue Law Journal*: Vol. 3: Iss. 2, Article 3. Available at: <http://epublications.bond.edu.au/rlj/vol3/iss2/3> (10/09/2016).

<sup>127</sup> See S.K. Gupta, *VAT Law and Practice in Kenya* (Newsread International 1998) 197.

<sup>128</sup> See the Seventh Schedule, Finance Act 1994.

<sup>129</sup> However, the VAT Act 2013 has since excluded Fuel from the list of exemptions. See the First schedule to the VAT Act 2013 available at [http://www.kenyalaw.org/lex//actview.xql?actid=No.%2035%20of%202013#part\\_XVIII](http://www.kenyalaw.org/lex//actview.xql?actid=No.%2035%20of%202013#part_XVIII) (accessed on 15/08/2015). Surprisingly the same Act has retained financial services within the list of VAT exemptions.

They included accountancy services, legal services, management consulting services, architectural services and engineering services.<sup>130</sup>

The Finance Act 2004 also had certain amendments to the VAT Act 1989 by inserting a new list of exempt goods. One of them was the Liquefied Petroleum Gas (LPG) which in my view was a government policy to reduce the cost of LPG with the increasing demand for LPG.<sup>131</sup> Secondly, the Government exempted sanitary towels and tampons from the VAT to reflect on the Government's policy to help in girl child education as well as making sanitary towels and tampons available to all at a reduced and affordable cost.<sup>132</sup>

The Finance Act 2007 also introduced various amendments to the VAT Act 1989 amending the Fifth Schedule by inserting a new list of items that were to be subjected to VAT at zero percent. Some of the most important items included mosquito coils and related burning substances to reflect the policy of the Government in the fight against malaria.

There have been various other amendments to the VAT Act 1989 up to and until the enactment of the VAT Act 2013 but all these amendments cannot be summarised in this paper. However, it is only fair to state that all these amendments mostly targeted the administrative aspect of the administration of VAT and the inclusion or exclusion of some items in the list of exemptions and zero rating.

#### **2.4.4. The VAT Act 2013**

The eras of Mr. Moi and Mr. Kibaki were marked by the introduction of Value Added Tax in Kenya's taxation and various amendments were made to the same in a bid to modernise Kenya's value added tax system and to reflect the changes in the governance structure as well as the economic policy of the new government.

The VAT Act 2013 was passed by the Parliament of Kenya and assented to by the President on the 14<sup>th</sup> day of August 2013. The commencement date of the Act was the 2<sup>nd</sup> day of September 2013. The VAT Act 2013 was enacted against a background of increased expenditure by the Government courtesy of the new governance structure introduced by the Constitution of Kenya 2010.

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<sup>130</sup> For the full list of the Taxable Services, see the Eighth Schedule of the Finance Act 1994.

<sup>131</sup> See the market trend and demand for LPG in Kenya as at 2009, <http://www.lpgbusinessreview.com/2016/01/07/walking-the-tight-rope-the-challenges-for-a-new-lpg-marketer-in-kenya/> (accessed 15/09/2016)

<sup>132</sup> See the Budget Statement 2004/2005 by the then Minister for Finance Mr. David Mwiraria.

The Jubilee Government that came into power inherited a large amount of debt from the Grand Coalition Government of Mr. Kibaki and Mr. Raila. The Jubilee Government also had a manifesto upon which they campaigned they will do and this meant need to raise more revenue to achieve all these.<sup>133</sup>

The Value Added Tax Act 2013 from a structural and layout point of view was similar to the VAT Act 1989. However, the differences between the two lied in some of the provisions of the Act as well as the number of items that were the subject of zero rating and exemption.

The VAT Act 2013 introduced only two rates of VAT. This was a departure from the old system where the rates kept on fluctuating all the way from fifteen rates to about three rates. It provided for a standard rate of 16% and zero percent on the items listed in the Second Schedule of the Act.<sup>134</sup>

The VAT Act 2013 also introduced the appointment of a tax representative for persons who are eligible to register for VAT but one reason or the other cannot be in Kenya.<sup>135</sup> The appointment of the tax representative must be in writing and he/she shall be jointly liable with the non-resident appointer.

Section 17 of the VAT Act 2013 also reduced the time limit for the input VAT claim from one year to Six months. Co-incidentally this time limit is the same as the one provided by the VAT Act 1989 upon its enactment which was later amended to One year.<sup>136</sup> The reduction of the time limit from one year to six months was an issue that was hardly fought by industry players such as the Institute of Certified Public Accountants of Kenya (ICPAK) who argued that the time limit is too short to be complied with and may lead to non-compliance and tax evasion.<sup>137</sup>

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<sup>133</sup> For more on the Jubilee manifesto and the sectors they targeted and how capital intensive they were, see, <http://www.mwakilishi.com/content/articles/2013/02/03/viewdownload-the-full-harmonized-jubilee-coalition-manifesto.html> (accessed 15/09/2016).

<sup>134</sup> See Section 5, VAT Act 2013.

<sup>135</sup> See Section 9, VAT Act 2013.

<sup>136</sup> Section 11, VAT Act 1989.

<sup>137</sup> See Institute of Certified Public Accountants of Kenya, *ICPAK Position Paper on VAT Bill 2013* (ICPAK 2013).

