KENYA NATIONAL TAX POLICY

Perspective from SMEs & Start-ups

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Kenya National Tax Policy

MSME and Start-up Taxation in Kenya

Submitted By:

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Contributors

www.viffaconsult.co.ke	Viffa Consult is a management consultancy with the primary focus of developing SMEs and Start-ups in Africa. The company's theory of change is premised on the idea that Africans can transform their socio-economic status through meaningful and profitable trade and business engagement.
www.assek.ke	The Association of Start-up and SMEs Enablers of Kenya (ASSEK) brings together organizations supporting the development and growth of start-ups and SMEs for maximum impact of such activities. ASSEK promotes networking among its members that are spread-out across the country, and is the driving force for Kenya's entrepreneurial success.
www.countrywidehubs.org	Countywide Innovation Hubs is an association of hubs located outside Nairobi. Their main objective is to promote activities and programs of the member hubs and support their vision of testing and building sustainable businesses in rural and second tier towns of Kenya.
www.kayana.org	Kayana is a community of female entrepreneurs of abundance that come together to move their businesses from ideation to start up. Typically, the businesses will be run from their homes or online, and the founders are looking at the next step of growth, but may not have the know-how or courage to do so.
www.smefoundersassociation.com	SME Founders Association a nationwide partnership of higher education, economic development organizations, chambers and other stakeholders dedicated to promoting a more enabling and sustainable business environment for Small and Growing Business Owners. The Association links Kenya's education system with communities to aid in the development of enterprises and the people around them.

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Abstract

MSMEs are by far the highest number of businesses in any developing economy. It therefore makes sense for a government to pursue higher inclusion of MSMEs as a means of increasing tax yields. In the same breath, the emergence of vibrant start-up ecosystems across markets provides governments with new, high potential, sources of revenue. MSME and Start-up business owners, however, often push back against taxation policies on account that compliance comes at a high cost in comparison to their incomes. This is especially the case for those involved in consumer goods value chains, who have to contend with slim margins and relatively low volumes in comparison with large corporations. It is incumbent upon tax policy makers to shift from a law enforcement approach in driving tax compliance to a more service-oriented tax administration regime. As the government moves to expand the tax net to cover more MSMEs and Start-ups, business owners will be seeking value for money. The proposed National Tax Policy must therefore prominently speak to the benefits of compliance, articulating the benefits accrued by entrepreneurs who opt for formalization and compliance. The resulting taxation procedures will need to be simple enough to make compliance easy to achieve, yet difficult not to.

Abbreviations

AGPO	Access to Government Procurement Opportunities
BPS	Budget Policy Statement
DST	Digital Services Tax
ESO	Entrepreneur Support Organization
GDP	Gross Domestic Product
KAM	Kenya Association of Manufacturers
KEPSA	Kenya Private Sector Alliance
KNBS	Kenya National Bureau of Statistics
KRA	Kenya Revenue Authority
MOITED	Ministry of Industry, Trade and Enterprise Development
MSE	Micro and Small Enterprises
MSEA	Micro and Small Enterprises Authority
MSME	Micro, Small and Medium Enterprises
SME	Small and Medium Enterprises
SRT	Single Replacement Tax
TCC	Tax Compliance Certificate
ToT	Turnover Tax
VAT	Value-Added Tax

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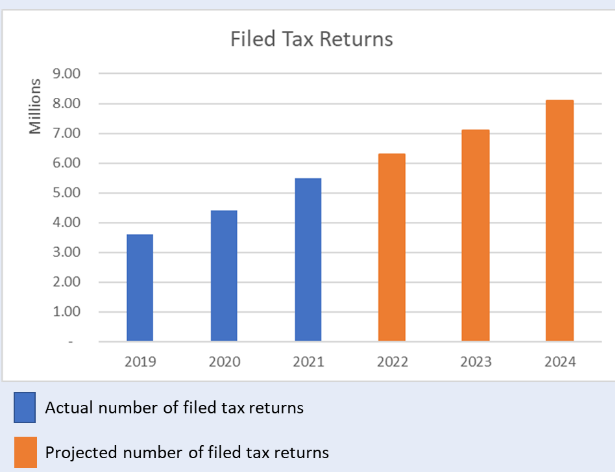
Executive Summary

The draft National Tax Policy (2022) is the first ever tax-focused policy document by the Government of Kenya. Hitherto, tax proposals were contained in annual Budget Policy Statements (BPSs). Having a standalone policy, that is reviewed at least once every five years, is a positive step towards providing enabling business environments for entrepreneurs. Unlike the BPS, the National Tax Policy provides business players clear engagement opportunities for alignment of government plans to market realities.

