ASSESSING THE RELEVANCE OF TAX INCENTIVES ON INVESTMENTS IN KENYA'S EXPORT PROCESSING ZONES: IN SUPPORT OF EQUITABLE SHARING OF TAX BURDENS

PAUL OTIENO OCHIENG'

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School of Law

University of Nairobi

Nairobi

DECLARATION

I, **PAUL OTIENO OCHIENG**, hereby declare this thesis my original work, and that it has not been submitted elsewhere, nor is it due for submission for a degree in any other university.

Signed…………………………

Date……………………………

PAUL OTIENO OCHIENG'

This thesis has been submitted for examination with my approval as Supervisor, University of Nairobi.

Signed………………

Date…………………

DR. NJARAMBA GICHUKI

TABLE OF CONTENTS

ABBREVIATIONS

AA	Action Aid
AGOA	Africa Growth Opportunity Act
EPZ	Export Processing Zone
FDI	Foreign Direct Investments
GDP	Gross Domestic Product
GOK	Government of Kenya
IEA	Institute of Economic Affairs
IMF	International Monetary Fund
KRA	Kenya Revenue Authority
OECD	Organisation of Economic Co-operation and Development
SADC	Southern African Development Community
TJNA	Tax Justice Network Africa
USAID	United States Agency International Development
VAT	Value Added Tax
WTO	World Trade Organisation

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ABSTRACT

Equitable sharing of tax burdens is one of the desirable attributes of a sound tax system. It requires everyone to contribute towards the support of the government and pay taxes in proportion to their abilities and revenue earned respectively. Accordingly, those with higher incomes ought to pay more taxes than those with relatively lower earnings in the society. This is necessary for two reasons, first, to ensure that the state generates adequate revenue to provide for the welfare of citizens and accomplish other public objectives, and second, to boost public confidence in the tax system. Thus, irrespective of the goals and design of a tax system, a government ought to ensure that it promotes fair sharing of tax burdens. As such, the use of tax incentives to stimulate higher levels of investments into Kenya's Export Processing Zones (EPZs) should achieve the ultimate goal of equity by ensuring that revenue generated is adequate to provide for public welfare, guarantees citizens' right to fair taxation and inspires public confidence in the tax system. Tax incentives must be relevant and the revenue foregone adequately compensated by the benefits accruing from the EPZs. This study sought to contribute critically to the debate on equitable taxation in the provision of tax incentives on investments by the Government of Kenya (GOK). The research involved a critical analysis of the Constitution, tax legislations and other relevant literature. At the end, the study made recommendations that apply the principle of equitable sharing of tax burdens in the provision of tax incentives on investments within the EPZs.

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Tax incentives on investments take the form of tax benefits offered by a government to encourage investments in certain projects such as capital goods for a specified period.[1] They are the fiscal forms of investment incentives that may be provided alongside the non-fiscal ones like government grants or loan guarantees, preferential access to government contracts and protection from import competition, among others. In the latter class, we also find regulatory incentives, which entail the relaxation of regulatory requirements in certain sectors of economy, for example, the derogation of labour standards in the export processing zones.[2]

The grant of tax incentives, in whatever form, constitutes preferential taxation because of their selective nature of application.[3] That is, they are tailored to only benefit a selected group of taxpayers such as capital investors who are considered more beneficial to a nation's economy than other taxpayers are, a move some have termed financial carrot dangling.[4] The idea is informed by the fiscal theory of compensatory expenditure, which downplays the classical challenges of shifts in the allocation of resources emerging from taxation to a change from the incidence of individual loses and benefits to the economy.[5]

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[1] Bryan A. Garner (8th ed.), *Black's Law Dictionary* (London: West Thompson, 2007) at 1502.
[2] Tax Justice Network-Africa and Action Aid, *Tax Competition in East Africa: A race to the bottom? Tax incentives and Revenue losses in Kenya*, (Nairobi: TJNA and AA, 2012) at 2.
[3] Sally M. Jones and Shelly C. Rhoades-Catanach, *Principles of Taxation for Business and Investment Planning* (New York: McGraw-Hill Irwin, 2010) at 32.
[4] Rebecca Murray, 2nd ed, *Tax Avoidance* (London: Sweet and Maxwell, 2013) at 31; above n3 at 30.
[5] Sunday O. Effiok, Arzizeh T. Tapanga nd Okon E. Eton, The Impact of Tax Policy and Incentives on Foreign Direct Investment and Economic Growth: Evident from EPZs (EPZ) in Nigeria *European Journal of Commerce and Management Research*, Vol. 2 Issue 9, 2013 at 191.

The Kenyan government provides a range of tax incentives in an effort to encourage high investment flow into the country's export processing zones.[6] These are enjoyed under the EPZ Act, Income Tax Act, VAT Act and the East African Community and Customs Management Act and they include a ten-year corporate tax holiday and 25% on the subsequent years, ten years withholding tax holiday on non-resident remittances and exemption from stamp duty. Others are exemptions from payment of Excise duty, 100% investment deduction on capital expenditure for the first 20 years on initial investment and total exemption from the provisions on import duty and VAT on imports such as plant, machinery, office equipment, and raw materials.[7]

The zones were introduced against a background of several development challenges that Kenya experiences such as high rate of unemployment, poverty and high dependency ration, poor investment environment, weak domestic market and low levels of technology, among others, which undermine the country's capacity for social, economic and political prosperity.[8] In response, Kenya has continuously instituted policy reforms whose overall objective is to improve the tax system's capacity to promote economic development.

From the 1986 Economic Management for Renewed Growth[9] that saw the adoption of the Tax Modernisation Programme and a year later, the Budget Rationalisation Programme to the Industrial Sector Adjustment project of 1990, and more recently, the 2003 Economic Recovery Strategy for Wealth and Employment Creation, the focus has remained the same.[10] With regard to the EPZs, the need to create a conducive climate for investments in the country and increase

[6] See EPZ Act, Cap 517, s 29; Income Tax Act, Cap 470, s 4B, 11 schedule; East African Community and Customs Management Act, 2004, s 169.
[7] Ibid.
[8] Ezekiel Mbitha Mwenzwa and Joseph Akuma Misati, Kenya's Social Development Proposals and Challenges: Review of Kenya Vision 2030 First Medium-Term Plan, 2008-2012, *American International Journal of Contemporary Research* Vol. 4 No.1 2014 at 1.
[9] Sessional Paper No. 1 of 1986.
[10] Nicholas Cheeseman and Robert Griffiths, *Increasing tax revenue in sub-Saharan Africa: The case of Kenya*, Economic Analysis No. 6 (Oxford: The Oxford Council on Good Governance, 2005) at 4.

the zones' potential to foster industrial growth motivated the restructuring of the industrial sector, which witnessed, among other things, the incorporation of investment incentives in the form of tax benefits to facilitate productive investment into the export sector.

EPZs are a model of the export programme adopted by Kenya in line with its export led growth policy founded on the policy paper Economic Management for Renewed Growth[11] and the subsequent Industrial Sector Adjustment programme.[12] These policies caused a paradigm shift in the country's economic system from an import substitution to an export oriented economy.[13] Through the programme, the government seeks to turn Kenya into an export-based economy and help tackle the said challenges by creating job opportunities, technology transfers, attracting new productive investments including domestic and foreign direct investments, establishing backward linkages between the domestic market and exporters.[14]

Thus, to lower the cost of operations and smoothen the running of business, the enterprises in the EPZs are allowed certain investment benefits in the form of tax exemptions, deductions and holidays highlighted above.[15] These, according to some people, help compensate the firms for any losses arising due to poor investment climate in Kenya and as such, enhance their capacity to accomplish the goals of the programme.[16]

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[11] Above n9.
[12] Attiya Waris, Matti Kohonen, Jack Ranguma and Alvin Mosioma Kenya, *Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare*, (Nairobi: Tax Justice Network Africa, 2009) at 25.
[13] Institute of Economic Affairs, *Industrial Relation Issues for AGOA Investor: The Case of EPZ's,* Trade Notes, Issue No. 8 (Nairobi: IEA, 2003) at 4; Rolph Van Der Hoeven and Jan Vandermoortele, Stabilisation and Adjustment Policies and Programmes in Kenya, *World Institute for Development Economics and Research*, 1985 at 33.
[14] Above n2 at 4. See also the objectives of the EPZ available at http://www.epzakenya.com/index.php/about-us/objectives.html.
[15] Gabriel Kitenga, *Introduction to Tax Law,* 2010, Law Africa Publishing Limited: Nairobi at 188.
[16] David Holland and Richard J. Vann, *Income Tax Incentives for Investment*, in Chapter 23, Income Tax Incentives for Investment: Tax Law Design and Drafting (volume 2; International Monetary Fund: 1998; above n15 at 188.

One of the major challenges facing the EPZ tax incentives in Kenya is the failure of the law to guarantee their relevance in enhancing equitable sharing of tax burdens.[17] Because of this, the country loses approximately 12 billion shillings, or more, annually in revenue in their provision despite the minimal role they play in influencing investment decisions and little benefits accruing to the economy from export programme.[18] This constrains the country's revenue capacity forcing the majority of Kenyans to bear the extra tax load to compensate for the revenue deficit occasioned by these investment concessions.

This has changed with the passage of the Constitution of Kenya, 2010, which, through Article 201 (b) (i), requires the burden of taxation to be borne fairly by everyone and recognises it as one of the principles of an equitable society, which the country's public finance system is obligated to promote. The Constitution also guarantees the equality of every Kenyan as far as the social, economic and political opportunities are concerned and prohibits the discrimination of anyone on grounds of sex, race, creed, religion, ethnicity, among others.[19]

In addition, it identifies equity, social justice, non-discrimination and sustainable development as some of the national values and principles to guide institutions in fulfilling their mandates to Kenyans.[20] In terms of taxation, therefore, it considers everybody equal and obligates the government to impose such levies in a manner that not only respects citizens' rights to equality but also ensures that everyone pays their fair share of the same. This safeguards the rights of Kenyans to a just tax system and underscores the importance of taxes not only as a source of public revenue but also as a catalyst for economic development.

[17] Tax Justice Network-Africa, *'Beyond Bretton Woods: The Transnational Economy in Search of New Institutions, Race to the Bottom: Incentives for New investments?* (Tokyo: TJNA, 2008) at 5.
[18] Tax Justice Network-Africa, *'Unlocking Tax Secrets Conference on Demystifying Taxation in Kenya'* (Nairobi: TJNA, 2011) at 5.
[19] Article 27 (1) (2) (3) and (4) of the Constitution of Kenya, 2010.
[20] Id at Article 10 (2) (b) and (d).

The call for equitable sharing of tax burdens in Kenya also comports with the ideals underlined in Vision 2030. Vision 2030 is one of the principle policies driving the social economic and political development in the country. It aims to ensure that Kenya becomes an industrialized middle-income economy and citizens to have high quality life by 2030.[21] Socially, it intends to transform Kenya into a just and cohesive society that is founded on precepts of equity and clean environment. Economically, the policy seeks to ensure that the country maintains a sustained economic growth of 10% annually for 25 years while politically encouraging an accountable, issue-based, people centred democratic governance.[22]

1.2 Statement of Problem

The grant of the EPZ tax incentives faces several challenges leading to massive tax revenue loss and unfair tax burdening of the majority of taxpayers in Kenya.[23] This is because the country spends a lot on incentives to attract investors whereas the majority of the investment decisions are influenced by factors such as macroeconomic stability, availability of production inputs, strength of domestic market, political stability and absence of institutional barriers to investment.[24] IMF concurs in this regard and explains that tax incentives play negligible role in facilitating investments besides the benefits of the export programme being less significant and not adequately compensating revenue foregone.[25]

Generally, the exempting nature of tax incentives has the effect of rendering the equitability of the country's tax system doubtful especially if not accompanied by meaningful returns.[26] This is because justice as a fundamental principle of taxation requires everyone to contribute fairly

[21] Government of Kenya, *Vision 2030*, 2007 at 1.
[22] Ibid
[23] Engman, M., O. Onodera and E. Pinali, *Export Processing Zones: Past and Future Role in Trade and Development*, OECD Trade Policy Papers, No. 53, OECD Publishing, 2007 at 32; above n18 at 5.
[24] Above n17 at 5; above n18 at 5.
[25] IMF, Kenya, Uganda and United Republic of Tanzania*: Selected Issues*, (2006) at 5.
[26]Above n1 at 612.

towards the support of the government and pay taxes in proportion to both their respective abilities and the revenue derived under the protection of the state.[27] As explained, the Constitution of Kenya, 2010 requires the burden of taxation to be borne fairly by everyone and hence, those with higher incomes ought to pay more taxes than those with relatively lower earnings in the society, not the reverse.

In this regard, notwithstanding the goals and design of the tax system, the government ought to ensure that it promotes fair sharing of tax burdens among Kenyans. Accordingly, the use of tax incentives to encourage higher levels of investment flow into the country's EPZs should fulfil the goal of equity by ensuring that the incentives are effective as investment promotion tools and the benefits accruing from the zones adequately compensate the revenue foregone. However, in light of their minimal role in attracting investments and the resulting revenue loss, the provision of the EPZ tax incentives in Kenya not only impacts negatively on the economy but also, and more importantly, contravenes Article 201 (b) (i) of the Constitution on equitable distribution of tax burdens, renders the tax system unjust and diminishes public confidence.

According to Nathan-MSI Group, a tax system is said to be equitable if minimises tax burdens for the poor, collects more taxes from the rich and avoids excessive tax rates and arbitrary levying of such charges. It also calls for uniform and equal treatment of taxpayers with similar economic circumstances in terms of ability to pay.[28] This thesis assesses the relevance of the EPZ tax incentives in enhancing the fair sharing of tax burdens in Kenya and seeks to establish the legal challenges undermining their effectiveness in promoting investments in the zones and the impacts of these challenges on the equitable taxation in the country.

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[27] Geoffrey Morse and David Williams (5th ed.), *Davies: Principle of Tax Law* (London: Sweet and Maxwell, 2004) at 6.

[28] Nathan−MSI Group, *Effectiveness and Economic Impact of Tax Incentives in the SADC Region,* submitted to USAID/RCSA SADC Tax Subcommittee, SADC Trade, Industry, Finance and Investment Directorate in February 2004 at 4.

1.3 Research Question

The use of tax incentives to facilitate investments in Kenya's EPZs begs the question of their relevance in ensuring fair sharing of tax burdens. As shown, the Constitution requires everyone to pay taxes and obligates the state to ensure that this is done fairly.[29] The research question that this thesis sought to answer therefore is whether there are legal challenges affecting the effectiveness of these incentives in attracting investments in the EPZs as well as the impacts of these challenges on the equitable taxation. In order to answer this question, the following questions are asked:

1. What are the objectives of EPZS?
2. Does the law facilitate the achievement of the EPZ objectives?
3. What are the legal challenges of tax incentives on investments in the EPZs?
4. What are the impacts of the said legal challenges on the fair sharing of tax burdens in Kenya?
5. How should these legal problems be solved?

1.4 Hypothesis

The legal challenges experienced in the administration of both the EPZ tax incentives and the export programme in Kenya undermine the relevance of the incentives in enhancing equitable sharing of tax burdens in the country.

1.5 Theoretical Framework

This thesis is based on natural law approach, in particular the theory of distributive justice. It relies on this theory in relation to equity and fairness in the sharing of the social economic burdens like payment of taxes. Various theorists under this school of thought have advocated for

[29] Above n19 Article 201 (b) (i).

equitable distribution of social economic benefits and burdens in the society. This thesis also supports the application of justice in the allocation of such entitlements in Kenya and relies on the views of Aristotle and other scholars who have continued the tradition of championing for the equitable distribution of resources.

According to them, despite the differences in approaches as to what constitutes justice, it remains the first virtue of social institutions.[30] With regard to taxes, these scholars posit that the aim of distributive justice is twofold: first is to enable a government to raise adequate resources necessary for the fulfilment of its mandate to the public.[31] Second is to ensure equitable taxation, which in turn boosts public confidence in the mechanisms employed by the state to generate such resources.[32] As such, they supported the view that there is a need to secure justice in the state's distributive mechanisms and ensure fairness in the bearing of the social economic burdens.