It was also noted that the VAT Act 2013 in an attempt to raise more revenue over focused on the raising of revenue at the expense of considerations such as conducive and stable macro and micro-economic environment which considerations are very vital in any tax reform process.<sup>138</sup>

The VAT Act 2013 was also characterised by its radical shift in taxing basic food stuffs such as milk, bread, maize flour among others. Taxing these products at 16% was considered not only economically not viable but punishing the common citizens who had difficulties in affording their essentials. However, this was subsequently amended in 2014 by the National Assembly through a Bill sponsored by Mr. John Mbadi.

The VAT Act 2013 in as much as it greatly reduced the list of exemptions and zero rated items wasn't free of criticism and amendments. As I have indicated above, the biggest challenge it faced was the taxation of basic goods such as bread, wheat flour and milk which they later amended to include them in the list of exemptions.<sup>139</sup>

The latest amendment to the VAT Act 2013 was done through the Value Added Tax (Amendment) Act 2016 which exempted sugar cane farmers from paying VAT on the transportation of sugarcane from the farms to the milling factories.<sup>140</sup> This move can be explained from a political perspective. The politics of sugarcane has been at the forefront in Kenyan politics where everyone both the Government and the opposition tried to woo the support of the sugarcane farmers in Western Kenya. This led to the enactment of the VAT (Amendment) Act 2016 which exempted sugarcane farmers from paying VAT on the transportation of sugarcane from the farms to the milling factories.<sup>141</sup>

## **2.5. Conclusion**

Chapter Two discussed the rise and history of VAT in Kenya. In the various sub-chapters, a number of pertinent issues on the history and rise of VAT were discussed. Chapter Two discussed the history and rise of VAT in the world. Chapter Two also discussed the pre-VAT era in Kenya, the enactment of the Sales Tax Act 1989, the enactment of the Value Added Tax 1989 which was the governing law on VAT until 2012 and the enactment of the VAT

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<sup>138</sup> ICPAK, *ibid*.

<sup>139</sup> For more on the up-to-date list of exemptions and zero-rated items, see the VAT Act 2013 (2015 Revised Edition).

<sup>140</sup> See the Amendment Act at <http://kenyalaw.org/kl/index.php?id=5994> (15/09/2016).

<sup>141</sup> See the debate on the Value Added Tax (Amendment) Act 2016 at [http://info.mzalendo.com/hansard/sitting/national\\_assembly/2016-06-15-09-30-00](http://info.mzalendo.com/hansard/sitting/national_assembly/2016-06-15-09-30-00) (15/09/2016).



Act 2013. In all these discussions, analyses of the trend of VAT globally and in Kenya was conducted and whether or not the intended purposes of the VAT reforms were achieved in Kenya.

From a best practice point of view and through the structural adjustment programs, the chapter argued that development partners had a role in the enactment and adoption of Value Added Tax in Kenya as was evident in the incorporation of best practices in the Value Added Tax Act and the Sales Tax Act which best practices are influenced by the writings and policies of development partners.

Similarly, Kenya's tax modernisation program (TMP) was not only influenced by the development partners but the desire to raise more revenue and alleviate the socio-economic problems associated with broad-based Value Added tax system have also been important policy considerations in the enactment and adoption of Kenya's model of VAT Law and Sales Tax.

The Kibaki era was also found to have been a turning point in Kenya's history of VAT law. Although, VAT was introduced during President Moi's era, little was done during his reign as the President. Most of the fundamental changes such as the standardisation of the VAT rates and the minimisation of the VAT exemption were all done during the Kibaki presidency.

## CHAPTER THREE: VAT EXEMPTION. THE KENYAN EXPERIENCE

### 3.1. Introduction

Chapter Three discusses one of the main elephants in a country's VAT Law, the issue of exemption. The Chapter also examines the concept of exemption and how it works as well as whether it is a good approach to VAT. Reference shall be made to exemptions in specific sectors of a country's economy and whether it is justified for a developing country like Kenya to have exemption in those sectors. Is it because, there is a social, economic or political aim that the exemption satisfies? Or is it just a case of being clueless and adopting a VAT model without consideration to a country's social engineering? The Chapter also examines the viability of an exemption oriented destination principle in the treatment of exports.

### 3.2. VAT Exemption defined and how it works

There is no specific or single definition of the phrase VAT Exemption. However, Scholars and Drafters defined VAT exemption by giving a description of how it operates and its effects. For instance, Alan Schenk and Oliver Oldman define VAT Exemption from the context of exempt sale. They define it as a sale that is not subject to VAT.<sup>142</sup> Ebrill et al in their book, *Modern VAT* define VAT Exemption from a context of how VAT Exemption works and how it is structured. They argue that VAT Exemption occurs when output is untaxed and the seller cannot claim the VAT in purchases/input VAT.<sup>143</sup>

In Kenya, an attempt was made in the VAT Guide published by the Kenya Revenue Authority to define VAT Exemption. Again the definition in the VAT Guide is an operational definition. It defines VAT Exemption by referring to the list of items that are the subject of exemption and explaining its effects. This is a scheduler kind of definition. The VAT Guide provides that persons making exempt supplies are not required to charge VAT on their supplies and cannot (though the text uses may not which I think is misleading) claim VAT on their purchases.<sup>144</sup>

From a statutory point of definition, the Sales Tax Act 1973 did not define the term Exemption. It actually did not use exemption in the Act at all but the usage of the phrase

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<sup>142</sup> Alan Schenk and Oliver Oldman, op. cit. 19.