Multi-sectoral engagements on taxation matters are not new in the country. Industry lobby groups such as the Kenya Private Sector Alliance (KEPSA) and the Kenya Association of Manufacturers (KAM) have long engaged with the highest ranks of all three arms of government on matters affecting their members, including taxation. However, Micro, Small and Medium Enterprises (MSMEs) and Start-up businesses have not been well represented at such forums, yet they are recognized as key actors in Kenya Vision 2030 (the country's economic development blueprint). The limited representation of MSMEs and Start-ups is evident in the framing of the National Tax Policy proposals. The Policy falls short of providing actionable information for MSME and Start-up business owners. By offering minimal insight into taxation strategies, this document risks creating an uncertain business environment for these businesses.

The National Tax Policy reveals that the Government of Kenya's intent to increase tax revenue yield from the MSMEs and Start-ups through expansion to agriculture and informal sectors, and strengthening tax collection measures in emerging sectors – particularly online businesses, and digital marketplaces. These are collectively classified as "hard-to-tax" sectors in the Policy.



A parallel review of KRA's Strategic Plan shows an objective to increase number of taxpayers from the current 6.1 million to at least 8.1 million by 2024. This is a modest projection in view of historical filing of tax returns by Kenyan taxpayers.

KRA's plan focuses on enforcement of compliance as the means of netting the additional 2 million taxpayers. A more aggressive growth rate can be achieved through leveraging existing MSME and Start-up business touchpoints and simplifying compliance over the next three years. It is noteworthy that there are at least 10M MSMEs/Start-ups, and 17M employed persons.

MSME and Start-up entrepreneurs find the cost of compliance to be high. Not only is it hard for them to estimate full costs (incorporating licenses, levies and tax obligations), but they see little value in having them anyway—they don't understand their purpose and perceive any benefit as too small compared with other factors like capital expenditure or revenue. This paper thus proposes an incentive-driven approach to compliance, as well as enhanced participation of MSMEs and Start-ups.

It being the first National Tax Policy, focus should be on obtaining data that can be used to formulate future taxation strategies. Collaboration with county government licensing offices and Entrepreneur Support Organizations (ESOs) can fast-track access to data. County governments license all businesses, while ESOs have intimate knowledge on MSME and Start-up business operations and performance. Data from the two sources can inform what constitutes a reliable tax base, tax revenue potentials and support needs that can be aligned with compliance.

Policy Objectives

The government's intention to develop the MSMEs and Start-ups is well documented. A critical policy, such as the National Tax Policy, must speak to:

1) Moving an enterprise toward a more formalized structure
2) Increasing involvement of small businesses in a strategic government project or activity
3) Making sure small businesses play their part in achieving national development objectives
4) Encouraging enterprises to adopt new technologies or practices that can help them grow faster
5) Ensuring that there is a clear link between business growth opportunities and government policies.

Kenya's Taxation Framework

MSMEs and Start-ups should be afforded more opportunities to participate in the taxation framework – particularly in the budgeting process. The current phase of the Tax Policy should exploit all opportunities available to demystify taxation to the market as well as collect feedback and other useful information for future phases. This role can be entrusted to recognized industry associations and ESOs.