Aristotle, in his *Nicomachean Ethics,* demanded for the application of justice in the distribution of wealth and other divisible assets, and equated it to fairness.[33] To him, a just system ought to treat equals equally and un-equals unequally. The differential treatment of un-equals in this respect should not be arbitrary but instead ought to be based on some relevant factors.[34] In other words, to ensure justice in the allocation of benefits, the society ought to do so fairly based on an

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[30] Robert Reiner, *Introduction to Jurisprudence and Legal Theory: Commentary and Materials* (London: Butterworth's: 2002) at 728.
[31] Linda Sugin, Theories of Distributive Justice and Limitations on Taxation: What Rawls Demands from Tax Systems, (2004) *Fordham Law Review*, Vol. 72, Issue 5, Article 27 at 1999.
[32] Deborah A. Brautigam, 'Introduction: Taxation and State-building in Developing Countries' in Deborah A. Brautigam , Odd- Helge Fjelstad and Mick Moore (eds.) *Taxation and State-Building in Developing Countries: Capacity and Consent,* (New York: Cambridge University Press, 2008) at 1.
[33] American Institute of Certified Public Accountants, *Tax Policy Concept Statement: Guiding Principles for Tax Equity and Fairness,* (New York: AICPA, 2007) at 1 available at https://www.google.com/#q=American+Institute+of+Certified+Public+Accountants%2C+Tax+Policy+Concept+Statement:+Guiding+Principles+for+Tax+Equity+and+Fairness accessed on 17 July 2016.
[34] Ibid.

individual's relative claims or needs, which should be determined by the unique circumstances of everyone in the society.[35]

John Rawls has also supported the application of justice in the allocation of common advantages and sharing of common burdens among members of a society. In one of his writings, "Justice as Fairness", he renders a broad conception of the term guided by questions like what is due to each, what constitutes being equal and what mechanisms would allow for greater or lesser distribution?[36] Rawls' enquiry arose from the view that justice is the most fundamental virtue applicable across the entire spectrum of human interactions and as such, its scope extends beyond mere fair distribution of material resources like income and wealth to cover non-material things such as decision-making, rights and duties among others.[37]

Accordingly, many issues are subject of the concept of justice since different kinds of things can be termed just or unjust.[38] Laws, institutions, social systems and even particular actions are all subject of justice and can be termed just or otherwise.[39] Justice as fairness is a political conception as opposed to being a moral or metaphysical predicate of the term. This is because members of a society must publicly accept as being fair the terms of cooperation through democratic political processes of governance, for instance, representation.[40]

The foregoing is a function of the view that human society is comprised of competing divergent moral, religious and political claims, which require a broad and comprehensive scheme for

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[35] M.D.A Freeman (5th ed), *Lloyd's Introduction to Jurisprudence* (London: Sweet and Maxwell, 2001) at 583.
[36] Christopher Roederer and Darrel Moellendorf, *Jurisprudence* (Lansdowne: Juta, 2004) at 626.
[37] Above n35 at 628.
[38] J. W. Harris (2nd ed), *Legal Philosophies* (London: Butterworths, 1997) at 276.
[39] John Rawls, *A Theory of Justice*, (Massachusetts: Belknap Harvard University Press, 1971) at 6.
[40] John Rawls, Justice as Fairness: Political not Metaphysical *Philosophy and Public Affairs*, Vol. 14, No. 3 (Princeton University Press, 1985) at 224.

adjudication in order to ensure harmonious coexistence.[41] As a political conception, justice as fairness, therefore, tries to adjudicate these competing claims by proposing two principles to guide the basic institutions in guaranteeing the fair treatment of everyone.[42] The first one is that each person has an equal right to basic rights and liberties, which is same for everyone while the second principle requires the society to adjust the social and economic inequalities in a manner that permits fair equality of opportunity and yields greatest benefits for the poor in the society.[43]

To safeguard the state distributive mechanisms against selfish sectarian interests, Rawls champions for the choosing of these principles behind the veil of ignorance. In this state, the participants are considered to be in their original positions where they are presumed oblivious of their true share in the outcome of the decision. [44] In such a situation, Rawls proposes, all persons are equal and possess similar rights in the procedure for choosing principles, and thus ensures that no one is advantaged or disadvantaged in the process.[45]

In doing so, the theory recasts the doctrine of social contract since cooperation in the society implies the existence of publicly acknowledged rules to govern members, acceptance of the fair terms of cooperation by everyone as mutually binding and an outcome that is beneficial to all participants. The participants are presumably free, equal and cooperating fully with each other by playing their part in the society.[46] Justice as fairness therefore serves to guide the main political,

[41] Id at 246.
[42] Id at 227.
[43] Ibid.
[44] Hristina Runcheva, John Rawls: Justice as Fairness behind the Veil of Ignorance, *Iustinianus Primus Law Review* 2013 Vol. 4:2 at 5.
[45] George C. Christie and Patrick H. Martin (2nd ed), *Jurisprudence: Texts and Readings on the Philosophy of Law* (Minnesota: West, 1995) at 307.
[46] Erin Kelly (ed.) *Justice as Fairness: A Restatement*, (Massachusetts: Belknap Harvard University Press, 2001) at 6.

legal and social institutions like the property or tax system in the assignment of rights and duties and in the distribution of benefits and burdens arising from social cooperation.[47]

Iris Marion has interpreted the foregoing function to imply the elimination of all forms of institutionalised domination and oppression to enable self-development of everyone in the society.[48] This requires the designing of public institutions in a manner that adjusts the economic realities to prevent possibilities of excessive concentration of property and wealth in the hands of the minority, which may result into political oppression.[49] For this reason, some people perceive distributive justice as also being an aspect of social justice.[50]

In terms of application to schemes of distribution such as taxation, distributive justice requires equal treatment of everyone in which case a tax system ought to assign rights and duties and regulate the distribution of the benefits and burdens arising from the social cooperation fairly and sustainably.[51] As explained of the theory, this is attainable in two ways. First is by reflecting the members of a society as being free and equal to each other and second is by demanding that the social and economic inequalities be distributed or adjusted for the benefit of everyone.[52]

In this regard, justice as fairness does not require the members of a society to be equal in terms of the income or wealth they derive; instead the burden of taxation and of other social economic inequalities should be borne equitably and to the benefit of everyone and in particular, the less fortunate in the society.[53] As such, distributive justice does not appear to favour any particular

[47] Id at 7.
[48] Iris Marion Young, *Justice and the Politics of Difference* (Princeton: Princeton University Press, 1990) at 37-38.
[49] Above n45 at 44.
[50] Above n30 at 730.
[51] Above n46 at 7.
[52] Philippe Van Parijs, 'International Distributive Justice' in Robert E. Goodin, Philip Pettit and Thomas Pogge (eds.) *A Companion to Contemporary Political Philosophy,* Vol.2, (Oxford: Blackwell, 2007), 638-52 at 1.
[53] Above n45 at 315.

pattern of distributing tax burdens.[54] In fact, according to John Rawls, a tax system is not a condition for distributive justice but one of the means of achieving it.[55]

However, the main challenges of distributive justice as a guide to the society's basic structures are that, first; it fails to provide a criterion on how to regulate the institutions as one unified scheme to attain a sustainably fair, efficient and productive system of social cooperation.[56] Second, a number of questions remain unanswered by Rawls' exposition of the first and second principle. For example, one would ask what liberties are to be regarded basic and how can the list be generated objectively in terms of the number and the nature of liberties to be included.

Third, can one distinguish equality of opportunity from equality of outcome?[57] Fourth, what is to be equalised and what amounts to equality of persons or even equality of welfare?[58] The fifth criticism relates to the issue of the original position and the veil of ignorance. Critics argue that there will never be a moment when individual differences can be pursued without anyone engaging in self-interested positioning because they do not know who they will be in the society.[59]

With regard to taxation, none of these theorists has considered that there may be challenges affecting the achievement of fair distribution of public burdens such as taxes more so if modified as tools for industrial development by incorporating elements of preferential treatment of the taxpayers. Their concern has mainly been for a government to raise adequate resources, to provide for the welfare of citizens and boost public confidence in the state's distributive

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[54] Above n31 at 1999.
[55] Id at 1997.
[56] Above n46 at 50.
[57] Above n30 at 749.
[58] Brian Galle, Tax Fairness, *Wash and Lee Law Review*, Vol. 65, 2008 at 1371.
[59] Burbidge, D., *Democracy versus Diversity: Ethnic Representation in a Devolved Kenya*, (2015) Working paper, Princeton University at 3.

mechanisms. Accordingly, in their opinion, it is of least concern how a society or a government for that matter organizes its political and social institutions to guarantee fairness in the allocation of tax burdens.[60]

Consequently, they do not dictate the design of a tax system or even the allocation of tax burdens.[61] Governments, as such, enjoy wide latitude of freedom to structure tax systems and allocate tax liability as they wish on condition that the burdens imposed by such arrangements are fair, equitable, and promote development. In other words, the state's approach for collecting taxes does not matter provided it utilizes the tax proceeds for the benefit of everyone in the society. It is free to elect how it taxes its citizens and hence, may exempt or grant tax reliefs to some classes of citizens but deny the same to others who might shoulder even higher tax burdens depending on the government's policies. In this regard, exemption from tax liability may be justified only if the tax privileges granted to the selected class of citizens or individuals enhance their productivity to yield more benefits to the society than if taxed on similar vein with the rest.

This thesis, in as much as it concurs with these theorists, goes a step further to state that there are challenges affecting the realisation of fair sharing of tax burdens in the provision of tax incentives to attract investments in Kenya's EPZs. Accordingly, it goes ahead to identify these problems as the failure of the law to guarantee the relevance of such fiscal enticements. Hence, this thesis assesses the relevance of these incentives with the aim of understanding both their effectiveness as investment promotion tools and impacts on the fair distribution of tax burdens in Kenya. Thus, the natural law approach is important as it concerns with questions of justice and discusses how to tackle the challenges affecting the realisation of fairness in the distribution of the social economic benefits and burdens in the society.

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[60] Above n46 at 50.
[61] Above n31 at 1999.

1.6 Literature Review

Although literature continues to emerge on tax incentives on investments in the Kenya's EPZs, very little literature exists with regard to the relationship between tax incentives on investments and equitable sharing of tax burdens. According to Nathan-MSI Group, equity concerns rarely get attention in debates concerning tax incentives whereas the aspect of preferential taxation goes against the primary goal of tax law, which is to raise revenue for the government. Besides, perception of unfairness can undermine public support for an incentive programme.[62]

The literature obtaining in Kenya on tax incentives on investments bears testimony to the views of Nathan-MSI Group. Simiyu in "Taxation in Kenya: Principles and Practice" has discussed the role of tax incentives in facilitating investments and advises that the government should first conduct a comprehensive study of the fundamental obstacles to investments before settling on the provision of tax incentives as panacea to the problems.[63] This author argues that the use of tax concessions to attract investments may prove fruitless in circumstances where it is not the tax system to blame for low level of business interests but other factors like political instability of a country.[64] The point is that to ensure effective incorporation of tax incentives as an investment promotion strategy, the government's decision should be informed by careful analysis of the country's investment challenges before opting for tax incentives as the solution.

On its part, the East Africa Law Society in "The Tax Law Digest: Practice Manual Series" also acknowledges the potential usefulness of investment incentives as a gateway for achieving public policy good of attracting foreign investors.[65] It however cautions courts to adopt sound

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[62] Above n3 at 31; above n28 at 4.
[63] Nicholas Simiyu (5th ed), *Taxation in Kenya: Principles and Practice* (Nairobi: Foundation Institute of Professionals, 2007) at 26.
[64] Ibid.
[65] East Africa Law Society, *"The Tax Law Digest: Practice Manual Series"* No. 2 at vi.

jurisprudential practice and attitude towards investment concessions.[66] This, it argues, would help safeguard national resources against exploitation by footloose investors who take advantage of tax systems to engage in tax avoidance in order to achieve unjustified benefits to the disadvantage of the citizens.[67]

The East Africa Law Society further warns that counterfeit investors employ various tactics to take advantage of loopholes in the tax legislation to obtain profits.[68] For instance, an investor may incorporate a foreign company or even divide the business between two related companies as was in the cases of *Commissioner General and another versus Mac Arthur and Baker International*[69] and *Afrolite Industries Ltd versus Commissioner of Income Tax*[70] respectively, to limit tax liability. As such, to be effective as a public policy tool for promoting foreign investments, the incentive regime should be governed by watertight laws and not provide unnecessarily too broad exemptions to prevent cases of abuse by fraudulent investors as already pointed out.

Attiya and Kohonen in "Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare" warn that whereas the level of foreign direct investment flow may be a key indicator for gauging the sustainability of the export led growth model in Kenya, it is not enough evidence. This is because such inflow does not necessarily have immediate corresponding impacts on the intended benefits. Hence, in addition to the level of foreign direct investment flow, there is need to find out the country's progress in realising the goals of the EPZs such as transfer of skills, job creation and increase of tax revenues, among others, in order to have a complete picture of its viability.

[66] Ibid.
[67] Ibid.
[68] Ibid.
[69] [2000] 1 EA 33.
[70] [2000] LLR 3025 (HCK).

They further note that the potential usefulness of this model in increasing tax revenues is largely dependent on both the structure of tax incentives and the nature of investment regime.[71] That is to say, due to the numerous tax incentives currently offered, Kenya's revenue capacity remains potentially restricted with the continuing tax revenue losses. Again, because the export promotion policy is more focused on fulfilling the quota conditions contained in the African Growth and Opportunity Act enacted by USA to enable it gain preferential market access than improve Kenya's competitiveness, it means the country is missing the opportunities for transfer of skills and other economic benefits associated with the export programme.[72]

Whereas the flow of foreign direct investments into Kenya may take time to bear fruits, the country has nonetheless had enough experience with export programme to gauge its viability. Two and half decades is enough time for the government to determine whether it would still want to continue providing tax incentives on investments despite the reality that the country is not benefiting from its export programme and the incentives remains ineffective in enhancing equitable sharing of tax burdens in Kenya, as there are no justifications for them.

The Institute of Economic Affairs in its study "Tax Incentives and Exemption Regime in Kenya: Is it Working?" paints a damning picture of massive tax revenue loss and faults the government for using the tax system as a policy tool for attracting foreign direct investments into the country. It considers the introduction of tax incentives inappropriate and instead holds that such financial privileges are properly utilizable to achieve the intended benefits if offered through direct expenditure as opposed to if done through the tax system.[73]

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[71] Above n12 at 24.
[72] Id at 25.
[73] Institute of Economic Affairs, *Tax Incentives and Exemption Regime in Kenya: Is it Working?* Issue No. 30 (Nairobi: IEA, 2012) at 1-2.

The report also blames the government for failing to undertake a cost benefit analysis to determine whether tax incentives are achieving the desired goal.[74] This organisation therefore calls on the state to revisit its decision on tax incentives on investment and institute necessary steps to ensure their relevance and effectiveness in addressing the country's investments problems.

In light of the observations by the 2009 World Bank Investment Climate Advisory Services, the Institute of Economic Affairs opines in its report that investment incentives cannot cure the ills of unattractive investment climate like poor infrastructure, high cost of production and political instability, among others.[75] As such, Kenya needs to rethink its tax policy on investments and eliminate these unnecessary tax incentives to foster their relevance and guarantee Kenyans of their right to equitable taxation.

Tax Justice Network Africa and Action Aid, in their joint report explain that poor investment environment, poor infrastructure and high cost of running businesses in developing countries also necessitate the countries to offer incentives in order to attract foreign direct investments.[76] This argument fails to appreciate that despite the adversities several investors venture into the market in developing countries and cut a niche for themselves without the incentives enjoyed by the EPZs. Some of these issues are gradually being tackled in developing countries especially in Kenya where the infrastructure has been progressively improved and the tax incentives do not justify the loss of current and future tax revenue.[77]

[74] Ibid.
[75] Id at 5.
[76] Above n2 at 2.
[77] Ibid.