<sup>143</sup> Ebrill et al, *Modern VAT*, op. cit. 83.

<sup>144</sup> The VAT Guide, op. cit. 98.

Non-Taxable goods can be argued to have meant exempt goods as the effect of exemption meant non-taxation of goods.<sup>145</sup> An attempt was made in the VAT Act 1989 to define the phrase VAT Exemption. The Value Added Tax Act 1989 defined Exempt supplies as the supplies of goods specified in the Second Schedule of the Act or supplies of services not specified in the Third Schedule of the Act.<sup>146</sup> Two things are worthy to note in this definition by Section 2 of the Value Added Tax Act 1989. First, there is similarity in the items listed in the Second Schedule of the Value Added Tax 1989 and the Second Schedule of the Sales Tax Act 1973. For instance, Tariff 01.02.10 of the Second Schedule of the Value Added Tax Act 1989 and Tariff 01.02.010 of the Second Schedule of the Sales Tax Act 1973 both provide for the exemption and non-taxation of pure-bred breeding animals, bovine respectively. Again if you look at the other Tariffs, you will find similarity in almost all the items listed there. Secondly, the definition by Section 2 of the Value Added Tax 1989 introduces a new angle to the definition of VAT Exemption. This is by defining VAT exemption as services not listed in the Third Schedule of the Act. The problem with this approach is that it opens a Pandora's Box as to what services are subject to exemption.

So what are the effects of VAT exemption? The potential effects of VAT exemptions can be explained from three perspectives. The first perspective is the effect on the taxpayer. This effect has been widely discussed both by scholars and drafters of VAT Law and Policies. The effect of VAT exemption on the taxpayer is that the taxpayer will not charge taxes on their supplies and cannot claim credit for their purchases. This effect of VAT Exemption applies in most of the countries that have modern VAT and have a credit based VAT. Even the Japanese system of VAT namely Japanese Consumption Tax (CT) denies input credit on purchases that are exempt from tax such as medical related services.<sup>147</sup> This effect has far reaching consequences on a country's economy. Ebrill et al in their book, *Modern VAT* discuss the various consequences that can arise out of VAT Exemption and denial of input credits. They argue that denial of input credit as a result of VAT exemption leads to a distorted input choice as this goes against the very feature of VAT namely preservation of undistorted production.<sup>148</sup> They also argued that denial of input credits as a result of VAT exemption creates the incentive to self-supply and this has the potential of leading to tax avoidance and subsequent loss of revenue by the Government. The second perspective to the

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<sup>145</sup> See the Second Schedule of the Sales Tax Act 1973.

<sup>146</sup> Section 2, Value Added Tax 1989.

<sup>147</sup> Alan Schenk and Oliver Oldman, op. cit. 68.

<sup>148</sup> Ebrill et al, op. cit. 86.

effects of VAT Exemption is its constraints on the ability of the government to raise more revenue. It has been argued by scholars and drafters of VAT law and policies that a long list of exemptions in a country's VAT law to satisfy political goals is not sustainable and may work against the very reason for the adoption of a broad based VAT system.<sup>149</sup> The effect of VAT Exemption on a country's fiscal goals is the apparent reduction in the revenue capacity of the Government of the day. The last perspective on the effects of VAT Exemption is its importance in addressing issues of socio-economic rights. This is more so with the promulgation of the Constitution of Kenya 2010 which under Chapter Four provides for socio-economic rights.<sup>150</sup> One of the arguments for VAT exemption is that it reduces the costs of essentials such as basic food, education and housing. As to whether the exemption of VAT on these essentials has led to the achievement of the aforementioned socio-economic goals is not the purpose of this paper and will require a whole study on Tax incentives and the achievement of socio-economic rights.

### **3.3. The Scope of VAT Exemption**

The scope of VAT Exemption depends on the model of VAT a country adopts. Scholars argue that there are mainly two models of VAT.<sup>151</sup> First the European Model which is the mostly used and adopted model and second, the New Zealand Goods and Services Tax (GST) model. The European Model of VAT is considered to have a long list of exemptions and zero rating compared to the New Zealand Model of VAT. Kenya can be argued to have adopted the European Model of VAT.<sup>152</sup> A country like South Africa adopted the New Zealand Model of VAT but with its own unique additions such as VAT on fee-based financial services.<sup>153</sup>

Generally speaking the scope of VAT exemption covers the areas of basic food commodities, financial services, government services provided by government bodies and Semi-Autonomous Government Agencies (SAGA), education services, medical services, fuel, aid-financed activities, books, newspapers and magazines, essential foods and national heritage related items.<sup>154</sup>

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<sup>149</sup> See Alan Schenk and Oliver Oldman, *ibid.* 71.

<sup>150</sup> See Article 43, Constitution of Kenya 2010.

<sup>151</sup> See Ebrill et al, *Modern VAT*; Alan Schenk and Oliver Oldman, *Value Added Tax: A Comparative Approach*; and Krever (ed), *VAT in Africa*.

<sup>152</sup> The emphasis is the writer's.

<sup>153</sup> See Alan Schenk and Oliver Oldman, *op. cit.* 58.

<sup>154</sup> See the discussion on the general items that are made subject to exemption, Ebrill et al, *Modern VAT*, *op. cit.* and Second Schedule of Value Added Tax Act 1989 and First Schedule of Value Added Tax Act 2013.