Budgeting Process

MSME and Start-up Businesses Participation Framework

1. Formulation	2. Approval	3. Implementation	4. Audit and Evaluation
Input from MSMEs and Start-ups	**Representation in legislature**	**Compliance support and service delivery**	**Focused reporting on performance**
MSE Authority MSE Associations MSME & Start-up ESOs	Ensure alignment to MSE policies, MSE Act and Start-up Act	MSE Authority MSE Associations MSME & Start-up ESOs	MSE Authority MSE Associations MSME & Start-up ESOs

Taxation Approach Proposals

Three themes are explored in our proposal:

1) Ease of doing business: streamlining compliance with licensing requirements; compliance with standards and quality controls; and filing of regulatory reports and payment of taxes.
2) Attractiveness of public procurement opportunities: Simplifying the journey to participation in public procurement.
3) Access to market and business support: Enabling access to adequate, affordable and timely credit; marketing resources and access to local as well as global markets; integration to large-

Proposal	Benefits
Application of Single Replacement Tax at business licensing level. Social security payments (NSSF and NHIF) can be incorporated into the SRT.	1) MSEs will know the real cost of doing business to entrepreneurs and therefore stimulate productivity. 2) Tax policy formulators can leverage gathered information for future taxation measures. 3) Sustainable increase in NSSF and NHIF collections 4) Improvement in entrepreneurs' quality of life through delivery of basic medical and social protection covers upon payment for trade licenses. 5) Simplicity of SRT scheme motivates voluntary compliance and reduces tax administration costs.
Link registration to public procurement opportunities and tax compliance	1) Businesses can be furnished with TCCs upon payment for trade licenses under SRT. TCCs will open new business opportunities to MSMEs and Start-ups thus enhance productivity. 2) Simplify identification of businesses that pre-qualify for inclusion in public procurement programmes through sharing data across multiple government agencies. 3) Well defined path to public procurement opportunities will make AGPO more inclusive.
MSEs participating in public procurement may be subject to turnover tax. The Policy could allow for such tax to be withheld by the procuring public entity.	1) Withholding turnover tax based on contract values will present opportunities for higher compliance while affording the businesses the latitude to plan their finances – now that the tax element would be been dispensed with. 2) Preferential taxation could be applied to locally produced goods and services.
Encourage digitization through tax breaks for fintech firms that implement digital tools for shops or treating acquisition of tech as a deductible cost.	1) Drive digitization of businesses for improved productivity. 2) Development of a digital database that the government can use to craft targeted support for MSEs. 3) Digitization of daily operations records will ease the burden of filing tax returns. The prevailing practice is that businesses use separate tools to conduct business transactions and file statutory reports.
Relief for online businesses to cushion them against the onslaught of global online marketplaces that do not remit any taxes to Kenya.	1) Improve Kenya's competitiveness in global markets. 2) Increase the eligibility of MSEs and start-ups for integration to large-scale business relationships and backward linkages with global value chains.

The first National Tax Policy should speak to the benefits of compliance, articulating the benefits accrued by entrepreneurs who opt for formalization and compliance. This implies a paradigm shift from penalty-driven compliance enforcement to a focus on the delivery of benefits to compliant taxpayers. Although penalties are a part of tax administration, various reports show that they have little impact on driving compliance within the MSE Sector.

1. Introduction

Micro and small enterprises are crucial to Kenya's development. They provide jobs, keep money circulating in rural areas, and reduce poverty. MSEs employ at least 15 million people and account for 29% of gross domestic product. These businesses primarily provide last-mile delivery of goods and services to consumers across value chains, including retail/wholesale trade, manufacturing and catering.

Given their potential to contribute to the economy, the Government of Kenya has taken specific steps to mainstream MSEs and facilitate more active participation in the formal economy:

1) The Kenya Vision 2030 (the country's economic development blueprint), advocates for mainstreaming of MSEs in six sectors - namely, Tourism, Agriculture and Livestock, Wholesale and Retail Trade, Manufacturing, Financial Services, Business Process Offshoring, and IT-Enabled Services.
2) The Access to Government Procurement Opportunities (AGPO) programme set aside 30% of all Government procurement for youth, women and persons with disabilities.
3) There are several loan programmes delivered through public funds to deliver credit to MSEs. The programmes include the Youth Enterprise Development Fund, Small and Medium Enterprise (SME) Fund, Uwezo Fund and Women Enterprise Fund.
4) The Micro and Small Enterprises Authority (MSEA) was established as a state corporation under the jurisdiction of the Ministry of Industrialization, Trade, and Enterprise Development (MOITED) to implement MSE Sector government policies.
5) There is established an MSE support and development framework. The framework is anchored in:
   a. The Micro and Small Enterprises Act (2012), which defines MSEs and statutory bodies responsible for their development; and
   b. The Kenya Micro and Small Enterprises Policy (2020), which outlines the national support structure and interventions for MSEs.