Tax incentives extended to EPZs tend to attract footloose firms, which relocate or wind up as soon as the tax holiday is over.[78] Since the introduction of EPZs in Kenya, no data has been recorded to capture the number of the firms that continue to operate after the expiry of the ten years tax holiday. Most companies relocate to other jurisdictions or wind up and the director incorporate new entities to start enjoying the tax holidays afresh. This denies the government a return on the ten-year investment. It is argued that tax holidays are best utilized on a transitory investment and not on a permanent basis because they lead to tax avoidance.[79]

1.7 Significance of the Study

It is half a decade since Kenyans enacted a new Constitution. Through it, they reaffirm adherence to the rule of law, social justice, sustainable development and respect for human rights, among others, and express their desire on how they would like to be governed. With regard to taxation, the Constitution obligates the government to impose taxes fairly and ensure that everyone pays. Hardly any academic work comprehensively deals with the relevance of tax incentives of the EPZs in guaranteeing the fair sharing of tax burdens in Kenya. This thesis sought to provide an answer to the question on whether there are legal challenges undermining the effectiveness of these incentives in attracting investments in the zones and the impacts of these challenges on equitable taxation in Kenya.

To add, loss of public revenue and unfair tax burdening of the citizens as some of the key problems of the export programme is not unique to Kenya. Majority of African countries with such programmes are also faced with similar challenges. It is believed that vital lessons can be learnt from evaluating the relevance of the country's EPZ tax incentives as enablers of fair sharing of tax burdens. The assessment will also provide insights into the likely legal challenges

[78] Id at 3.
[79] Id at 4.

Kenya may encounter in the administration of investment incentives established by the special economic zones programme, and how to tackle them.[80]

1.8 Research Methodology

This thesis relied on desktop research only. It involved a critical analysis of the Constitution, tax laws and other related legislations. It also relied on all relevant literature, including journal articles, books, case laws, government policy papers, reports and other relevant materials.

1.9 Limitation and the Scope of the Study

As the title of this thesis suggests, the focus is on the relevance of the EPZ tax incentives in enhancing fair sharing of tax burdens in Kenya. As such, this thesis did not investigate the level of public awareness and perception of fairness of Kenya's tax system with regard to the EPZ tax incentives. Neither did it investigate the challenges that may be affecting the realisation of equity in the other aspects of the country's tax regime nor discussed the problems encountered in the provision of the non-fiscal incentives in the EPZs.

1.10 Overview of Chapters

This thesis is divided into six chapters. The first one is this introductory chapter.

Chapter Two is on the conceptual framework. It is in this Chapter where the key concepts, for example, tax incentive on investment and EPZs are defined. Again, it is here where the objectives of Kenya's export programme and the country's experience in fulfilling such goals are discussed. The Chapter also highlights Mauritius' successful experience with the export programme.

[80] Section 35 (1) (2) of the Special Economic Act No. 16 of 2015 of the Laws of Kenya grants a wide range of tax incentives to investors in the special economic zones.

Chapter Three discusses the equity concerns surrounding the tax incentive on investments in Kenya's EPZs. The task requires a clear understanding of the concept of justice in taxation and the underlying theory before turning to explore the role of taxation generally. This is followed by a discussion of the principle of fair sharing of tax burdens and an explanation on the functions of taxation in Kenya. Lastly, it concludes by evaluating the equitability of tax incentives on investments in Kenya.

Chapter Four discusses the legal challenges facing the EPZ tax incentives in Kenya. In this regard, it first discusses their administration followed by an analysis of the legal problems encountered in such a process. It then explores the legal challenges undermining the realisation of the objectives of the export programme. It concludes by stating that these challenges water down the effectiveness of EPZ tax incentives as investments promotion tools in Kenya.

Chapter Five discusses the impacts of the legal problems of EPZ tax incentives on equitable sharing of tax burdens in Kenya. It begins the discussion by asserting that the disadvantages of tax incentives outweigh their merits owing to the legal challenges discussed in Chapter four above. It then concludes by laying down the position that the exemption of the EPZ businesses from tax liability is unwarranted and the 12 billion shillings incurred annually in these fiscal inducements is without basis as they fail to enhance fair taxation and guaranteeing citizens' rights in this regard.

Chapter Six concludes this thesis by presenting conclusions and recommendations.

CHAPTER TWO

CONCEPTUAL FRAMEWORK

2.1 Introduction

The state's obligation to fulfil public goals may compel a government to design its tax system, in some circumstances, as a policy tool for accomplishing other state building roles besides raising revenue.[81] This may involve preferential taxation in which tax incentives can be used to facilitate investments in certain economic projects such as the EPZs. The purpose of this chapter, therefore, is to define the concepts of tax incentive on investment and EPZ, discuss Kenya's experience with the export programme and highlight Mauritius' successful experience in this regard.

A tax incentive on investment refers to a deduction, exclusion or exemption from tax liability that a government offers to encourage investments in specified activities for a certain period.[82] As observed, this is justified by the fact that preferential treatment of the capital investors is more beneficial to a country's economic development than if taxed.[83] An export-processing zone, on the other hand, has been defined by World Bank, as an industrial estate, usually a fenced-in area of 10–300 hectares that specializes in manufacturing for export[84] that offers firms free trade conditions and a liberal regulatory environment.[85]

Kenya's EPZ Act defines an EPZ as a designated part of Kenya where any goods introduced are generally regarded as far as import duties and taxes are concerned, as being outside the customs

[81] Above n3 at 31.
[82] Above n1 at 1502.
[83] Above n5 at 31; above n4 at 30.
[84] World Bank, *Export Processing Zones*, Economic Policy Series Paper 11, Washington, D.C, 1998 at 1 available at http://www1.worldbank.org/prem/PREMNotes/premnote11.pdf accessed on 3/7/2016.
[85] Dorsati Madani, *A Review of the Role and Impact of Export Processing Zones*, at 5 available at http://elibrary.worldbank.org/docserver/download/2238.pdf accessed on 13/12/2012.

territory but are duly restricted by controlled access and where in the benefits provided under this Act apply.[86] However, the concept has undergone significant changes over the years owing to incorporation of more flexible rules with regard to export requirements.[87] As such, it is currently defined as a government policy to promote export of goods and or services by offering a more competitive business environment through provision of special benefits including and in particular, tariff exemptions to inputs either in a geographically defined area or through a specification process.[88]

At the core of tax incentives on investments lies the requirement for equitable distribution of tax burdens. Equity obligates the state to tax citizens in a manner that respects one's ability to pay and the revenue derived so that those with the same ability to pay, pay the same amount of tax while those with greater ability to pay, pay more than the ones with lesser abilities.[89] Accordingly, the use of tax incentives to attract investments in Kenya's EPZs ought to safeguard the right to fair taxation and inspire public confidence in the tax system. The incentives must be relevant, effective and the revenue foregone adequately compensated by the benefits accruing from these zones.

The effectiveness of tax incentives implies the extent to which they stimulate an additional level of investments in the EPZs minus the non-tax factors.[90] To determine this, one must take into account several issues, first, the associated costs and benefits of the incentive like the revenue lost vis a vis the returns realised, that is, the additional investment. Secondly, the data on the incentives provided and qualifying the investments realised as a result and thirdly, the benefits to

[86] Section 2 of the Export Processing Zones Act Chapter 517 of the Laws of Kenya.
[87] Above n23 at 10.
[88] Id at 11.
[89] Above n27 at 6.
[90] Above n28 at 5.

the economy.[91] Important for note: the term equitable distribution of tax burdens is synonymous with fair taxation, tax equity and equitable taxation. It will be discussed in details in the next chapters.

2.2 Objectives of Export Programme in Kenya

The overall goal of the export programme, as highlighted, is to turn Kenya into an export economy with the specific objectives of creating employment opportunities, bringing technology transfers and strengthen the domestic industry by establishing backward linkages with the exporters.[92] Currently, there are forty-seven zones operating in the country, forty-five are privately controlled while two are public.[93] As mentioned, to attract higher levels of investments into these zones and enhance their capacity to attain the said goals, the GOK provides a wide range of investment incentives in the form of tax benefits, among others, to investors.

The majority of these enterprises are textile industries which fact is attributable to the AGOA pact, which, as explained, is meant to give the Kenya's EPZ investors preferential access to the US market.[94] They are found in five of the former eight provinces with Coast topping the list at twenty-six followed by Nairobi which has eight, Rift Valley and Eastern each having five and Central province has three areas designated as EPZs.[95] Nyanza, North Eastern and Western provinces have none. Ownership of the zones can be 100 percent local or foreign. As of 2012, Kenyans owned 14 percent of the 99 companies found in these zones.[96]

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[91] Organisation for Economic Cooperation and Development, *Tax and Development: Principles to Enhance the Transparency and Governance of Tax Incentives for Investments in Development*, available at http://www.oecd.org/ctp/tax-global/transparency-and-governance-principles.pdf accessed on 17 July 2016 at 2.
[92] Above n2 at 4.
[93] EPZ Authority, *EPZs Annual Performance Report*, 2012 at 13.
[94] Above n23 at 41; above n13 at 2.
[95] Above n93 at 14.
[96] Above n2 at 4.

2.3 Administration of the Export Programme

The EPZ Authority is responsible for administering the export programme in Kenya. It is mandated to facilitate export-oriented investment, develop an enabling environment for investors in the country[97]and ensure that the programme's objectives are accomplished. In executing this mandate, the Authority advises on the removal of impediments and creates incentives for investments, and regulates the activities of the firms while encouraging self-regulation of the individual EPZ enterprises.

It also functions to protect government revenue and foreign currency earnings.[98] In doing so, the Authority is obligated to notify the Kenya Revenue Authority of the firms that are licensed to operate. Such a notice should specify the commercial activities or the goods, which the firm specializes in producing and conditions of the license.[99]

The EPZ Authority is established to operate as a "one-stop" centre through which enterprises channel their applications for permits and facilities not handled directly by it.[100] To be licensed, such an enterprise must meet the following qualifications, namely, be a company incorporated in Kenya for the sole purpose of developing and operating an EPZ, have the necessary capital and expertise required for developing such an establishment and must be capable of owning or leasing land for a minimum period of thirty years within the zones.[101]

The EPZ Act contains elaborate provisions on the types of operations to be carried on by the export enterprises. These ranges from goods imported and exported in Kenya to taking of goods

[97] Above n86, preamblular section.
[98] Id at section 9 (1) (a) (b) (c).
[99] Id at section 17 (3) (a) (b).
[100] Id at section 9 (2) (i).
[101] Id at section 21.

out of the zones to prohibited activities.[102] In this regard, it is worth emphasising that an EPZ firm is allowed to sell only twenty percent of its products domestically for which taxes and duties will be charged normally; the bulk of the EPZ goods are required to be exported since exportation is the primary goal of the programme.[103] To this end, the Authority is required to maintain data on the performance of the zones and make recommendations on how to tackle challenges facing the programme.[104]

2.4 Kenya's Experience with the Fulfilment of EPZ Objectives

2.4.1 Creation of Job Opportunities

According to Tax Justice Network-Africa 2012 report "Tax Competition in East Africa: A race to the bottom? Tax incentives and Revenue losses in Kenya" the objective of employment creation is proving difficult to realise. This is in terms of both the nature of jobs created and the number of Kenyans employed within the EPZs. First, the jobs are mainly low paying. Majority of Kenyans work either as unskilled or semiskilled with only a handful working as skilled employees since the top management are composed of foreigners.[105]

Secondly, workers work under deplorable conditions often characterised by lack of permanent jobs, persistent lay-offs and meagre pay for work done. EPZ employees, for example, are paid an average monthly wage of about Kshs. 10,585, which are excluded from the taxable pay or do not attract P.A.Y.E because of being low.[106] Employees also work long hours. Additionally, slum settlements are on the rise around these zones because majority of the workers cannot afford decent housing. All these have resulted into destabilisation of labour relations in Kenya.

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[102] Id at Part VII.
[103] Above n93 at 39.
[104] Above n86 at section 9 (2) (l).
[105] Above n2 at 16.
[106] Section 17 (b) of the Finance Act No. 38 of 2016.

Thirdly, due to global economic challenges, the Wall Street of the United State of America and the Eurozone crisis, a number of companies within the zones have been forced to either slow down their operations or shut down completely due to the loss of markets for their products.[107] This has in turn resulted into massive job loss as many Kenyans are retrenched and laid off. According to this the said Tax Justice Network-Africa report, the number of Kenyans employed in the zones has been declining gradually, from 38,000 in 2005 to 30,000 in 2012.[108]

The integration process of the East Africa countries has further compounded the foregoing state of affairs. The emergence of a common market has shrunk the export market in that the domestic market, which allows only twenty percent of the products for sale, has expanded to include countries such as Tanzania, Uganda, Rwanda and Burundi, which originally formed part of the foreign market for goods and services produced from the zones.[109] This means that EPZ firms have to incur extra cost in search of markets for their products forcing those that cannot cope to close shop with the overall effect being loss of employment opportunities for Kenyans.[110]

Again, following the integration process coupled with the changing economic realities, the EPZ Act has had to be changed from time to time in order to attune with the common market objectives.[111] However, this has been done without adequate consultation with the investors

[107] Above n93 at 39.
[108] Above n2 at 16.
[109] Above n93 at 41.
[110] Ibid.
[111] The changes have been brought about by successive Finance Acts and they include, according to *EPZs Annual Performance Report*, 2012, exclusion of commercial activities from the income tax holidays and disallowing parallel commercial and manufacturing activities by a single enterprise; requirement that commercial activities be licenced only after consultation with the Commissioner General, Kenya Revenue Authority and imposition of mandatory (as opposed to discretionary) 2.5% duty surcharge on EPZ goods sold to the domestic market. In addition, the EPZ companies must label the goods with their original country of origin and operate from a building where manufacturing activity is not taking place, requirement that sales by EPZ companies to domestic be subject to prior approval by the Minister for Trade. Introduction of a claim system for previously duty exempt petroleum fuels for EPZ firms.

forcing them to bear the extra administrative cost of compliance with the changes.[112] These realities cast doubt on the viability of the export programme in achieving the goal of job creation in Kenya and, by extension, tackling the social economic challenge of unemployment. As already noted, the types of employment created are not of the category to sustain the country's economy on a long-term basis considering that the wages of the majority of Kenyan workers are not taxed.

2.4.2 Transfer of Technology

The goal of transfer of technology aims to achieve two key results, namely inculcate high productivity skills and training in the Kenyan workers and increase of the number employed within the EPZs.[113] As mentioned, the companies operating within these zones are mainly textile industries and are majorly low technology.[114] They are not blue chip and their businesses do not demand high-level technology.

The foregoing phenomenon is attested to by the nature of the majority of workers working here. They are mainly unskilled and semiskilled. Majority of the skilled labourers, who form part of the top management, are foreigners, with only a handful being Kenyans.[115] Therefore, in addition to the fact that the majority of the zones companies are of low technological orientation, the few skilled Kenyans cannot adequately impart concrete knowledge and skills for there to be tangible results in terms of technology transfer into the country.

Besides, as explained, taking stock of the number of Kenyans who have gained skills is, admittedly, a challenge to EPZs Authority. This is because it lacks the necessary monitoring and evaluation tools to enable it track and obtain tangible reliable data on the number of people

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[112] Above n93 at 39.
[113] Id at at 38.
[114] Above n2 at 16.
[115] Above n12 at 25.

putting to use the skills acquired from employment in the zones in terms of establishing their own enterprises.[116] Another challenge is that of dumping. Unscrupulous investors seeking to dispose of their obsolete equipment and machineries at a price set up industries with the aim of accomplishing such negative goals. This causes environmental degradation. To this end, the objective of transfer of technology is less beneficial for the country's general wellbeing and economic development.

2.4.3 Backward linkage with the Domestic Market

The objective is realised when enterprises within the EPZs rely on the local market for supplies of raw materials, labour, equipment and machineries.[117] However, this is hard to achieve being that the majority of the companies import raw materials with only a few things purchased locally. For example, textile industries in the zones import most of the raw materials from countries like Egypt with stable cotton production industries unlike Kenya where such industries had long collapsed.[118] In addition, the emergence of synthetics is proving to be a better option as a source of raw materials compared to the natural source because they are cheap and as such puts the local producers at a disadvantage.