### 3.3.1. VAT Exemption on the Broad Areas of Public Sector Services, Education, Financial Services among others

Value Added Tax is a transaction based system of taxation.<sup>155</sup> It is upon the basis of this statement that I discuss VAT exemption in the broad areas of financial services, education, public sector, health, housing services and books.

The taxation of financial services encompasses the imposition of Value Added Tax on all ranges of financial services. There is no specific definition of financial services but when one is told of financial services the common that comes to one's mind are services such as banking, insurance related services and securities trading services.

The European Model of VAT which is the most widely used VAT Model exempts VAT on financial intermediation services provided by banks and insurance companies.<sup>156</sup> The rationale for VAT exemption in financial intermediary services have been explained by various scholars such as Ebrill et al and Alan Schenk.<sup>157</sup> They argue that the main rationale for the exemption of VAT on financial intermediary services is the difficulty to determine value addition in financial services.<sup>158</sup> In the case of Kenya, from the enactment of the Sales Act 1973 to the VAT Act 2013, Kenya's VAT law on the exemption of financial services has been consistent. More discussions on the topic of VAT Exemption and Financial Services are provided towards the end of Chapter Three (Chapter 3.5).

VAT Exemption also covers the area of educational services. Scholars have argued for long that the taxation of educational services is a complex matter.<sup>159</sup> This is partly because the taxation especially an indirect form of taxation such as VAT would mean the costs will pass to the final consumers who in this case are the learners. An increased cost of education will go against the universal right to education as some people and in the case of developing countries most of the people will be forced out of education. However, a difficulty arises when the provision of educational services takes the form of a commercial nature such as in the case of tertiary education and private schools. There are two views on how this should be addressed. Some scholars such as Ebrill et al suggest that such institutions should be taxed at

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<sup>155</sup> Alan Schenk, Financial Services in Richard Krever (eds), *VAT in Africa* (Pretoria University Law Press 2008) 16.

<sup>156</sup> Alan Schenk, *ibid.* 32.

<sup>157</sup> Alan Schenk and Ebrill et al, *op. cit.*

<sup>158</sup> Ebrill et al, *ibid.* 94.

<sup>159</sup> See for instance, Ebrill et al, *Modern VAT*, *op. cit.* 93.

a lower VAT rate.<sup>160</sup> Again has the problem of unfairly targeting private institutions whereas the public institutions enjoy tax incentives. The second view on this is to zero-rate such educational services.<sup>161</sup> Again this suggestion comes with the consequence of dealing with VAT refund claims. Considering how big educational institutions and the wide range of valuable purchases they make, it will be a bad policy to even think of zero-rating educational services (emphasis mine).

On the area of VAT Exemption and educational services, a major problem has been how to treat programs that aim to promote educational services wherein the promoters of the services partner with the institutions. This issue was considered and debated in the case of *Open University v. The Commissioners*.<sup>162</sup> The facts of the case were that in 1966 the British Parliament recommended the establishment of a television based university which would present its courses through television, radio, programmed learning and audio-visual aids. It was agreed that the television based university was to enter into agreement with the British Broadcasting Corporation (BBC). The program ran as planned and fees were collected from the students and the BBC was paid its money. A dispute arose as to whether the educational promotional services offered by the BBC were tax exempt. The university argued that the BBC services were exempt under Article 13A1 (i) of the Sixth Directive. It argued that the use of the term incidental services in the provision of educational services was covered under Article 13A1 (i). On the other hand, the Commissioners argued that what the BBC provided was merely services aimed at the promotion of education and that the educational services were provided by the University. The VAT Tribunal held that the services provided by the BBC were not tax exempt and was to be taxed at the standard rate. The Tribunal argued that even though the services provided by the BBC was closely related to the supply of University education but the fact that the BBC was not the one mandated by the law governing education to provide educational services meant that it could not enjoy the exemption and the same can only be enjoyed by an institution that is mandated by law to provide educational services.

The experience of Kenya on the exemption of educational services dates back to the enactment of the Sales Tax Act 1973. The Sales Tax Act 1973 did not at all provide for the taxation of services as the scope of the application of the Act targeted imports and manufacture only. The VAT Act 1989 was also characterized by its lack of inclusion of

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<sup>160</sup> Ebrill et al, *ibid.* 94.

<sup>161</sup> See Ebrill et al and Alan Schenk and Oliver Oldman, *op. cit.*

<sup>162</sup> (1982) VATTR 29 as is quoted and discussed in Alan Schenk and Oliver Oldman, *op. cit.* 277.

services within the scope of the VAT. However, the Finance Act 1993 introduced the Third Schedule to the VAT Act 1989 (1993 Revised Edition) wherein a list of taxable services was introduced and this did not include educational services. The Third Schedule indeed exempted conference services aimed at educational services with the authority of the Minister for the time being in-charge of education.<sup>163</sup> It can therefore be argued that the VAT Act 1989 in essence exempted educational services. Part II of the First Schedule of the VAT Act 2013 clearly exempts educational services.<sup>164</sup> It provides for the exemption of pre-primary, primary, secondary school, technical, university, institutions established for the promotion of adult education, vocational training and technical educational services. The part excludes the exemption of business or user training and other consultancy services designed to improve work practices and efficiency of an organization. The clarity in the exclusion of consultancy services and user training services from the list of exemption of educational services can be said to be a reflection of the disputes that arose out of broad exemption of educational service such as what happened in the Open University case.