With the recent release of the draft National Taxation Policy, the government is now looking at increasing yield from the MSE Sector:

1) The draft Policy speaks to the need to expand taxation to agriculture and informal sectors. These are collectively classified as "hard-to-tax" sectors in the Policy.
2) The draft Policy also seeks to strengthen tax collection measures in emerging sectors – particularly online businesses, and digital marketplaces.

The draft Policy calls for a paradigm shift in Kenya's entrepreneurial culture to transition from informality to a high regard for formal operations and compliance with regulations. The informal nature of operations is particularly rife among micro-enterprises. A report by the Kenya National Bureau of Statistics (2016) states that only 21% of the estimated 7.41 million MSMEs are formally registered. The same report indicates that small businesses employ over 15 million Kenyans, yet, the Kenya Revenue Authority has a record of 6.1 million taxpayers – who comprise enterprises of all sizes and individuals.

Various reports attribute the low appetite for formal operations among MSMEs to the poor articulation of benefits they would accrue. Small businesses often associate formalization and compliance with regulations with lengthy, complex and bureaucratic processes underpinned by incidences of corruption. Entrepreneurs view government and regulatory authorities at the national and county levels as business inhibitors instead of business enablers.

The purpose of this paper is to proffer suggestions that would enrich the draft National Tax Policy and bolster the participation of MSMEs in the formal economy. The paper draws from the experience of other markets that have successfully implemented tax regimes for small businesses – particularly where considerable voluntary compliance was recorded. Four themes are explored throughout the paper:

1) Ease of doing business: streamlining compliance with licensing requirements; compliance with standards and quality controls; and filing of regulatory reports and payment of taxes.
2) Attractiveness of public procurement opportunities: Simplifying the journey to participation in public procurement.
3) Access to market and business support: Enabling access to adequate, affordable and timely credit; marketing resources and access to local as well as global markets; integration to large-scale business relationships; and acquisition of certification for backward linkages with global value chains.

2. Development of the Report

In recent years, the role of Micro, Small and Medium-sized Enterprises (MSMEs) has steadily gained importance in development cooperation being one of the driving forces for job creation, business innovation and green and inclusive growth. As such, the Association of Start-up and SME Enablers of Kenya (ASSEK) together with its partners and collaborators continually seeks ways to support entrepreneurs and MSMEs in the country.

One of the key programme areas for ASSEK has to do with driving policy for members with the government, development partners and investors. The objective of the programme is to develop rigorous ecosystem standards and guidelines for MSMEs and Start-ups.

In view of the foregoing, Viffa Consult, a founding member of ASSEK, conducted a review of the draft Kenya National Tax Policy, with a focus on its implication to Micro, Small and Medium-sized Enterprises (MSMEs) and Start-ups. In the report, the terms MSE, SME or MSME have been used interchangeably only for purposes of retaining the terminology used by publications and/or reports used as sources of certain information.

2.1. Desktop Study

Viffa Consult conducted a desktop study focusing on the impact of taxation policies in the development of MSMEs and Start-ups in Kenya. It involved summarizing and collating existing secondary data relevant to taxation policies and their impact to MSMEs and Start-ups in a number of markets. Reports and strategic plans authored by taxation experts, as well as yearly reports on performance of the Kenya Revenue Authority, was evaluated to enrich this study. This helped the researchers generate insight on the published draft Kenya National Tax Policy.

2.2. Virtual Workshop

ASSEK hosted a one-day virtual workshop that brought together the association's members and partners for purposes of considering outcomes from Viffa Consult's research as well as obtain independent views on the Tax Policy from participants.