Again, being that Kenya is not a machine manufacturing country, many of the equipment and machineries used by these companies are imported. In other words, the challenge facing this objective is that the local industries lack the necessary input and are poorly integrated within the export programme.[119] The foregoing reality calls into question the usefulness of the EPZ tax incentives in enhancing the capacity of export programme to deliver on its goals. Consequently, the programme fails to contribute effectively to the country's economic development and renders

[116] Ibid.
[117] Above n23 at 33.
[118] Above n93 at 41.
[119] Above n23 at 34.

tax incentives on investments unjustified as it amounts to an injustice to exclude some individuals from the payment of taxes there being no concrete benefits to show for the revenue foregone.[120]

2.5 Mauritius Export Programme Experience

Mauritius is among the countries considered successful because it has used the export programme to create employment opportunities, diversify its exports, build up human capital, and increase the level of foreign direct investment inflow and tackle various social economic challenges.[121] For example, the number of Mauritians working in the export zones grew from 61,700 in 1986 to 77,623 in 2003 and the local traders are adequately linked with the exporters.[122] As such, it is approximated that employment in the zones accounts for 17.1 percent of the national force.[123]

This was made possible due to the existence of abundant educated labour force, political stability, favourable labour laws, and effective regulatory and administrative requirements.[124] The proper setting up of the EPZs and use of sound macroeconomic policies also played part in its success.[125] These involved pursuit of integrated strategic trade policies such as the integration of the export industry, establishment of long-term commitments with investors, upgrading of the local companies to help achieve the objectives of backward linkages with the domestic market and cautious grant of investment incentives, to ensure relevance and curb against abuse by counterfeit investors.[126] Lastly, Mauritius got the idea of the export programme at the opportune

[120] Above n12 at 4
[121] Above n85 at 73.
[122] Above n23 at 30.
[123] Above n85 at 73.
[124] Id at 75.
[125] Above n84 at 1.
[126] Above n85 at 75.

moment; it is among the first countries in Africa to establish EPZs and succeeded in taking advantage of such economic strategies.[127]

2.6 Conclusion

Kenya's experience with the EPZ tax incentives indicates that they are ineffective as investment promotion tools and are not yielding the intended benefits. As such, they not only constitute loss of government revenue but hinder the country's potential for sustainable development as well. Because of this, their provision raises serious equity concerns for the simple reason that the fundamental goal of the country's tax system, which is to secure fair and equitable taxation, among other public goals[128] is lost. The revenue spent in providing tax incentives to investors in the hope for the creation of meaningful job opportunities, technology transfer and backward linkage between domestic investors and exporters and so on is not matched by the resulting benefits. Unlike Mauritius, which as observed has been successful in using tax incentives to spur industrial growth, increase public revenue and accomplish a number of economic goals, Kenya's export programme compares to a bottomless sinkhole where so much public funds are invested without prospects of meaningful gains. This implies lack of justification for the exemption of these businesses from payment of taxes.

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[127] Ibid.
[128] Above n19 at Article 201 (b) (i).

CHAPTER THREE

EQUITY CONCERNS OF EPZ TAX INCENTIVES IN KENYA

3.1 Introduction

As earlier mentioned, one of the main problems affecting the EPZ tax incentives in Kenya is the legal failure to safeguard their relevance in fostering equitable sharing of tax burdens.[129] Consequently, Kenya loses approximately more than 12 billion shillings in revenue annually despite the minimal role of the incentives in attracting investments and the export programme having little positive impacts on the economy.[130] As a result, the country's revenue capacity is limited forcing the government to seek for alternative sources of funding such as foreign borrowing and subject the majority of Kenyans to the extra tax load in order to make up for these losses.

This chapter aims to examine the equity concerns surrounding these incentives.[131] The task requires a clear understanding of the concept of justice in taxation and the underlying theory before exploring the role of taxation generally. This is followed by a discussion of the principle of fair sharing of tax burdens and a highlight of the functions of taxation in Kenya. It concludes by providing a brief overview of the equitability of tax incentives on investments in the country.

3.1.1 Reasons for Taxation

Taxation is important for a number of reasons. First, it is a tool for generating revenue and hence a source of public funding that a government utilizes to provide for the citizens' welfare.[132] Secondly, it can be utilised as an instrument for realising economic policies like income and

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[129] Above n17 at 5.
[130] Above n18 at 5.
[131] Above n4 at 31.
[132] Yoseph Edrey, Constitutional Review and Tax Law: Analytical framework, *American University Law Review*, Vol. 56:5, 2007 at 1193.

wealth redistribution, resource allocation and economic stability.[133] Taxes such as excise duty on alcoholic drinks, cigarettes and cosmetics are used to regulate social behaviour. This category of levies is known as sin taxes because they seek to control the consumption of those items considered undesirable or harmful.[134] In light of these realities, taxation forms one of the central arenas for negotiations under the social contract theory and creates a legal relationship between citizens and their governments.[135] Under this arrangement, citizens are obligated to pay taxes to their government on the understanding that the taxes collected are utilized to provide for their welfare.[136]

To this end, taxation underwrites the state's capacity to accomplish public mandates and as such, without the ability to raise sufficient revenue and ensure equity, a government is not only constrained in the extent of fulfilling such goals but also bereft of legitimacy.[137] For this reason, the imposition of taxes should conform to some basic guidelines such as it should be certain and predictable, convenient to the taxpayer, efficient and above all, fair and equitable.[138] Additionally, levying of taxes should be based on the law; be politically acceptable and imposed by the relevant arm of government.[139]

3.1.2 Significance of Justice in Taxation

Whereas political scientists, economists, tax planners and so on, consider justice as the most fundamental norm applicable to any kind of human interactions, there is little consensus among

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[133] Taddese Lencho, Income Assignment under the Ethiopian Constitution: Issues to Worry about, *Mizan Law Review*, Vol. 4. No. 1, 2010 at 32.
[134] Above n27 at 3.
[135] Above n35 at 128.
[136] Above n132 at 1193.
[137] Above n32 at 1.
[138] Edward Cannan (ed.), *Adam Smith: An Inquiry Into the Nature and Causes of the Wealth of Nations (1784)* (New York: The Modern Library, 1937) at 777-79.
[139] Rupert J. Ederer, The Question of Justice in Taxation: The Basics of Tax Reform in terms of the Solidarity Concept of Heinrich Pesch, S.J, *The Catholic Social Science Review* , Vol. 13, 2008 at 3.

them on the exact definition of justice or what it constitutes in any given situation.[140] Many issues are subject of justice since different kinds of things can be termed just or unjust.[141] Accordingly, not only laws, institutions and social systems can be termed just or unjust but also particular actions.[142] As such, writers differ fundamentally in their approaches and conclusions as to what justice really is.[143]

Its application in complex social economic environments such as the tax systems compounds the challenge even more and lack of consensus as to the exact nature of tax equity continues to pose great difficulties to tax planners in their attempt to attain just tax systems.[144] This is because of the following reasons; first, the involvement of justice in taxation is more or less a projection of ethics into the sphere of economics. The problem with ethics is that a significant portion of it, in the widest sense, is not judicially enforceable but is left to the conscience of every individual person who decides what is just and equitable. This makes the exercise of defining justice a highly subjective and discretionary affair.[145]

On this note, it is difficult framing any general rules agreeable to everyone's expectation of what is fair. In terms of distribution of tax burdens, the realisation of justice is the subject of interplay of various imperfect financial considerations. The level taxes payable by the individual citizen is justified using key economic concepts such as the ability to pay and the benefit derived by taxpayers, which are problematic.[146] For instance, one big problem associated with the ability to

[140] Above n36 at 626.
[141] Above n38 at 276.
[142] Above n39 at 6.
[143] Above n36 at 626.
[144] Above n3 at 32; above n27 at 7.
[145] Above n1 at 579.
[146] Above n139 at 324.

pay principle is the lack of clarity on how and when best to measure an individual's ability to pay.[147]

Secondly, being that taxation forms part of the overall economic system, the fairness or unfairness of a tax regime cannot be evaluated in isolation from other government policies.[148] That is, an examination of tax fairness is not a one-dimension affair but one that requires attention to be paid to a number of issues as well in order to say whether a tax system is fair or not. Meaning, in evaluating the equitability of a tax system, one must also examine the fairness of other state policies to discern their overall impacts on the entitlements accruing from the economic system as a whole.

Thirdly, equitability of a tax system is largely a matter of public perception. This implies the need for simplicity of the rules for certainty and better understanding by the citizens.[149] However, the requirement for certainty of the revenue law creates a serious dilemma. On one hand, the simpler the rules the less fair they are because they fail to take into account the details of justified differences and on the other, the fairer they are, the more complex thus making it difficult for the public to understand.[150] For this reason, the realisation of justice from the point of view of either simplicity or complexity of tax law is hard to come by because the citizens' perception of tax fairness is affected largely by the level of information they either have or do not have.

The above challenges notwithstanding, the importance of justice in taxation cannot be gainsaid. Its application in the management of a country's affairs derives from the argument that the moral

[147] Above n58 at 1373.
[148] Lars Osberg, *What is Fair? The Problem of Equity in Taxation* at 65-66 available at http://myweb.dal.ca/osberg/classification/book%20chapters/Whats%20Fair/Fair.pdf accessed on 17th July 2016; above n31 at 1992.
[149] Above n33 at 1.
[150] Above n27 at 3.

character of the state, by its very nature, requires just and fair distribution of public burdens.[151] Ronald Dworkin in his paper, "What is Equality: Equality of Welfare?" explained justice in terms of equality of welfare and emphasised that it entails in making available the resources necessary for development of a person's physical, mental, educational and material wellbeing.[152] Hence, to be realised, individuals must be equal in the designated resources, which government should distribute in a manner that leave them as equal as possible in their quality of life.[153]

The utilitarians have also advocated for a system that allows for the greatest benefit for the maximum number of citizens as a way to ensure justice. In this regard, John Stuart Mill has considered an individual's happiness to entail more than a mere quantification of pleasure.[154] He adopts a qualitative rather than a quantitative approach used by Jeremy Bentham and shifts away from happiness in favour of the concept of welfare.[155] He therefore urges that the impacts of government policies on the lives of individual citizens should be the basis for judging the validity of such state actions to ensure maximization of citizens' welfare.[156]

To Stuart Mill, a person's liberty is significant for ensuring a meaningful life[157] and hence argued for a form of life that not only seeks to benefit a greater number but also maximizes individual freedom, which should not be interfered with unduly by either government or other individuals.[158]To this end, no matter how efficient and well arranged a social system is, the society must abolish it if found to be unjust.[159]

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[151] Above n139 at 323.
[152] Ronald Dworkin, What is Equality: Equality of Welfare? *Philosophy and Public Affairs*, Vol. 10, No. 3 (Princeton University Press, 1985) at 226.
[153] Id at 192.
[154] Wayne Morrison, *Jurisprudence: from the Greeks to Post-modernism* (London: Cavendish, 1997) at 200.
[155] Nigel E. Simmonds (3rd ed.), *Central Issues in Jurisprudence* (London: Sweet and Maxwell, 2008) at 18.
[156] Id at 19-20.
[157] Above n36 at 389.
[158] Above n154 at 200.
[159] John Rawls, *A Theory of Justice: Revised Edition* (Massachusetts: Belknap Harvard University Press, 1999) at 3.

Justice is crucial in the levying of taxes both as a matter of principle and practise.[160] As already observed, citizens have the right to expect fair treatment by tax systems and governments are under obligation to ensure that this is achieved.[161] On the other hand, a tax system that is seen to be unfair is most likely to be resisted by taxpayers and hence, tends to generate less revenue and incur high administrative costs as compared to one that is thought to be equitable and just.[162] For this reason, revenue law must set out the criteria for determining fair imposition of taxes on the citizens in order to make government's authority legitimate and maintain a working relationship between it and its citizens.[163]

The foregoing explains why it is considered one of the standards for gauging the justness of a tax system.[164] It requires the government to levy taxes in a manner that respects both the citizens' ability to pay and the benefits they get owing to state's protection. Hence, those with the same ability to pay should pay the same amount while those with greater ability to pay, pay more taxes to the government than those with lesser abilities.[165]

In this regard, to enjoy public confidence in imposing taxes, a government should ensure fairness and equity and not ask for more than is bearable from the taxpayers.[166] In other words, the ability to charge taxes justly by taking into consideration the unique circumstances of every taxpayer is what underlies assumptions of state's legitimacy and government's authority to demand for taxes from the citizens.

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[160] Above n148 at 63.
[161] Above n152 at 192.
[162] Mick Moore, 'Between Coercion and Contract: Competing Narratives around Taxation and Governance' in Deborah A. Brautigam , Odd- Helge Fjelstad and Mick Moore (eds.) *Taxation and State-Building in Developing Countries: Capacity and Consent,* (New York: Cambridge University Press, 2008) at 35.
[163] T. Honoré, The Dependence of Morality on Law, (1993) *Oxford Journal of Legal Studies*, Vol. 13 Issue 1 at 5.
[164] Above n4 at 32; above n27 at 6.
[165] Above n27 at 6.
[166] Abdul Azim Islahi, *Ibn Khaldun's Theory of Taxation and Its Relevance Today* in The Islamic Research and Training Institute, paper presented at the Conference on Ibn Khaldun (Madrid, 2006) at 16.

In light of the above reasons, justice can therefore be said to give taxes their political acceptance since the primary goal for imposing such levies is to enable government to raise revenue so as to provide for the welfare of its citizens and accomplish other public objectives.[167] On this basis, Oliver Wendell Holmes has equated such payments to the price individuals pay for belonging in a civilised society. He remarked, "I like to pay taxes. They are the price we pay for a civilised society."[168]

As such, it has a pivotal role to play in both the making and administration of revenue law[169] which is why its application in taxation is a multidimensional concern covering issues that are substantive in nature such as the individual's ability to pay, sources of income and tax base as well as administrative like timeliness, efficiency et cetera.[170] This multifaceted focus is important for ensuring that a tax system is not only used to generate revenue and pursue other state building objectives but also promote fairness in taxation.[171]

3.2 Dimensions of Equitable Sharing of Tax Burdens

As already explained, justice requires everyone to contribute towards the support of government in proportion to both their respective abilities and the revenue they derive under the protection of the state.[172] This requirement embodies two criteria for justifying the amount of tax paid by individuals, namely: the ability to pay and the benefit principle.[173] The former gives rise to horizontal equity whereby those with equal ability to pay are required to pay equally while the

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[167] Above n27 at 3.
[168] Compania Gen. De Tabacos de Filipinas v Collector of Internal Revenue, 275 US 87, 100 (1927)
[169] Above n27 at 6.
[170] Above n33 at 1.
[171] Above n31 at 1999; above n35at 315.
[172] Attiya Waris, Taxation without Principles: A Historical Analysis of the Kenyan Taxation System, *Kenya Law Review*, Vol. 1:272 (2007) at 276.
[173] Above n132 at 1227.

latter leads to vertical equity in which individuals with greater ability to pay, pay more taxes to the state.[174]

3.2.1 Horizontal Equity

Horizontal equity requires individuals who are similarly placed to be taxed similarly. That is, those with equal ability to pay owe equal amount of taxes to the state.[175] To actualise this principle it is important to define the taxpaying unit and set out the criteria for similarity.[176] With regard to direct taxes like the personal income tax, a taxpaying unit could be the individual or the family while the criteria of similarity could entail their similarities in terms of need, degree of use of public services, income or wealth ownership, personal characteristics such as citizenship et cetera.[177] On other hand, indirect taxes such as the retail sales tax, the taxpaying unit is intrinsically the individual taxpayer and the basis for similarity is most likely to be in terms of the degree of use or consumption of the goods or services in question.

One fundamental concern about horizontal equity, however, is the lack of clarity on how and when best to measure an individual's ability to pay.[178] In asserting that two individuals are equally placed for tax purposes, this principle assumes that each person had a fair opportunity to get to where they stand when the taxman comes to charge them. This raises the question: does equal ability to pay among taxpayers mean identical taxation, or is it fair for two people with the same wealth to pay different amounts of taxes because of the origin of the resources?[179]

[174] Above n58 at 1325; above n166 at 16.
[175] Ibid.
[176] Above n148 at 70.
[177] Ibid.
[178] Above n58 at 1373.
[179] Cesar Augusto Dominguez Crespo, The Ability to Pay as Fundamental Right: Rethinking the Foundations of Tax Law, *Mexican Law Review*, Vol. 3, No. 1, at 54.