The other sector that has been the subject of VAT exemption is the health services sector. It is noteworthy that health is considered as a basic service worldwide. This is more so in developing countries like Kenya. The Constitution of Kenya 2010 considers the access to medical treatment and highest standard of health as a basic fundamental right.<sup>165</sup> The scope of VAT exemption in health services has been limited to professional services of registered doctors, dentists and the supply of certain drugs.<sup>166</sup> The VAT Act 2013 exempts the supply of medical, veterinary, dental and nursing services from the scope of taxable services.<sup>167</sup> However, what is not clear from the VAT Act 2013 is the exemption of certain pharmaceutical goods. The First Schedule of the VAT Act 2013 gives a list of pharmaceutical and medical goods that are exempt from VAT but confusion arises as to the status of those that have not been listed in the schedule. If we follow the strict interpretation rule of tax laws, then it will mean that any item not listed as exempt will be subjected to VAT unless classified as zero rated. One may as well use the purposive approach of tax law interpretation and argue

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<sup>163</sup> Third Schedule, VAT Act 1989 (1993 Revised Edition).

<sup>164</sup> First Schedule, VAT Act 2013.

<sup>165</sup> Article 43, Constitution of Kenya 2010.

<sup>166</sup> Ebrill et al, op. cit. 94.

<sup>167</sup> Paragraph 4, Part II, First Schedule, VAT Act 2013.

that any item that falls within the ambit of facilitating access to medical, dental and nursing services qualifies as exempt supply.<sup>168</sup>

### 3.4. VAT Exemption of Financial Services

One of the areas that attracted the attention of scholars and practitioners of VAT is the area of VAT exemption on financial services. In this section, I examine the scope of financial services (with focus on banking services), the Kenyan experience of VAT exemption on financial services and the way forward for a better taxation of financial services.

Financial services have been defined by various scholars as the services offered by financial institutions such as banking services, insurance services and wealth management. One such scholar is Alan Schenk who defined financial services as the services rendered by financial institutions ranging from intermediation services offered by banks to their customers, fees charged for traveller's cheques to fees charged to create, issue and trade in financial products.<sup>169</sup> The services rendered by banks and other financial services institution do not fit in a transaction based VAT system which is the system in place both in Kenya and a large portion of countries that have adopted VAT.<sup>170</sup> This failure to fit financial services into a transaction-based VAT system complicates the need to subject financial services to VAT. This is more so in countries such as Kenya who have not been innovative enough to find a way to circumvent this complication and subject financial services to VAT. South Africa and Botswana have been hailed as the only African countries that came up with innovative ways to subject financial services to VAT.<sup>171</sup> South Africa and Botswana amended their VAT laws to exempt non-fees based financial services and tax fees based financial services.<sup>172</sup>

Kenya needs to consider tapping into the lucrative financial services sector by coming up with ways to subject some of the services to VAT. Like the case of South Africa and Botswana, using the fee-based method to tax some of the financial services such as letters of credit, forex and financial advisories would yield the government of the day a lot of revenue.

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<sup>168</sup> For more on VAT/GST interpretation, see part II of the book, David White and Richard Krever (eds), *GST in Retrospect and Prospect* (Thompson Brookers 2007) pp 113-131.

<sup>169</sup> Alan Schenk, 'Financial Services' in Richard Krever (eds), *VAT in Africa* (Pretoria University Law Press 2008) 32.

<sup>170</sup> Alan Schenk, *ibid*, 31.

<sup>171</sup> See Alan Schenk, *ibid*, 33.

<sup>172</sup> Alan Schenk, *Ibid*.



Scholars have identified three approaches to the treatment of financial services under VAT.<sup>173</sup> The first approach is the traditional approach which exempts most financial services. The second approach is the partial approach wherein certain fees-based financial services are taxed. The last approach grants credit for tax on business inputs used in rendering exempt financial services to registered businesses.<sup>174</sup>

In Kenya, the VAT Act 2013 under Part II of the First Schedule exempts eighteen (18) financial services, fifteen for banking services and three for insurance services.<sup>175</sup>

It is therefore apparent in the Kenyan VAT Act 2013 that going by the scheduler system of taxation, any financial services not listed under the above Part II of the First Schedule of the VAT Act 2013 will be subjected to the normal rate of VAT unless the same is zero-rated by the same Act.

### **3.5. The Case for Exemption of Exports**

Unlike income tax which apart from the United States of America (USA) taxes income earned within the territory, VAT in dealing with international trade (imports and exports), taxes transactions using two methods.<sup>176</sup> The destination and the origin principle.<sup>177</sup>

Most countries in the world adopted the destination principle in determining the imposition of VAT on exports and imports. This is against the availability of the alternative of using the origin principle in imposing VAT on exports and imports.<sup>178</sup>

#### **3.5.1. The Destination Principle Versus the Origin Principle**

The destination principle dictates that tax levied at all stages of production must be fully credited before the final consumption tax is levied.<sup>179</sup> As the name suggests the destination principle applies tax at the country of destination wherein exports are not tax taxed (the major practice being zero rating) and imports are taxed. The origin principle on the other hand

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<sup>173</sup> Alan Schenk, *ibid*

<sup>174</sup> *Ibid*, 34.