Because of this, horizontal equity is said to be arbitrary and lacks objectivity, as it does not explain how to determine when two individuals are in equal positions. Despite these criticisms, this dimension of tax fairness has great potential in enhancing the revenue function of taxation.[180] Moreover, the attainment of equity is a goal to be realised through the involvement of a number factors in a tax system and hence, is not the sole function of horizontal equity, which is why, as earlier mentioned, the fairness of other government policies also influences equity in taxation.[181]

3.2.2 Vertical Equity

According to vertical equity, it is fair that those with greater capacity to pay taxes to bear a relatively higher tax burden than those with lower earnings in the society.[182] It forms the basis for progressive taxation in which it is believed that the rate of taxes should increase with the increase in the ability to pay to enhance distributive equality with regard to the after-tax income.[183] The major problem with vertical equity, however, is that it lacks the objective criteria for determining the extent of progressivity that best assist a society to balance its values for maximum social equality, personal liberties and freedoms and capital growth for economic development.[184] Of importance, nonetheless, is the requirement that the rich ought to shoulder bigger tax burdens to help increase the revenue potential of a tax system, foster fair taxation and this is justified by the idea that they use social capital more and hence, have to pay higher amounts of taxes than those with relatively less earnings in the society.[185]

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[180] Above n58 at 1378.
[181] Above n31 at 1992; above n148 at 65-66.
[182] Above n132 at 1227; above n172 at 276.
[183] Above n148 at 75.
[184] Above n148 at 79.
[185] Above n132 at 1227.

3.3 Functions of Taxation in Kenya

The preoccupation with taxation by the various fiscal policy interventions in Kenya, for example the 1986 Economic Management for Renewed Growth[186], Industrial Sector Adjustment project of 1990 et cetera is due to important role taxes play in the economic development of the country.[187] Whereas economic development can be easily equated with economic growth, the two are quite different from each other. The former is broad in scope and it is the product of long-term investments in the generation of new ideas, knowledge transfer, and infrastructure, and it depends on functioning social and economic institutions and on cooperation between the public sector and private enterprise. The latter, on the other hand, is narrow and majorly reflects increase in aggregate outcome.[188]

The government of Kenya uses taxation to achieve a number of objectives in this respect namely for raising revenue, promoting industrial growth and for regulating certain social behaviours such as smoking, consumption of alcoholic drinks and so on. This focused attention on taxation is key in two major ways. From the point of view of international financial institutions, improved taxation reduces a country's dependency on foreign aid relieving these external bodies of the problem of having to bail out broke governments.

By contrast, a government's ability to fund public projects from its domestic revenue greatly enhances state legitimacy and autonomy.[189] Kenya has performed relatively well over the years and decreased its reliance on external funding in this regard to 4.9% of the GDP compared to

[186] Above n9.
[187] Above n10 at 4.
[188] Maryann Feldman, Theodora Hadjimichael and Lauren Lanahan, *Economic Development: A Definition and Model for Investment*, 2014 at 1 available at https://www.eda.gov/tools/files/research-reports/investment-definition-model.pdf.
[189] Above n10 at 2.

Guinea Bissau, Sierra Leone and Malawi, which, according to IMF, stands at 37.3, 28.7 and 26.2 percent respectively.[190]

However, the problems of taxation in development are a concern that is generally studied from two counteracting dimensions, which are quite distinct and often opposing. There is the perspective of resources and the other of incentives.[191] The proponents of the former blame insufficient growth and investment on lack of resources and as such are majorly concerned with increasing resources available for investment by additional taxation.

On the other side of the coin, those who believe that lack of adequate incentives is responsible for insufficient growth and investment would be concerned with improving the tax system by granting additional investment concessions.[192] To this end, taxation compares to a double-edged sword in that the fulfilment of the revenue goal may jeopardise a country's potential for economic development and vice versa.

Therefore, to enhance the role of taxation in the overall development of a country, it is important that the revenue function of taxes is properly balanced with their incentivising goal. In Kenya, for example, the failure to increase tax revenue is blamed on structural challenges of the economy arising from low levels of formal employment, poverty wages and a high dependency ratio, which limits the government's capacity to increase income tax revenue.[193] Hence, while

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[190] Ibid.
[191] Nicholas Kaldor, *The Role of Taxation in Economic Development,* Seminar on the Programming of Economic Development by United Nations Educational Scientific and Cultural Organisation held in Sao Paulo, Brazil on 30th December 1962 to 17th January 1963 at 1.
[192] Ibid.
[193] Above n10 at 3.

focusing on revenue growth the government must also be careful to balance it with economic growth.[194]

3.3.1 Revenue Generation

Taxes constitute an important source of public revenue in Kenya, financing almost 60% of the total government expenditure over the past decade.[195] The main sources of tax revenue include the income taxes, VAT, excise and custom duties.[196] Due to its centrality, the issue of tax fairness, tax performance and revenue adequacy, among others, have become serious concerns for the public, businesses as well as policy makers, and continue to shape the debates around tax policies and their economic implications in Kenya.[197]

With the passage of the 2010 Constitution that recognises fair sharing of tax burdens, attention has now been turned on how best the government can utilise the tax system to ensure fairness and equitable distribution of income and welfare of the citizens.[198] The Constitution establishes a two-tier system of government to assist Kenyans realise the social, economic and political dreams and goals underlining its adoption.

The system comprises of the national government and forty-seven county governments.[199] Each is mandated to levy certain taxes: the former retains the power to impose taxes both direct taxes including income taxes and indirect taxes namely; VAT, excise duty and customs or import duty.

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[194] Christine Achieng' Awiti, *Taxes and Economic Growth in Kenya: A Theoretical Perspective*, at 1 available at https://editorialexpress.com/cgi-bin/conference/download.cgi?db_name=CSAE2014&paper_id=535 accessed on 17 July 2016.
[195] Institute of Economic Affairs, *A Citizen's Handbook on Taxation in Kenya* (Nairobi: IEA, 2012) at 6.
[196] These are charged according to the sections 3 (2), 5 (1) (2), 16 and 5(1) of the Income Tax Act, Cap 470, VAT Act No. 35 of 2013 and East African Community and Customs Management Act, 2004 and Excise Duty Act No. 23 of 2015 respectively.
[197] Above n195 at 6.
[198] Above n19 at Articles 10(2) (b) and (d), 27 and 201 (b) (i).
[199] Id at Article 6(2).

The latter, on the other hand, is confined to imposing property taxes, entertainment taxes and such other taxes as may be feasible at this level of government.[200]

In this regard, the supreme law, through taxation, provides Kenyans with a framework for formalising mutual obligations that exist amongst them by defining those inequalities, which they collectively accept and intend to address, sets limits on the kind of actions a government can take and defines the membership of a political community.[201] This reality comes hot on the heels of the fact that the country has become a high tax burden economy with 80 per cent of the total public revenue coming from taxes yet the need for more revenue is ever pressing.[202]

With the above realities come equity concerns. This is because, despite Kenya being one of African countries with the most progressive tax systems, the government is yet to reform the tax system to broaden the tax base by identifying new sources of revenue, doing a review of the investment incentives and bringing more individuals into the revenue fold, among others.[203] Reforming the tax system, therefore, would be essential for promoting equitable distribution of tax burdens in Kenya and guaranteeing revenue adequacy to enable the funding of public expenditure and accomplish other state building roles without resorting to drastic funding options such as borrowing, printing money, among others.[204]

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[200] Id at Article 209 (1) (3).
[201] Isaac Williams Martins, Ajay K. Mehrotra and Monica Prasad, *The New Fiscal Sociology: Taxation in Comparative and Historical Perspective* (New York: Cambridge University Press, 2009) at 1.
[202] Eliud Moyi and Erick Ronge, *Taxation and Tax Modernisation in Kenya: A Diagnosis of Performance and Options for Further Reforms* (Nairobi: Institute of Economic Affairs, 2006) at 1.
[203] Above n195 at 6.
[204] Above n73 at 1; above n202 at 1.

3.3.2 Other Functions

As an arena for negotiations, taxation provides citizens and their governments with a forum to agree on how to promote development and enhance the general wellbeing of the society.[205] The concept of development, as a process of expanding human freedoms, demands for a holistic realisation of citizens' welfare.[206] It requires states to do more with their distributive mechanisms such as tax systems and pursue those goals that are germane for the betterment of individuals' lives socially, economically and politically.[207]

In this regard, the pursuit of other state building roles such as industrial growth, income redistribution, social control and such like has compelled the Kenyan government to modify its tax system to achieve such objectives aside from income generation. As a tool for social control, as mentioned, taxes are used to regulate the consumption of alcoholic drinks, cigarettes and cosmetics, which the government of Kenya considers harmful to citizens' health apart from being merely luxurious. It is on this basis that such goods attract excise duty though the government's main goal is to discourage their consumption rather than just raise revenue.

On the other hand, the pursuit of industrial development in Kenya has resulted in preferential taxation where some classes of taxpayers are allowed tax incentives in the form of tax exemptions and deductions.[208] This has led to use of tax incentives to induce investments in the EPZs in order to enhance the programme's capacity to make the country prosper.

Tax incentives owing to their selective nature involves shift of tax burdens.[209] In this regard, therefore, in determining the fairness of Kenya's tax system to determine if it treats taxpayers

[205] Above n35 at 128.
[206] Amartya Sen, *Development as Freedom*, (Oxford: Oxford University Press, 2001) at 36.
[207] Ibid.
[208] Above n4 at 32.
[209] Ibid.

equitably and fairly, it is important to analyse all the tax burdens imposed, the possibility of differential allocation of such burdens and reasons for such decisions. As pointed out, selective treatment of EPZ investors is guided by the idea that selective treatment of the capital investors is more beneficial to the country's social, economic and political development than if such individuals were to be taxed on the same footing as the other taxpayers.[210]

Courts of law have had the occasion to explain the principle of equality and fairness in a manner so broad as to generally imply that the mere breach of a right is not a sufficient ground for declaring a law null and void.[211] When faced with such questions, they are obligated to examine the prevailing circumstances to establish whether the alleged violation is justified.[212] With regard to taxation, courts have observed that some shifting of tax burdens, based on the ability to pay, may be necessary or justified, for as long as no class of citizens is favoured to the detriment of another without good cause.

The Supreme Court of Israel, for instance, while dealing with the question of whether tax preferences for capital gains were justified, observed in *Kaniel v. Minister of Justice HCJ 9333/03* that for as long as there was a right balance between the harm to the individual taxed discriminatorily and the benefit to the public investment privileges were justified. The benefit was that, for the time being, the investment privileges attracted foreign investors thus increasing international investments and stabilising the stock exchange of Israel. For this reason, the court held that tax preferences for capital gains were justified.[213]

The Kenyan courts have also had the chance to deal with the questions of fairness of tax incentives on investments and held that they are important for attracting foreign direct

[210] Above n3 at 31.
[211] Above n132 at 1205.
[212] Ibid.
[213] Id at 1205-06.

investments in the country's economy.[214] However, they warn that in order to benefit the economy, the provisions of the revenue law on incentives should not be ambiguous or grant too many exemptions in order to prevent the turning of the country's tax regime into a tax avoidance scheme by investors who merely shop for tax havens.[215] To this end, for as long as tax burdens are properly distributed and matched by equal benefits for all Kenyans, then payment of taxes, irrespective of the differences in the individual's tax load, is not an injustice at all.[216]

3.4 Conclusion

Despite the little consensus among scholars as to the exact nature of justice in any given situation, it remains the most fundamental principle underlining assumptions of legitimacy of democratic states today. It recasts the doctrine of social contract in the state-citizen relationship and gives the governments and their citizens the leeway to agree on how and what goals are to be achieved through taxation. The government of Kenya is therefore free to structure the tax system not only for the primary goal of raising revenue but also for fulfilling other state-building roles such as the fostering of economic development et cetera.

The decision to use tax incentives to encourage investments in the country's EPZs is not necessarily unjust and their exempting nature is not sufficient to constitute injustice in Kenya because of the imposition of different tax burdens on individuals. Of fundamental importance should be for these fiscal incentives to enhance the productivity of these selected classes of citizens or persons to yield more benefits to Kenya than if they are taxed like the rest. As such, if the investment benefits granted to investors within these zones improve their capacity to promote

[214] Above n65 at vi.
[215] *Afrolite Industries Ltd versus Commissioner of Income Tax* [2000] LLR 3025 (HCK).
[216] Liam Murphy and Thomas Nagel, *The Myth of Ownership: Taxes and Justice* (New York: Oxford University Press, 2002) at 14.

equitable taxation through the accomplishment of the set goals, then the practice of granting investment incentives should be encouraged and vice versa.

CHAPTER FOUR

LEGAL CHALLENGES OF EPZ TAX INCENTIVES IN KENYA

4.1 Introduction

As observed, Kenya has modelled its tax system as a tool for facilitating industrial growth with the aim to encourage investments in the export sector, achieve social economic development and empower citizens.[217] The modification led to the introduction of tax benefits in the form of tax exemptions, deductions, among others, to attract investments in the EPZs.[218] It was done on the assumption that preferential taxation of capital investors would be more advantageous than if taxed like other taxpayers as it helps improve the former's capacity to create jobs, ensure technology transfers, link the domestic market with the exporters, turn Kenya into an export-based economy and so on.

However, as mentioned, experience indicates that Kenya loses so much revenue through tax incentives on investments in spite of the benefits deriving from the EPZs not matching the revenue foregone.[219] That is, not even a single goal of the programme is being properly realised. This state of affairs continues unabated despite the reality that incentives only constitute a secondary factor to most investors, who instead consider cost of production, availability of market, political stability and security and infrastructure development as primary.[220] The ultimate result: the equitability of the country's tax system has been rendered doubtful there being no meaningful gains to justify the exemption of export businesses from paying taxes on their incomes.

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[217] Above n2 at 4. See also the objectives of the EPZ available at http://www.epzakenya.com/index.php/about-us/objectives.html.
[218] Rolph Van Der Hoeven and Jan Vandermoortele, *Stabilisation and Adjustment Policies and Programmes in Kenya,* (World Institute for Development Economics and Research, 1985) at 33.
[219] Above 17 at 5.
[220] Above n25 at 5.

Towards this end, therefore, it is necessary to examine the legal challenges facing the EPZ tax incentives. As such, the aim of this chapter is to discuss these problems analytically. The point of departure in this respect recognises that some of these challenges are unique to the administration of the incentives while others directly affect the objectives of the export programme. Accordingly, this chapter begins by analysing the problems underlying the administration of the incentives as investments promotion tools before discussing those ones undermining the fulfilment of the EPZ goals. It concludes by pointing out that Kenya, in view of the prevailing legal hiccups, cannot benefit much from its export programme.

4.2 Administration of EPZ Tax Incentives

Kenya's export incentive regime is governed by several legislations, which are revenue and non-revenue in nature. They include the EPZ Act, Income Tax Act, VAT Act and the East African Community and Customs Management Act.[221] These are administered by different state departments, which enjoy administrative discretion over the declaration of incentives.

The EPZ Authority is responsible for the EPZ Act[222] while KRA administers the Income Tax Act, VAT Act and the East African Community and Customs Management Act.[223] These departments fall under different ministries: the EPZ Authority is under the Ministry of Industry, Trade and Cooperatives whereas the Ministry of Finance oversees the operations of KRA.[224] This means the administration of tax incentives in Kenya is the responsibility of more than one public institution.

[221] Above n6.
[222] Above n86 at section 9 (2).
[223] Income Tax Act, Chapter 470 section 122, VAT Act No. 13 of 1995 section 3, and East African Community and Customs Management Act, 2004 section 5.
[224] Find EPZA at http://www.industrialization.go.ke/index.php/state-corporations and KRA at https://www.kenyans.co.ke/government/ministry-finance-national-treasury accessed on 17 July 2016.

As explained, among the investment gains accruing to an EPZ firm are tax incentives, which are in the form of exemptions, deductions and tax holidays.[225] An enterprise is qualified to benefit by simple fact of being licensed to operate as such within the zones, not more. This is, however, subject to the requirements that a firm maintain its business accounts in a convertible foreign currency of its choice but with approval of the Commissioner of income tax and submit an annual return of income under Section 52 and business accounts under Section 54 of the Income Tax Act.[226]

Whereas the use of tax incentives may be regarded as a laudable investment promotion strategy the reality indicates otherwise. As explained, the incentives are merely of secondary importance to most investors in Kenya[227] apart from leading to loss of public revenue, constraining the country's tax system and the benefits deriving from the EPZs not adequately compensating taxes foregone.

Moreover, they are granted against the background of Kenya's commitment to uphold WTO rules against the use of investments subsidies. The government acknowledges this particular problem and has undertaken to rationalise the incentive regime to comply with the said rules.[228] However, the passage of the Special Economic Act with almost similar incentives as the other statutes leaves a lot to be desired of the government's commitment in this regard.[229]

The above problems can be blamed on the weak legal framework governing the administration of the EPZ tax incentives in Kenya. This manifests itself in several forms ranging from lack of

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[225] Above n6.
[226] Section 4B 11th Schedule paragraph 2 and 4 of the Income Tax Act Cap 470 of the Laws of Kenya.
[227] Above n25 at 5.
[228] Above n2 at v.
[229] Above n80.

transparency, weak anti-tax avoidance measures, improper targeting of incentives and lack of reliable data on their impacts to contravention of WTO trade rules on subsidies.

4.3 Legal Challenges facing the Administration of EPZ Tax Incentives

4.3.1 Lack of Transparency

As a legal problem, lack of transparency in Kenya is caused by various factors, the main ones being, first, the inadequate coordination among the institutions responsible administering the EPZ incentives. As explained, the declaration of incentives can be done by different state departments.[230] Coupled with the discretionary powers enjoyed by these institutions, lack of proper coordination exposes the incentive programme to the hazard of arbitrariness since any Cabinet Secretary can perfunctorily declare an incentive without proper consultation with the relevant bodies.[231]

This has led to inconsistency of the incentives and invited all manner of economic and political abuse by fraudulent investors in Kenya, for example corruption, as was in the Goldenberg's affair in which exemptions were allowed for false exports.[232] Lack of transparency also complicates Kenya's ability to get data on the impacts of the EPZ tax incentives and ascertain their effectiveness as investment promotion tools.[233]

The second factor concerns the secrecy and scantiness of the data on how much Kenya spent on tax incentives. A close look at the KRA website shows that such information is not readily

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[230] Section 122 of the Income Tax Act, Chapter 470, section 3 of the VAT Act No. 13 of 1995, and section 5 of the East African Community and Customs Management Act, 2004.
[231] Above n2 at 19.
[232] Above n28 at 8.
[233] Above n2 at 19.

available for public access.[234] One is left to wonder why that is so considering that the Constitution of Kenya, 2010, recognizes the citizens' right to information and mandates the public institutions to uphold national values and principles of good governance such as transparency, accountability, and so on.[235]

Anyway, the country has promulgated the Access to Information Act, 2015, which provides guidelines on the actualisation of Article 35 of the Constitution on the right to information.[236] It is hoped that this law will encourage proactive disclosure of information held by public bodies and end the mantra of secrecy characterising their operations. However, as to whether this will happen in the administration of tax incentives remains to be seen.

4.3.2 Weak Anti-Tax Avoidance Measure

Kenya uses a specific anti-avoidance approach in combating tax avoidance.[237] It works on two broad sets of rules in order to curb tax avoidance; namely the 'purpose to avoid' and mechanical rules.[238] The first one requires the examination of a taxpayer's purpose for organising its transaction.[239] With regard to Kenya, this rule empowers the Commissioner to make a finding as to the intention of a taxpayer where he or she suspect that such a taxpayer has been motivated by tax avoidance desire to enter a transaction and make such adjustments as he or she deems appropriate to ensure tax collection.[240]

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[234] Refer to the KRA website available at http://www.kra.go.ke/. It does not contain any information regarding data on the revenue lost from tax incentives on investments.
[235] Above n19 at Articles 10 (l2), 35 (1) (a) (3) and 201 (a).
[236] See the preambular section of the Access to Information Act, No. 36 of 2015. It provides, *"AN ACT of Parliament to give effect to Article 35 of the Constitution; to confer on the Commission on Administrative Justice the oversight and enforcement functions and powers and for connected purposes."*
[237] Sections 23 and 24of the Income Tax Act Cap 470 of the Laws of Kenya.
[238] Victor Thuronyi, *Rules in OECD Countries to Prevent Avoidance of Corporate Income Tax*, [online] available at http://unpan1.un.org/intradoc/groups/public/documents/APCITY/UNPAN017808.pdf accessed on 18 August 2015 at 8.
[239] Id at 9.
[240] Above n237 at section 23.

The second set of rules, on the other hand, does not depend on the taxpayer's purpose to avoid; all that matters is for the circumstances set forth in the statute to be present for the rule to apply.[241] In this regard, the Kenya's Income Tax Act identifies avoidance by the non-distribution of dividends.[242] In other words, where a corporation's decision to defer payment of dividends fulfils the conditions set so as to be categorised as avoidance of tax liability, the Commissioner is required to cancel such a transaction to prevent tax avoidance.

Whereas the approach may be praised for legal certainty and enjoys considerable ovation over the general approach in this regard, due to close tailoring of the rules towards combating tax avoidance,[243] it remains problematic for several reasons. First, it is ineffective in combating tax avoidance incidences such as transfer pricing, round tripping, false declaration of exports and division of business between two related legal entities, among others, which the EPZ firms engage in to exploit the investment benefits offered under the programmes' incentive regime.[244]

For example, in an attempt to tame tax avoidance by way of transfer pricing, section 18 (3) of the Income Tax Act requires adjustments to be made to transactions between resident and non-resident that are not at an arm's length. However, section 10, in requiring that any payment in the form of management or professional fees, royalties et cetera that is paid by a resident person to be considered as a taxable pay, excludes certain payments by a resident permanent establishment of a non-resident to the non-resident.

This is problematic in the following ways. Not only do the sections conflict with each other but also, and more importantly, the exclusion of certain payments by a resident permanent establishment of a non-resident to the non-resident gives a taxpayer the option of relying on

[241] Above n238 at 11.
[242] Above n237 at section 24.
[243] Above n238 at 8.
[244] Above n2 at 22.

section 10 to justify its payment to its non-resident relative in a low tax regime. This compromises the regulation of transfer pricing.[245]

The second problem is with regard to the discretionary powers granted to the Commissioner under section 23 of the Income Tax Act to treat a transaction as constituting an attempt to avoid taxes. The section is inadequate in the sense that it does not obligate the Commissioner to state the grounds on which he or she may make a finding as to the existence of tax avoidance motive in a transaction. This means the Commissioner can exercise his discretion arbitrarily, which not only waters down transparency in the administration of taxes but also undermines taxpayers' right to information.

Third, specific anti-avoidance being rule-based is inflexible and encourages creative compliance with the law in which investors use the revenue law to evade regulations without breaching the rules.[246] Owing to this reality, the approach not only lacks guidance on how to solve problems where the legislature has not provided a solution but also allows taxpayers to get away with tax avoidance and reduce their tax obligations against the law.[247]

This is what Kenya continues to experience with regard to the mentioned tax avoidance incidences. In such situations, courts' freedom to interpret the tax law to fight tax avoidance is restricted, which means they are unable to appropriately remedy and deal with those aspects of tax avoidance, such as the ones mentioned above, which, as observed, are not adequately contemplated by the Income Tax Act.

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[245] Kenya's experience with case of *Unilever Kenya Limited versus Commissioner of Income Tax* Income Tax Appeal No. 753 of 2003 highlights the inadequacy of the Income Tax Act in combating tax avoidance terms of the contradiction between section 10 and 18 (3) of the same.

[246] Doreen McBarnet and Christopher Whelan, The Elusive Spirit of the Law: Formalism and the Struggle for Legal Control, (1991), *Modern Law Review*, Vol. 54 at 64.

[247] John Avery Jones, Tax Law: Rules or Principles? (1996), *Fiscal Studies* (1996) vol. 17, no. 3 at 75.

Fourth, because the legislature is always expected to come up with rules to control every aspect of tax avoidance, the approach increases not only the bulkiness of tax law but also the complexity and rigidity of the same.[248] With regard to Kenya, it should be noted that currently the country has rules to combat various tax avoidance opportunities, for example transfer pricing.[249] However, it is yet to enact more rules to deal with the other incidences such as round tripping and double dipping.

To this end, the courts' warning that for Kenya to benefit, the provisions of the revenue law on incentives ought to be clear and not grant too many exemptions in order to prevent tax avoidance incidences in the EPZs, alludes to challenges of the approach and establishes a case for reforming the law to improve the fight against tax avoidance.[250]

4.2.3 Improper Targeting of Incentives

An incentive is well targeted, and therefore effective, if an additional level of investments can be attributed to it (directly or indirectly) minus the non-tax factors.[251] To be realised, the deficiency that it is intended to counterbalance or address ought to be specifically stated, the associated costs ascertained and the data on their benefits qualified.[252] This explains why successful countries peg the grant of tax incentives on factors such as time limitation or specific criteria like minimum levels of employment or investment and so on, and are selective in the granting such benefits.[253]

In Kenya, the challenge of improper targeting of the EPZ tax incentives is brought about by the failure of the law to condition the grant of these incentives on needs assessment. That is, the

[248] Above n238 at 6.
[249] See the Income Tax (Transfer Pricing) Rules, 2006.
[250] Above n65 at vi.
[251] Above n28 at 5.
[252] Above n91 at 2.
[253] Above n23 at 17.

incentives were introduced without doing a cost benefit analysis to establish their real benefits and if they constitute optimal policy options for investors.[254] This could be explained by the country's experience with the investments in the EPZs, which according to the assessment by OECD only began increasing in 2000 after the country signed the AGOA agreement with the US.[255] Some companies such as Tri-Star Garment Company moved to Uganda after the expiry of the AGOA quota and the tax holiday in Kenya.[256] These experiences show that incentives, in spite of their extensive provision, are mainly secondary investment factors and have little effect in terms of retaining such companies so that they continue operating in the country.

In addition, while the EPZ Authority is mandated to maintain data on the performance of the programme[257], the legal failure to peg the incentives on certain conditions such as additional flow of investments, increase in the number of Kenyans employed et cetera makes it hard for the Authority to discern the actual impacts of these investment benefits. As such, this weakens the Authority's capacity to not only monitor the progress of the individual EPZ enterprises but also get reliable data on the benefits of the incentives.

In this regard, it is challenging linking the realisation of the export objectives with their stimulating effects on the level of investments.[258] In fact, research shows in this regard the country has been unable to establish the number of Kenyans who have gained skills from the zones and are putting the knowledge to use. Besides, the export promotion policy is more focused on fulfilling the quota conditions contained in the AGOA enacted by USA to enable it gain preferential market access than improve Kenya's competitiveness in terms of the

[254] Above n73 at 4.
[255] Above n23 at 41.
[256] Above n12 at 25.
[257] Above n86 at section 9 (2) (l).
[258] Above n91 at 4.

opportunities for transfer of skills and other economic benefits associated with the EPZ programme.[259]

4.2.4 Lack of Reliable Data on their Impact

A number of studies have decried the rampant use of tax incentives as investments promotion devices whereas their real benefits or impacts have not been conclusively established and there is inadequate data to support their use.[260] Which begs the question, why do governments insist on using them while fiscal inducements are not part of the optimal policy options considered by the majority of investors?[261] Two main arguments have been fronted to answer this question, the first one is that governments are under intense lobbying by multinational corporations who influence government officials, and at times bribe them, to allow preferential taxation of capital investors.[262] For example, it is alleged that some Nigerian public officials were bribed to exempt a foreign company from taxes.[263]

The second argument relates to the cost of establishing the infrastructure to make the investment climate conducive. Building of roads, electricity, water supply, just to mention a few, normally require large capital outlay, which a government might find very expensive and unjustified particularly if the expected returns are delayed.[264] As such, many a nation may consider such costs unnecessary, if not optional, and grant fiscal incentives instead in the hope that they indemnify the investors of the losses arising out of unfavourable investment environment.

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[259] Above n12 at 25.
[260] Robert S. Chirinko and Daniel J. Wilson, *State Investment Tax Incentives: A Zero-Sum Game?* Federal Reserve Bank of San Francisco, Working Paper Series at 1.
[261]Above n17 at 6.
[262] Id at 6.
[263] Above n91 at 2.
[264] Above n23 at 31.

As a problem, lack of reliable data on the impacts of the EPZ tax incentives stems from the other legal challenges, which as observed include lack of transparency, weak legal framework on monitoring by the concerned authorities, improper targeting of the investment benefits, among other challenges facing the administration of tax incentives in Kenya. Owing to this, it is almost impossible for the country to qualify their effects and obtain reliable data in this regard. In fact, there is simply no reliable information on the impacts or benefits of these fiscal inducements and it is difficult attributing an additional level of investments in the EPZs to the incentives minus the non-tax factors.

After all, as the experience of the country shows, the incentives are merely of secondary relevance to investors and hence, are no match to primary factors such as cost of production, availability of market, political stability and security and infrastructure development.[265] Furthermore, the extent to which the prevailing tax conditions in Kenya affect investment decisions has more to do with the tax bases, tax rates and so on rather than tax exemptions, deductions and holidays.[266]

4.2.5 Contravenes Trade Rules of WTO

Although none of the WTO agreements: the General Agreements on Trade in Services (GATS), Subsidies and Countervailing Measures (SCM) and the Trade Related Investment Measure (TRIM) mention about tax incentives, the definition assigned to export subsidy seems to cover them.[267] A subsidy refers to any financial contribution by a public body which confers benefit.

[265] Above 25 at 5.
[266] Above n16 at 2.
[267] Above 23 at 32; above n18 at 45.

Accordingly, direct fund transfers for example, loan, grant, among others, and any revenue that is due but is foregone, qualify as subsidies.[268]

Generally, subsidies are prohibited and so are tax incentives.[269] However, special treatment is accorded to those nations that are considered least developed and developing countries and as such, are exempted from this prohibition.[270] Kenya is not classified as a least developed country but a developing one and therefore enjoys the exemption subject to the condition that it maintains export subsidies for a limited period of eight years effective from 2003.[271] This was however extended to 2007 following the resolutions reached at the 2001 WTO Ministerial Decision in Doha on the Implementation-Related Issues and Concerns and related documents.[272]

Eight years from 2007 implies that Kenya should have done away with the tax incentives in 2015 unless permitted under special circumstances. As observed, the government is aware of their negative impacts and has planned to rationalise the incentive regime to comply with WTO rules.[273] However, how prepared it is remains to be the question considering that in the very year the government was expected to get rid of these incentives, it passed the Special Economic Act with an equally generous incentive scheme as the other Acts.[274]

4.4 Legal Challenges of EPZ Objectives

The above experience shows that the law is doing little to facilitate the realisation of export programme's objectives due to the following legal challenges: failure to establish indicators of

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[268] Article 1 of the Subsidies Countervailing Measures Agreement, 1990.
[269] Id at Article 3.1 (a).
[270] Article 27 of the Subsidies Countervailing Measures Agreement, 1990 provides for Special and Differential Treatment of Developing Country Members where it is stated that the prohibition on export subsidies does not apply to developing countries referred to in Annex VII.
[271] Id at Article 27.2 (b).
[272] Above n23 at 46.
[273] Above n2 at v.
[274] Above n80.

success, problematic definition of an EPZ, cumbersome legal procedures and policy inconsistencies and inadequate protection of labour conditions of EPZ workers.

4.4.1 Failure to establish Indicators of Success

Whereas the EPZ Authority is required to provide a favourable environment for investors and ensure that the zones perform in terms of fulfilling the programme's objectives, the EPZ Act has not provided guidelines on how to measure the success of the programme. This makes it difficult knowing, for example, whether the goal of employment creation is being achieved. In other words, in the absence of proper measurable indicators on the quality and quantity of investments, the number of Kenyans to be employed, the volume of purchases by export firms from the domestic market and the kind technology to be transferred, it would be difficult determining if the programme objectives are being realised.