<sup>175</sup> See Part II, First Schedule, VAT Act 2013. The Part lists banking services ranging from the maintenance of accounts to the latest entrant in the banking services, banking services structured in conformity with Islamic finance.

<sup>176</sup> See Alan Schenk, *ibid*, 195.

<sup>177</sup> See Alan Schenk, *ibid*, 195.

<sup>178</sup> Alan Schenk, *ibid*, 182.

<sup>179</sup> Ebrill et al, *op. cit.* 179.

dictates that VAT should be imposed in the country of production irrespective of where the goods are consumed.<sup>180</sup>

These two principles are important in the discussion of consumption taxation of international trade as they have been the focus of scholars, policy makers and professionals of VAT Law. For the purpose of this paper, I will focus on the destination principle which is the practice in Kenya and in almost all the other countries with the exception of the Commonwealth of Independent States (CIS). Most of the scholarly and professional writings on the justification of the destination principle and use of zero rating including case laws decided in the European Court of Justice use the justification of regional trade promotion and recovery of taxes paid in the acquisition of the exported goods and services. However, there have been alarming literature absence on the economic viability of zero rating exports for small economy countries against the backdrop of need for a wider tax base and less tax refunds. With the exception of Peter Gottfried et al and Ebrill et al who passively touch on the economic viability of an exemption oriented destination principle, all the other scholars and policy makers seem to advocate for and are at home with destination zero rating principle.<sup>181</sup>

### **3.5.2. Is an Exemption Oriented Destination Principle Viable?**

The biggest argument for the zero rating of exports under the destination principle has been in two folds.<sup>182</sup> The first fold is the avoidance of the distortion effect of VAT. Ebrill et al in their book *the Modern VAT* argue that the exemption of items by a country's VAT Laws removes the key features of VAT.<sup>183</sup> This first fold argument as is espoused by some of the writers on VAT law, as you will note in itself focuses more on distortion in terms of the decision making by tax payers in how they should go about their inputs as the same cannot be claimed under exemption but rather under zero rating. The second fold for zero rating and avoidance of exemption is the net effect exemption has on the VAT. Both Ebrill et al and Gottfried et al argue in their writings that VAT exemption has the likely net effect of increasing the VAT burden when in effect it should reduce the VAT burden.<sup>184</sup>

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<sup>180</sup> Alan Schenk, *ibid*, 183.

<sup>181</sup> See Peter Gottfried et al "Exemption versus zero rating. A hidden problem of VAT" (1991) Vol. 46, *Journal of Public Economics* 326; and Ebrill et al, *op. cit.* 184 .

<sup>182</sup> See Ebrill et al; Alan Schenk and Peter Gottfried et al. *op. cit.*

<sup>183</sup> Ebrill et al, *op. cit.* 86.

<sup>184</sup> Ebrill et al, *ibid* 85; Peter Gottfried et al, *ibid* 308.

### **3.5.2.1. The Underlying Problem with the commonly accepted Policy of Destination Zero Rating of Exports and the way forward**

The very same writers and proponents of Destination Zero Rating of exports acknowledge some of the underlying structural and administrative problems with destination zero rating albeit subtly.

Ebrill et al argue that because of the lack of effective treatment of excess credits mostly arising out of exports, the VAT runs the risk of introducing significant and costly distortions for these groups.<sup>185</sup> It is ironical that the same argument of distortion against exemption is again being espoused as an underlying problem with zero rating. It is therefore, the writer's view that indeed the issue of the distortive effect of any tax indeed occurs only within a context. For instance, a tax policy might be considered distortive if it goes against the very reason for widening a tax base or if it can affect the decision making of tax payers as regards inputs (in the case of VAT).

The second inherent problem with a destination zero rating principle is the refunds issue and revenue losses occasioned by the tax refunds. Most writers on VAT acknowledge the underlying refunds problem of export zero rating. This is more so when the country adopting the destination zero rating is a small economy or developing country such as Kenya. Some of the refunds problem include the strain refunds have on a country's ability to collect more revenue.<sup>186</sup> For instance, in the case of Kenya, the Treasury commits over Kenya Shillings One Billion and Five Hundred Million per month towards exports refunds.<sup>187</sup> This translates to approximately Kenya Shillings Fifteen Billion, a sizeable amount that can be channelled towards other development projects such as affordable housing. Refunds arising out of exports have also been characterized by the risks of fraud, increased corruption and administrative difficulties.<sup>188</sup> This is more so with developing and transition economies such as Kenya where collusions between revenue officials and tax payers have been reported and well documented.<sup>189</sup> In Kenya and East Africa, some research was done by the Tax Justice

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<sup>185</sup> Ebrill et al, ibid 155.

<sup>186</sup> Peter Gottfried et al, ibid 326.

<sup>187</sup> See Victor Amadala, "KRA Tax Refund Efficiency among the Best in the World", the Star, August 19, 2017 at [https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world\\_c1619293](https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world_c1619293) (accessed on 15/08/2018).

<sup>188</sup> Ebrill et al, ibid 156.

<sup>189</sup> See Victor Amadala, "KRA Tax Refund Efficiency among the Best in the World", the Star, August 19, 2017 at [https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world\\_c1619293](https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world_c1619293) (accessed on 15/08/2018). The article focuses more on the efficiency aspect and is subtle

Network and in their report they indicated that between 2003 and 2008, Kenya lost revenue totalling to around Kshs. Twenty Four Billion.<sup>190</sup>

Lastly, the generalist preposition of destination zero rating falls short of the need to differentiate between small economies and developed nations. Gottfried et al acknowledge that revenue performance arising out of VAT exemption in small countries exceeded zero rating by approximately 20 percent.<sup>191</sup> This indeed challenges the commonly generalized assumption that destination zero rating principle is the only viable approach of taxing exports.