Similarly, it would be hard to know the extent to which to an additional level of investments can be attributed to tax incentives on investments and not the non-tax factors. As explained, the level of investments is said to have increased only when the country entered the AGOA pact, which upon expiry saw some of the EPZ firms relocate to other countries. In any case, the EPZ Authority currently is unable to take proper stock of the number of Kenyans putting to use the skills acquired from employment in the zones due to lack of effective monitoring and evaluation tools, which makes it almost impossible to tell if the programme is successful.

4.4.2 Problematic Definition of an EPZ

The meaning assigned to EPZs by the Act appears to lay critical emphasis on the element of geographical location of such entities. As observed, it is defined as a designated part of Kenya where any goods introduced are generally regarded as far as import duties and taxes are concerned, as being outside the customs territory but are duly restricted by controlled access and where in the benefits provided under this Act apply.[275] This has restricted the setting up of the zones to certain areas and led to their unevenly spread in the country.

As highlighted above, not only do the zones miss in three of the former provinces but also are not evenly distributed in those areas where they are found. For instance, a region as big as Rift Valley with fourteen counties has only five EPZs.[276] This limits investment opportunities for both the EPZ firms and domestic investors, which undermines the programme's potential to achieve the goal of backward linkage with the domestic market and encourage a balanced development of the country. In essence, the ring fencing approach to defining an EPZ by the Act, which gives pre-eminence to the element of geography in situating the zones, hinders integration of the local industry with the export programme.

4.4.3 Cumbersome Legal Procedures and Policy Inconsistency

As explained, the EPZ Authority is expected to operate as one-stop shop for the licensing of the EPZ firms. However, careful analysis of the licensing process indicates that it is not one-stop venture that can be commenced and concluded by the Authority without having to go through other public institutions such as Registrar of Companies, Lands Office, among others.

Owing to this challenge, foreign investors have had to incur huge costs in terms the expenses incurred during the licensing and registration process of the foreign companies. The huge cost is experienced due to the protracted processes involved, which are not only cumbersome and

[275] Above n86 at section 2.
[276] Rift Valley is made up of Bomet, Kericho, Uasin Gishu, Nandi, Baringo, Laikipia, Kajiado, Narok, Turkana, Elgeyo-Marakwet, Samburu, West Poko, Nakuru and Transzoia.

expensive but also time consuming.[277] Therefore, it is simply not true that the Authority is a "one-stop" centre as outlined in the law.

In addition, the EPZ Act, as observed, has been changing frequently over the years introducing one condition after another for various reasons. Some of these include aligning the export programme with the East Africa's common market goals, licensing commercial activities in the zones subject to the prior consultation with the Commissioner General of KRA and introducing a claim system for previously duty exempt petroleum fuels for EPZ firms for effective tax administration. The other one is the selling of the EPZ products in the local market with the prior approval by the Minister of Trade, among others, to avert breach of the export goals.[278]

Whereas some of these moves may have positive impacts, others have resulted into policy inconsistencies. For instance, to require the Commissioner General of KRA to be consulted when licensing the EPZ commercial activities not only creates a conflict of mandate between EPZ Authority and KRA but also between the line Ministries, such as Ministry of Finance and of Trade and Industrialisation, under which these public bodies fall.

Coupled with the lack of proper coordination among these bodies, this is likely to cause duplicity of roles and diminish the administrative liberty of the EPZ Authority as the agency responsible for the licensing of the zones. As mentioned also, because these changes are done without adequate consultation with the investors, these policy inconsistencies have forced the investors to incur extra administrative cost in order to comply with the changes

[277] Above n93 at 40.
[278] Id at 39.

4.4.4 Inadequate Protection of Labour conditions of EPZ Workers.

Relaxation or derogation of labour standards, as explained earlier, is one of the key regulatory incentives used to allure the EPZ investors.[279] This explains why the prevailing labour conditions in the zones are deteriorated; the employees engagement are often characterised by lack of permanent jobs, persistent lay-offs, low pay and they work for long hours. The foregoing can be best explained by the rise in slum settlements around the zones because majority of the workers cannot afford adequate housing.[280]

These can be blamed on the weak labour regulatory mechanisms that are not adequate to safeguard the conditions of the workers in these areas and stabilise labour relations leading strikes.[281] In other words, the current mechanism does not have appropriate compensation schemes for the workers in case the EPZ companies suddenly close down. Besides, there is lack of efficient and affordable labour dispute resolution channels to enable workers advance their demands for better terms of employment and ventilate their grievances.

4.5 Conclusion

In spite of the significance attached to the EPZ tax incentives as investments promotion tool, however owing to the numerous legal challenges encountered by the programme, the incentives are largely of secondary importance and cannot adequately compensate the EPZ investors of the losses arising from poor investment climate in Kenya. As stated, the majority of investors of Kenya are influenced by cost of production, availability of market, political stability and security and infrastructure development, which they consider primary determinants of investments. Moreover, owing to these problems, not even a single goal of the export programme is being

[279] Above n2 at 2.
[280] Id at 16.
[281] Above n13 at 2.

realised properly, which means benefits deriving from the programme do not match the revenue foregone through the incentives. Accordingly, the preferential taxation of these export businesses are not warranted; instead, the scheme should be reviewed and the tax revenue spent on more important projects in order to eradicate poverty, promote sustainable development and above all guarantee Kenyans of their right to a just tax system. Kenya could consider borrowing some lessons from Mauritius in this respect.

CHAPTER FIVE

IMPACTS OF THE LEGAL CHALLENGESOF EPZ TAX INCENTIVES ON EQUITABLE DISTRIBUTION OF TAX BURDENS IN KENYA

5.1 Introduction

As observed at the beginning of this thesis, tax incentives on investments are allowed on the basis that preferential taxation of the certain individuals such as capital investors is more beneficial to a nation's economy than if such investors were taxed on same footing as the rest of other taxpayers.[282] For this reason, if properly utilised, the incentives can increase a country's potential for social economic growth through the creation of employment opportunities, stimulating productive investments, technology transfer and build-up of human capital, enhanced growth of domestic industries et cetera.

On the other hand, if poorly targeted, tax incentives can have wide-ranging negative effects on a country's prospects for economic growth. In terms of the distribution of tax burdens, they may render the fairness of a tax system questionable and deprive the incentive regime of the necessary public support.[283] Public support is central to taxation as a means of funding government budget because imposition of tax burdens is a politically driven process and as such, citizens' right to fair treatment by tax systems must be considered in this regard.[284]

As stated, the incorporation of the EPZ tax incentives as investments promotion tools in Kenya, like in any other country, is based on the fiscal theory of compensatory expenditure. The theory champions for the balancing of the individual loses and benefits attendant on allocation of tax

[282] Above n4 at 31.
[283] Above n4 at 31; above n28 at 4.
[284] Above n5 at 191.

burdens against the aggregated advantages accruing to sectors of the economic.[285] Thus, some shifting of tax burdens, based on the ability to pay, may be necessary provided no Kenyan is favoured to the detriment of another without justification.[286] All that matters is for a proper balance to be maintained between the injury to the individual Kenyan taxed discriminatorily and the benefit to the public investment goals.

However, the country's experience indicates that the EPZ tax incentives are faced with numerous legal challenges, which water down their effectiveness as investment promotion tools and impact negatively on equitable taxation in Kenya. The foregoing reality continues to exist despite the Constitution of Kenya, 2010 requiring the burden of taxation to be borne fairly and the tax system used to promote sustainable development, equality, social justice, among other values.[287] Therefore, the purpose of this chapter is to analyse the impacts of these legal challenges on equitable sharing of tax burdens in Kenya.

5.2 Impacts of the Legal Challenges

5.2.1 Loss of Revenue

Tax incentives constitute revenue losses and are indirect expenditure on the state. They go against the primary goal of the revenue law, which is to generate income for the government.[288] In establishing their relevance, therefore, the standard test is to compare the opportunity cost incurred in their provision vis a vis the benefit accruing generally to the economy.[289]

The foregoing explains why some shifting of tax burdens have been considered necessary as long as the injury to the individual taxed discriminatorily is sufficiently counterbalanced by the

[285] Above n5 at 191.
[286] Above n132 at 1205-06.
[287] Above n19 at Articles 10(2) (b) and (d), 27 and 201 (b) (i).
[288] Above n4 at 31.
[289] Above n28 at 5.

benefits deriving from public investment goals. Hence, the loss of government income becomes a disadvantage only if the returns fail to compensate the revenue foregone optimally.

The revenue losses arising from the EPZ tax incentives in Kenya, as already highlighted, is approximated to be 12 billion shillings, or even more, annually.[290] A study by KRA shows that the country lost almost 220 billion in revenue through these investment benefits within a six-year period between 2000/04 and 2008/09, representing 1.7 percent of GDP foregone annually during that time.[291] This is disadvantageous in the sense that the incentives are majorly of secondary importance to investors and the programme's objectives remains poor realised, which means the revenue foregone is not justified and the incentives are simply ineffective.

Secondly, they expose the country's tax system and the export programme to the dangers of tax avoidance, which leads to loss of revenue, among other challenges. Tax avoidance is defined as the legitimate means of reducing one's tax burdens.[292] This is achieved by arranging one's financial circumstances in a manner that enable the exploitation a tax advantage contrary to the intention of the legislature.[293]

Despite the colour of legality, however, many countries have enacted anti-tax avoidance laws to prevent taxpayers from reducing their tax burdens since such behaviours constrain public revenue, promotes unfair business competition and leads to the unfair tax burdening of the other law-abiding taxpayers.[294] In a nutshell, tax avoidance is considered evil because it goes against the primary aim of revenue laws, which is to ensure that everyone contributes to the support of government by paying taxes.

[290] Above n18 at 5.
[291] Above n73 at 5.
[292] Above n1 at 1599; above n3 at 70.
[293] Above n4 at 1.
[294] Id at 6.

Tax avoidance manifests in Kenya's EPZs in various forms such as round tripping, transfer pricing, false declaration of export sales and division of business between two related legal entities, among others, to exploit the investment benefits offered under the programmes' incentive regime.[295] Round tripping is a business strategy in which an enterprise sells its assets to another with an agreement that the asset will be bought back at a future time in order to increase the amount of sale within the specified period.[296]

In an export programme, round tripping happens when there is channelling by direct investors of local funds to economic zones abroad and the subsequent return of the funds to the local economy in the form of direct investment.[297] It is discouraged since it leads to the loss of revenue for governments and encourages tax avoidance.[298] In Kenya, fraudulent investors: local and foreign alike, aware of the existing double tax treaty agreements between Kenya and other countries with equally extravagant incentive regimes, for example Mauritius, incorporate companies in both jurisdiction in order to exploit those countries' investment benefits leading to loss of public revenue.[299]

On the other hand, transfer pricing is the act of establishing the price of a cross border transaction between two companies that are part of the same multinational group.[300] Although the practice is not necessary illegal or abusive but its manipulation by investors is owing to the risk of concealing profits to reduce tax rates on taxable income. This may have negative impacts

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[295] Above n2 at 22.

[296] See the definition of round tripping available at http://thelawdictionary.org/round-tripping/ accessed on 12 September 2015.

[297] Direct Investment Technical Expert Group, *IMF Committee on Balance of Payments Statistics and OECD Workshop on International Investment Statistics: Round Tripping*, Issue Paper No. 13 (Hong Kong: Census and Statistics Department, 2004) at 2.

[298] Ibid.

[299] Tax Justice Network Africa moved to the High Court to stop a double-taxation treaty between Kenya and Mauritius fearing that Kenyans will dodge taxes through round tripping like it happened with India, which has lost $600 million arising from its bilateral taxation agreement with Mauritius.

[300] See the definition of transfer pricing available at http://www.taxjustice.net/topics/corporate-tax/transfer-pricing/ accessed on 12 September 2015.

on the legitimate tax revenues of countries where economic activity of the multinational company takes place and as such impede economic development of such countries.[301] In this regard, Kenya is approximated to have lost close to 156 billion shillings between 2000 and 2008 through transfer pricing alone.[302]

Closely linked with transfer pricing is the offence of false export declaration in which investors make false report to KRA on their volume of sales abroad in order to reduce taxes due to the Authority. The Goldenberg scandal best illustrates this form of tax avoidance scheme. As explained, it involved the making of false export declarations in order to extract hundreds of millions of dollars in export subsidies.[303] Consequently, tax avoidance complicates the country's ability to establish the actual benefits of the export programme since a lot of revenue is lost through such schemes.

5.2.2 Promote Dangerous Tax Competition in East Africa

The competition among governments to attract and retain investments has pressurised them into lowering their fiscal burdens by engaging in widespread preferential taxation such as reduced tax rates, tax exemptions and deductions in order to get investors' attention.[304] Proponents of tax competition, for instance, Milton Friedman, compares its benefits to those of a market environment where competition among individual traders is said to lead to provision of better services, quality goods and fair prices for the consumers. With regard to governments, tax competition compels them to offer favourable fiscal conditions to attract investors and increase

[301] United Nations, *Practical Manual on Transfer Pricing for Developing Countries*, ST/ESA/347 (New York: Department of Economic and Social Affairs, 2013) at iv.
[302] Above n2 at 14.
[303] Above n28 at 8.
[304] Above n17 at 3.

public sector productivity and growth with eventual outcome of enhanced capacity of the states to fulfil their public mandates.[305]

The opponents of tax competition, on the other hand, argue that, unlike the market set up that permits the individual businessperson the discretion to decide the allocation of resources and production factors, the bearing of tax burdens is a political process, shaped by political realities. Accordingly, the citizens' right to fair treatment by government must be taken into consideration in any decision relating to tax benefit relationship and the economy.[306] Moreover, it is fundamentally important that such decisions that be carried out by the responsible arm of government.[307]

They add that aggressive competition among countries have turned such societies into tax havens with downward spiral effects of tax reductions and exemptions depriving such governments of revenue and leading to race to the bottom.[308] East African countries are engaged in this dangerous race and are offering incentives to woo investors without finding out whether such fiscal inducements are relevant or needed to stimulate investments.[309]

The findings of a study done in 2012 shows that tax incentives take up a significant portion of these countries' GDP: Rwanda spends 4.7 percent, Tanzania 3.9, Kenya 1.7 while Uganda spends 0.4 percent.[310] This translates into massive revenue losses, which in reality seriously limits these governments' capacity to fulfil their public mandates.

[305] Above n17 at 2.
[306] Above n5 at 191.
[307] Above n139 at 3.
[308] Above n17 at 2.
[309] Above n2 at 1; above n17 at 1.
[310] Above n73 at 5.

5.2.3 Undermines Kenya's Commitments under WTO

The use of subsidies whether fiscal or non-fiscal, as explained, is generally prohibited by the WTO rules. Being a developing country, however, Kenya qualified for special treatment and as such, was exempted from this ban for a period of eight years starting from 2007 when it signed the Subsidy Countervailing Measures agreement undertaking to rationalise its incentive regime and stop attracting investments through incentives by end of the period. Subsidies are generally frowned upon because of their negative effects on the social economic and political wellbeing of a country.

In this regard, they have led to loss of government revenue, promoted dangerous tax competition between it and the neighbouring countries, and encouraged unhealthy business competition between the EPZ firms that are exempted from taxes and local businesses that do not get such benefits. The incentives have also discouraged the government from improving the country's investment conditions by developing the infrastructure, reducing the cost of production, boosting security and political stability and so on, which, as demonstrated, constitute the optimal policy options for investments.