### **3.6. Conclusion**

Chapter Three discussed the history, law and policy of VAT Exemption in Kenya. The writer in this Chapter questioned and challenged some commonly held beliefs in VAT such as the destination zero rating principle. The Chapter also examined VAT exemption in the education sector, health services and in the financial services sector. With regard to VAT exemption of financial services, the chapter made the argument that it is possible to subject some forms of financial services to VAT taxation. Some of these types of financial services such as forex services, letters of credit and loan services are transactional and thus can be subjected to VAT since the main argument against VAT taxation of financial services has been the difficult to determine the transaction value in them.

This Chapter has made the finding that VAT exemption serves two purposes. The first being administrative convenience and the second being distributive reason. The administrative convenience touches on sectors such as the financial services industry whereas the distributive rationale touches on mainly food and medical services.<sup>192</sup>

The Chapter also made the case for an exemption oriented destination principle. This has two advantages. First, is the administrative convenience that comes with it and the avoidance of any likely loophole for corruption and fraud. The second advantage is the saving on government revenue that was initially spent on refunds. These savings can be channelled towards better development causes such as affordable housing, an Agenda under the Big Four

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and/or silent on fraud issue and corruption. See also Galgallo Fayo, "Man Charged with Sh. 7 billion tax Evasion", the Daily Nation, April 6, 2018 at <https://www.nation.co.ke/news/Man-charged-with-Sh7bn-tax-evasion/1056-4374174-sr4p0kz/index.html> (accessed on 15/08/2018).

<sup>190</sup> See the Report by the Tax Justice Network available at <http://www.taxjusticeafrica.net/wp-content/uploads/2015/11/eac-tax-competition-report.pdf> (accessed on 08/12/2015)

<sup>191</sup> Peter Gottfried et al, *ibid* 326.

<sup>192</sup> See Peter Gottfried et al, *ibid* 308.

Agenda of the current Kenyan government or even generally towards funding the budget deficits.

## CHAPTER FOUR: SUMMARY OF FINDINGS, RECOMMENDATIONS AND CONCLUSION

### 4.1. Introduction and Findings

This study made a case for the rethinking of Kenya's VAT law on exemption and in part the zero rating of exports. In particular, it has argued that the continued policy and legal justification of VAT exemptions using best practices has led to small economies such as Kenya lose out on the opportunity to bring some of the items under the list of exemptions within the realm of VAT taxation. This is more so under the background the new constitutional dispensation which has been partly blamed for ballooning the government budget.

This study has also made the finding that there is a need to rethink the destination zero rating of exports. Borrowing from the reports of institutions such as the Tax Justice Network, it has made the case for an exemption oriented destination principle in the treatment of exports.<sup>193</sup> Further, this finding has been reaffirmed by the fact that the rationale behind destination zero rating of exports has not been found empirically to be of economic importance to small economies that are bedevilled by corruption and collusions between tax officials and exporters.<sup>194</sup> The blind adoption of destination zero rating principle of exports is no longer viable in light of the above analyses and there is a need to rethink the same. It is worrying to note that the Kenyan Government spends over Kenya Shillings Fifteen Billion towards VAT refunds (the highest percentage being exports refunds).<sup>195</sup> This comes at a time when the same amount can be used towards more deserving development projects such as affordable housing. Adopting an exemption oriented destination principle will not only save the government a lot of money but will also make the administration of exports easier and will seal corruption loopholes.

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<sup>193</sup> See the report by the Tax Justice Network available at <http://www.taxjusticeafrica.net/wp-content/uploads/2015/11/eac-tax-competition-report.pdf> (accessed on 08/12/2015).

<sup>194</sup> Galgallo Fayo, "Man Charged with Sh. 7 billion tax Evasion", the Daily Nation, April 6, 2018 at <https://www.nation.co.ke/news/Man-charged-with-Sh7bn-tax-evasion/1056-4374174-sr4p0kz/index.html> (accessed on 15/08/2018).

<sup>195</sup> Victor Amadala, "KRA Tax Refund Efficiency among the Best in the World", the Star, August 19, 2017 at [https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world\\_c1619293](https://www.the-star.co.ke/news/2017/08/19/kra-tax-refund-effeciency-among-the-best-in-the-world_c1619293) (accessed on 15/08/2018).

The study also found that the structure and adoption of VAT Exemption in Kenya has also been characterized by a long list of exemptions which have with time been reducing. Of particular note, is the practice where the items under exemption were just adopted either on a best practice basis<sup>196</sup> or as a policy directive/lobbying by development partners such as the World Bank and IMF.<sup>197</sup> The paper acknowledges the importance and the practice of adopting best practice by borrowing legislations and items from countries with similar history and circumstances. However, in the case of this study there was no evidence of initiative on the part of Kenya and the adoption of VAT in Kenya was partly a product of Sessional Paper No. 1 of 1986 and the reforms were mostly as a result of pressure and pre-conditions by the likes of IMF.<sup>198</sup> Further, such an approach has been found not to be no longer sustainable and practical given that Kenya now has experts who can properly question the viability of any policy recommended by development partners in the context of the country's economic and political set up.