5.2.4 Complicates Administration of Tax Laws

The fairness of a tax system, as observed, is largely a matter of public perception. Perception is key for several reasons. Aside from boosting public confidence in justness of a tax regime, it also reduces the cost of administering taxes since citizens are likely to cooperate with the revenue collector only if they perceive the system to be just.[311] This justifies the need for simplicity of the tax rules not only for certainty but also, and more importantly, for understanding by citizens

[311] Above n162 at 35; above n148 at 63.

since the level of information they either have or do not have is what influence their perception of tax fairness.[312]

The introduction of tax incentive provisions increases the bulk of the revenue code making it complex, seemingly unfair and driving up the cost of administering a tax system.[313] However, the condition of simplicity of a revenue law, as stated, poses serious challenges to tax planners. On one hand, the simpler the rules the less fair they are because they fail to take into account the details of justified differences and on the other, the fairer they are, the more complex thus making it difficult for the public to understand.[314] The situation is made worse if the incentive regime is governed by multiple legislations; with some fiscal benefits provided within and others without the revenue laws, and are administered by several institutions exercising administrative discretion and are uncoordinated in their operations.[315]

The forgoing is the scenario currently prevailing in Kenya. As explained, the incentives are spread across various non-tax and tax statutes, and are administered by KRA and other non-revenue collection agencies such as the EPZ Authority, Investment Promotion Authority et cetera.[316] The Ministries of Finance and of Industry, Trade and Cooperatives are also part of the institutional matrix being that they provide policy directions and strategic guidance on various social political and economic issues in the country. This arrangement has not only complicated coordination among these institutions but also led to lack of transparency in the administration of the incentives.

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[312] Above n33 at 1.
[313] Above n148 at 63.
[314] Above n27 at 3.
[315] Above n91 at 2.
[316] KRA is responsible for Income Tax Act, Chapter 470, VAT Act No. 13 of 1995 and the East African Community and Customs Management Act, 2004 while EPZ Authority is in charged of EPZ Act, Chapter 517.

5.2.5 Inadequate Fulfilment of EPZ Objectives

As explained, Kenya's experience indicates that it loses so much revenue through tax incentives on investments in spite of the benefits deriving from the EPZs not matching the revenue foregone.[317] That is, none of the goals, be it employment creation, technology transfer, backward linkage with the domestic et cetera, is being properly realised calling into question the usefulness of the EPZ tax incentives in enhancing the capacity of export programme to deliver on its goals.

Consequently, the programme fails to contribute effectively to the country's economic development and renders tax incentives on investments unjustified as it amounts to an injustice to exclude some individuals from the payment of taxes there being no concrete benefits to show for the revenue foregone.[318] Accordingly, Kenya's revenue capacity remains fundamentally restricted with the consequences that the citizens have to bear the extra tax burden in order to remedy the revenue deficiency arising from these tax exemptions.

5.3 Conclusion

As explained, the EPZ tax incentives are considered fair only if the revenue foregone is adequately compensated by benefits accrued. This is because justice demands everyone to contribute towards the support of the government and pay taxes in proportion to both their respective abilities and the revenue they respectively derive under the protection of the state. Accordingly, those with higher incomes ought to pay more taxes than those with relatively lower earnings in the society, not the reverse. The Constitution of Kenya, 2010, in this regard, obligates the government to ensure that the burden of taxation is borne fairly and equally by everyone, and pursue sustainable development, social justice, the rule of law and respect for the fundamental human rights, freedoms and liberties.

[317] Above n17 at 5.
[318] Above n28 at 4.

Therefore, to be justified, the impacts of tax incentives ought to be positive and their advantages felt in the economy. They must not only be effective as investment promotion tools but also as enhancers of capacity of the government programmes to tackle the social economic challenges such as unemployment, poor investment climate, weak domestic market and low levels of technology and so on currently facing the country. In Kenya, the disadvantages of tax incentives outweigh their merits owing to the legal challenges discussed above. As such, the exemption of the EPZ businesses from tax liability is unwarranted and the 12 billion shillings incurred annually in these fiscal inducements is without basis.

CHAPTER SIX

CONCLUSIONS AND RECOMMENDATIONS

6.1 Conclusions

The objective of this thesis was to assess the relevance of the EPZ tax incentives in enhancing fair sharing of tax burdens in Kenya. As such, Chapter Two discussed the conceptual framework and defined the key concepts, for example tax incentives on investments and EPZ. Chapter Three analysed the concept of equitable sharing of tax burdens and examined the equity concerns surrounding the use of tax incentives to stimulate investments in the country's export zones. Chapter Four proceeded to examine not only the legal challenges facing the administration of the EPZ tax incentives but also those affecting the realisation of the export programme goals. Chapter Five analysed the impacts of these legal challenges on equitable sharing of tax burdens in Kenya. This concluding chapter reiterates the major findings of this thesis and makes recommendations on how the incentives can be better utilised to promote the equitable taxation in Kenya.

As to whether the EPZ tax incentives could help foster equitable taxation in Kenya, the thesis has shown that they are faced with several legal challenges making their role merely secondary and as such, do not form part of the optimal policy options, for example, cost of production, availability of market, political stability, which are considered important by most investors. Thus, the incentives fail to indemnify the investors of the losses arising from the unfavourable business climate and fall short of enhancing the programme's capacity to create jobs, bring technology transfers, attract high levels of investments et cetera to help compensate the revenue foregone as a result. This is attributable to the legal failure to appreciate their relevance enablers of fair sharing of tax burdens in Kenya.

6.2 Recommendations

This thesis makes two-prong recommendations to help deal with the legal problems identified above. The first set focuses on the administration of EPZ tax incentives while the second one addresses the legal challenges facing the objectives of the export programme.

6.2.1 EPZ Tax Incentives

The recommendations under this include proper targeting of the incentives, requiring their administration to be done by KRA, strengthening of the anti-tax avoidance measure and a review of the incentive regime to comply with the WTO rules.

6.2.1.1 Proper Targeting of Tax Incentives

As stated, these investment privileges are currently granted without tangible evidence linking them to any additional level of investments in Kenya's EPZs. This makes it hard obtaining data on the extent to which they stimulate investments without the influence of other factors such as cost of production, market availability, among others. Furthermore, it is unclear on what happens on expiry of the tax holidays. Therefore, to deal with this legal challenge, it would be advisable to focus the incentives properly. This would require the government to be selective in granting them and specify the condition under which an investor may benefit from such privileges.

As such, a clear procedure ought to be established to guide how the grant is to be done. It could include basing the incentives on time limits, specific criteria such as minimum levels of employment, volume of purchases from the domestic market by the export firms, investment levels and so on, and should be accompanied by well-maintained data on their impacts as investments catalysts. This would enable the government to avoid granting the EPZ incentives unnecessarily but instead do so for the right reasons.

6.2.1.2 Administration of Tax Incentives by KRA

According to the English case of *R v Sussex Justices*, *Ex parte McCarthy*, not only must justice be done; it must also be seen to be done.[319] Although the case has gained popular use within judicial corridors, where it informs the doctrine of impartiality and recusal of presiding officers, it may also be applied to other government activities for it essentially underscores the importance of openness of state operations.[320] In terms of taxation, openness or transparency is crucial for public scrutiny. The ability to scrutinise boosts citizens' confidence in the tax system and minimises feelings of unfair tax burdening among taxpayers. This brings with it the additional benefit of reduced cost of administering taxes.[321]

Transparency in the administration of tax incentives is central both principally and practically. The Constitution of Kenya, 2010, acknowledges this reality and obligates public institutions and government officials to maintain optimum degree of openness in their operations and exercise their mandates responsibly. Article 210 (2) of the supreme law, in this respect, stipulates that where legislation waivers any tax or licensing fee, a public record of such waivers plus the reasons for doing so ought to be maintained and reported to the Auditor General.

Hence, it would important that the Auditor General undertake a public audit of the country's incentive regime to ascertain the tax expenditure incurred in the provision of these investment benefits and make its findings public to enable scrutiny by the citizens. Whereas transparency is important in the administration of these investment benefits generally, it is not easy to achieve currently. This is because, as shown, they are spread across the various non-tax and tax statutes,

[319] *R v Sussex Justices*, *Ex parte McCarthy* ([1924] 1 KB 256, [1923] All ER Rep 233)
[320] Transparency is one of the fundamental values recognised in Article 10 of the Constitution of Kenya, 2010.
[321] Above n2 at 7; above n148 at 63.

and are declared and administered by a number of revenue and non-revenue institutions, which enjoys administrative discretion.

Due to the lack of adequate coordination among these bodies, this discretion has been exercised abusively and in some instances used perpetrate corruption like was in the Goldenberg's case, which involve false export declaration by the architects of the scandal. As such, to solve this problem, it is recommended that the declaration of tax incentives should be made the sole responsibility of the Ministry of Finance and administered by KRA being the revenue collection agency.

To be effective, the incentives should be provided in tax statutes as opposed to investment legislations, as is currently the case. This would not only be in line with the provisions of section 4B 11th Schedule of the Income Tax Act, which requires the EPZ firms to file their annual returns of income and business accounts to the Commissioner but also recognises KRA as the body with the principle mandate to administer taxes. This should be accompanied by the requirement that the information on the cost incurred in provision of these investment concessions is made public and readily accessible by everyone to ease the burden of tax administration, improve the accountability of the tax system, guarantee citizens' right to information and boost public confidence.

6.2.1.3 Strengthen Anti-Tax Avoidance Measures

The point of departure in this regard appreciates the conceptual difficulties often associated with the fight against tax avoidance. The challenge usually is that the application of the anti-avoidance rules involves a conflict of principles between the constitutional freedom to plan one's commercial affairs in accordance to one's wish on one hand and the constitutional principle of equality of taxation on the other.[322] This makes it difficult for the authorities to distinguish a legitimate from illegitimate transaction when determining the application of anti-avoidance rules to a transaction.[323]

As such, a country's decision to opt for a specific anti-avoidance measure, the general approach or a blend of the two is determined normally by the perceived merits or demerit of each of the approach in terms of reconciling these difficulties in the fight against tax avoidance. As explained, Kenya preferred specific anti-avoidance measure to the general anti-avoidance approach because of the former's advantage of legal certainty[324], unlike the latter, which is criticised for being indeterminate and open-ended in character.[325]

However, as stated, the specific anti-avoidance approach is fraught with challenges and hence it has been not able to effectively deal with tax avoidance incidences prevalent in the EPZs. Therefore, to overcome the foregoing problems, Kenya should reform its tax system and adopt the approach which emphasizes the significance of taxation while at the same time reconciles the principles of fair taxation and the liberty to plan one's transactions as one pleases while fostering certainty of the tax law.

Towards this end, it ought to be noted that despite the general anti-avoidance approach being open-ended in nature, it nonetheless has one major benefit, which if combined with that of the specific anti-avoidance would enhance Kenya's fight against tax avoidance. This has to do with the fact that the former is principle-based and it encourages purposive construction of the law.

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[322] Henry Ordowe, The Culture of Tax Avoidance, (2010),*Saint Louis University School of Law*, Vol. 55, Issue 47 at 48.
[323] Above n238 at 2.
[324] Rebecca Prebble and John Prebble, Does The Use Of General Anti-Avoidance Rules To Combat Tax Avoidance Breach Principles Of The Rule Of Law? A Comparative Study, (2010), *Saint Louis University Law Journal*, Vol 55, Issue 21 at 28.
[325] Above n238 at 8.

Consequently, a combination of the advantages of specific and general anti-avoidance measures would offer sound solution in this respect. That is, backing up the specific anti-avoidance rules with principle-based general approach would encourage principle-based construction of the revenue statutes with the benefit of enhancing the liberty of Kenyan courts to deal with situations not covered by the law without the legislature having to enact rules to offer guidance. This would also minimize the complexity and rigidity of the revenue statutes, and enhance tax administration.[326]

6.2.1.4 Review of EPZ Tax Incentives to Comply with WTO Rules

As explained, subsidies such as tax incentives are generally prohibited by the WTO rules because of their negative effects on a country's economy. In Kenya, they have led to the loss of government revenue, encouraged unhealthy business competition between the EPZ firms and local businesses and so on. In order to tackle this legal problem therefore, this thesis recommends the review of the export incentive regime to conform to the WTO rules. In doing so, Kenya would do well to place itself in the same league as progressive economies that are committed to establishing conducive environment for doing business and using their tax systems to foster revenue adequacy, boost public and guarantee the fair sharing of the tax burdens.

6.2.2 EPZ Programme

With regard to the EPZ programme, the following recommendations would be useful in enhancing the programme's capacity to provide employment opportunities, bring technology transfers, establish backward linkage between exporters and the local industry, and tackle the various social economic challenges facing Kenya, among other benefits.

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[326] John Braithwaite, Making Tax Law More Certain: A Theory, (2003), *Australian Business Law Review*, Vol 31at 75.

6.2.2.1 Establish Indicators of Success

As pointed out, without a clear mind on how the objectives of the export programme are to be realised, it would be hard to determine whether they are being realised. In addition, it would not be easy knowing the extent of effectiveness of the EPZ to tax incentives in attracting investments. Hence, to overcome this challenge, it would be advisable for the government to establish measurable indicators and specify the expected returns to help it quantify and qualify the benefits accruing from fulfilment of the export programme objectives. As such, the criteria could take into account the following, namely, the expected number of Kenyans that ought to be employed by EPZ businesses together with the wage scale, the required labour conditions; volume of investments and evidence of human capital build-up and knowledge transmission to assist ascertained the real benefits of the goal of technology transfer.

In addition, the government could consider coming up with a minimum percentage volume of supplies to the export sector by the domestic industry, the attainment of which could be used to qualify the backward linkage objective as successful or failing. This should be accompanied by long-term commitment between government and investors. In this regard, provisions relating to labour rights and conservation of environment should be included in the investment agreements to give the GOK the right to hold the defaulting companies to account for violations committed and pay for compensations where necessary.

To this end, this thesis emphasizes that attracting investments into Kenya should not be a reason for undermining the realisation of fundamental human rights of the workers, which the government is constitutionally obligated to enforce.[327] As such, setting up of regulatory mechanisms to protect the rights of workers in the EPZs is critical not only for stabilising labour

[327]Above n19 Article 41; Employment Act, 2007, s 26-34; Convention of the International Labour Office of 1952.

relations but also goes a long way to enhance the objective of employment creation in the country.

6.2.2.2 Investments Diversification and Integration of the Local Industry

As stated, one of the legal challenges accounting for the inadequate realisation of the objective of backward linkage between exporters and domestic market is the restrictive definition assigned to an EPZ by the Act. This confines the setting up of zones in certain areas, and not others, with the overall consequence of poor integration of the local industry with the export programme. Therefore, to tackle this challenge, this thesis recommends the adoption of an EPZ concept that does not just focus on the element of geographical location of the zones but also gives prominence to a more competitive business environment through provision of special benefits including in particular tariff exemptions to inputs through a specification process.[328]

Kenya is already intensifying its efforts to diversify investment opportunities under the special economic zone programme (SEZ). Unlike, the EPZ, which was designed to mainly attract garment firms and confined them to only certain areas, the SEZ has been set up in such a manner that the investing companies will be spread widely throughout the country and invest in different locations in economic activities. With the diversification of investment opportunities, the local market will be able to supply various types of inputs such as labour skills, commodities and raw materials. This will enable the integration of the local industry with the export programme. The other benefit under this programme is that the SEZ Authority will function as a truly one-stop centre, which would make the licensing process less protracted and reduce the legal costs incurred by investors in this regard.

[328] Above n23 at 11.

6.2.2.3 Background Check of Investors

Doing a background check of the investors would be help Kenya avoid a scenario where tax haven shoppers, for example, Tristar company, which exploited the tax holiday in the country only to close shop and relocate to Uganda upon expiry of such investment benefit, come in with the sole intention of abusing the investments privileges before shutting down. To realise this, it would be prudent for the GOK to undertake a number of activities, first is to establish information sharing networks with other governments to get insight into the records of accomplishment of the companies investing in other countries to avoid those, which exploit workers and abuse the incentive regimes of the host nations. Secondly, as stated, it could also be wise to secure labour rights, environment conservation obligations and other undertakings in the investment pacts to give the government grounds to demand for compensation in the event of any violations by investors.

In conclusion, even though the EPZ tax incentives may not be well placed to answer to the equity concerns surrounding their use as investment stimulus due to the legal challenges outlined above, not all is lost with the export led growth programme. The recommendations, if taken up by GOK will enhance the programme's capacity to accomplish the overall goal of turning the country into an export based economy with the benefits of creating jobs, transferring technology, establishing backward linkages between the domestic market and exporters, and the incentives used to promote equitable sharing of tax burdens in Kenya.

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