The paper also made that finding that VAT Exemption is generally a good approach to VAT Law in Kenya and the same has been justified through the exemption of basic food and medical services.

The failure to bring financial services within the ambit of VAT was also found to be a failure on the part of the successive governments as other countries such as South Africa have been able to tax (VAT) some of the financial services using the fee-based method.<sup>199</sup>

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<sup>196</sup> This include items provided for in the European Union Model of VAT. Kenya unlike South Africa never bothered to look into the tax rationale (Apart from once when the VAT Act 2013 excluded flour in then list of exemptions) such as the taxation of financial services.

<sup>197</sup> See Susan Morse, "How Australia got a VAT" (2011) *Tax Analysts* where she discusses the influence of development partners in the enactment of VAT in developing countries like Kenya.

<sup>198</sup> See Susan Morse, "How Australia got a VAT" (2011) *Tax Analysts* where she discusses the influence of development partners in the enactment of VAT in developing countries like Kenya; Government of Kenya, Sessional paper No. 1 of 1986 on Economic Management for Renewed Growth (Government Printer, 1986) 28; and Bernadette Wanjala and Stephen Karingi (2005), "Tax Reform Experience in Kenya" Tax Policy Unit, Nairobi, Kenya: KIPPRA at 2.

<sup>199</sup> For more on South Africa's Fee-based taxation of Financial Services, see Alan Schenk, 'Financial Services' in Richard Krever (eds), *VAT in Africa* (Pretoria University Law Press 2008) 41.

## **4.2. Recommendations**

This study makes far reaching recommendations aimed at rethinking the Kenyan VAT law on VAT exemptions. This is done, bearing in mind the possible effects of the same on the economy and the possibility of counter-arguments on the same. That is welcome by the writer. These recommendations are aimed at igniting discussion around the viability of putting these recommendations to practice.

### **4.2.1. Reconsidering the VAT Zero Rating of Exports under the Destination Principle**

As discussed and explored in this study, Kenya loses a minimum of Kenya Shillings Fifteen Billion towards VAT exports refunds out of the zero rating of exports. There is no economic rationale behind this apart from the generally assumed position that it will encourage exports.

The Government of Kenya can consider adopting an exemption oriented destination principle in the treatment of exports to save on refunds which can later be used towards other worthy development projects or in the repayment of debts.

In the absence of a strong case for a destination zero rating of exports, this study has found that it is possible and beneficial for the government to adopt an exemption oriented destination principle in the treatment of exports.

This recommendation can be effected by deleting Paragraph 1 of Part A of the Second Schedule to the VAT Act 2013. Once deleted it can be put under the list of exemptions under the First Schedule of the VAT Act 2013.

### **4.2.2. Reconsidering the VAT Exemption of Financial Services**

From the time Kenya enacted the Sales Tax Act to the enactment of VAT Act 2013, the exemption of financial services has been consistent. This study, however, calls for a review of that and to bring financial services within the taxation ambit of VAT. Some of these types of financial services such as forex services, letters of credit and loan services are transactional and thus can be subjected to VAT since the main argument against VAT taxation of financial services has been the difficult to determine the transaction value in them. Further, this has been proven to be viable through the fee-based system adopted by South Africa where certain services such as letters of credit and forex have been brought under the VAT regime. By doing this, the government of the day will be able to tap into the large fees charged by financial institutions.



### **4.2.3. The Viability of the Recommendations Made**

The recommendations made in this paper have been so made with the likely challenges the same may attract in mind. This is more so, in the context of the VAT taxation of some of the financial services wherein most of the players in the financial services sector may counter the same along the arguments of over-taxation and through lobbying. It is a finding of this study that in the absence of scientific and econometrics based evidence to counter these recommendations, Kenya should proceed and bring some of the financial services within the realm of VAT taxation. At the minimum, these recommendations are expected to ignite discussions among the players involved to come up with a common ground and viable approach to address the issues raised in this study.

### **4.3. Conclusion**

This study examined and assessed the viability of the current Kenyan law and policy of VAT exemptions. Further, it has made a case for the rethinking of Kenya's VAT law on exemption and in part the zero rating of exports. In particular, it has argued that the continued policy and legal justification of VAT exemptions using best practices has led to small economies such as Kenya lose out on the opportunity to bring some of the items under the list of exemptions within the realm of VAT taxation. This is more so under the background the new constitutional dispensation which has been partly blamed for ballooning the government budget.

The study also makes the case for exemption of exports rather than the current practice of zero rating. It is the finding of this study that the approach recommended shall have two advantages. First, is the administrative convenience that comes with it and the avoidance of any likely loophole for corruption and fraud. The second advantage is the saving on government revenue that was initially spent on refunds. These savings can be channelled towards debt repayment or even better development causes such as affordable housing, a key agenda under the current government's Agenda 4 which are enhanced manufacturing, food security and nutrition, universal health coverage and affordable housing.<sup>200</sup>

This study focused more on the legal and policy issues. The writer intentionally avoided econometrics issues as this is beyond the scope of this study. Future studies may focus on the economics of VAT exemption and how the same has impacted on the Kenyan economy. An

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<sup>200</sup> The Big Four Agenda, available at <http://www.president.go.ke/> (accessed August 27, 2018).

econometrics projection of the changes in the economy in light of the recommendations made is welcome.

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