2.3. Final Report

The final report is a product of collation of desktop study findings and inputs from the virtual workshop.

3. MSME Sector

3.1. Evolution of the Sector

Businesses are generally defined using the combination of personnel numbers and capital investment size. Personnel numbers is the more universal metric, with investment sizes differing across countries – depending on the maturity of the economy. As such, firms are classified as micro, small, medium or large depending on number of fulltime employees engaged and/or capital investment made into the business.

The classification of businesses traces its roots to a report published in 1972 by the International Labour Organisation (ILO) on employment and incomes in Kenya. The report revealed that there exists small businesses that provide more employment than large corporates could possibly generate. At the time (and even today), large corporations and industries accounted for no more than 20% of total employment. It is said that the term "Informal Sector" was first used in the report, which meant business ventures that bore the following characteristics:

- → no formal structures and rigorous licensing (if any) to initiate;
- → reliance on indigenous resources for start-up, expansion, and general operations;
- → ownership remained within the family either as sole proprietorships or partnerships;
- → small scale operations within a household or small commercial premise;
- → labour-intensive and adapted technology;
- → skilled acquired outside the formal school system mainly through apprenticeships; and
- → participation in unregulated and competitive markets.

The ILO report motivated widespread studies on the importance, role and output of small businesses. These were set aside and grouped together as Small and Micro Enterprises (SMEs). Still following the employment metric, SMEs came to mean businesses that engage between 1-99 employees. They were characterised as being formal or informal, and with permanent, semi-permanent or temporary premises.

The focus then shifted to increasing the productivity of small businesses in developing nations. To achieve this, many developing nations created a new definition for microenterprises, removing them from their larger classification as small enterprises or small businesses. The objectives were to address high rates of informality and craft support programmes that fit a business' circumstances. Thus, the SME sector expanded to become the MSME sector.

- → Micro-enterprises: 2 to 9 employees
- → Small enterprises: 10 to 49 employees
- → Medium-sized enterprises: 50 to 99 employees

3.2. Definition of MSMEs in Kenya

Kenya classifies small businesses as micro, small and medium enterprises (MSMEs) using the following criteria:

- → micro enterprises employ less than 10 people;
- → small enterprises employ 10-49 people; and
- → medium enterprises employ 50-99 employees.

Just as in other countries, small businesses play a key role in Kenya's economic development and job creation agenda. They account for at least 80% of jobs and contribute 29% of GDP. Of concern to the government, however, is that 79% of small businesses are informal and therefore challenging to support. It is for this reason that the government took the step to curve out micro and small enterprises (MSEs) out of the larger MSME classification. This move was to enable a focused approach in transitioning small businesses from informal outfits to productive medium-sized enterprises.

The government thus published the Micro and Small Enterprises Act, 2021 and the Micro and Small Enterprises Policy that provided for definition of MSE businesses as follows:

Segment	**Characteristics**
Micro Enterprise	→ Annual turnover: < Ksh. 1M → Employees: < 10 persons → Manufacturing sector capital investments: < Ksh. 10M → Services or Agriculture sectors investments: < Ksh. 5M
Small Enterprise	→ Annual turnover: Ksh. 1M to 5M → Employees: 10 to 50 persons → Manufacturing sector capital investments: Ksh. 10M to 50M → Services or Agriculture sectors capital investments: Ksh. 5M to 20M

4. MSME Development

4.1. Mainstreaming MSMEs

The government's intention to develop the MSME sector is well known. A critical policy, such as the draft National Tax Policy, must demonstrate that its intention is to further develop the sector. It must specifically speak to: (i) moving an enterprise toward a more formalized structure; (ii) increasing involvement of small businesses in a strategic government project or activity; (iii) making sure small businesses play their part in achieving national development objectives; (iv) encouraging enterprises to adopt new technologies or practices that can help them grow faster; and (v) ensuring that there is a clear link between business growth opportunities and government policies.

Kenya's Draft Policy on Tax Collection reveals that the government plans to expand the tax base to include agriculture, informal and emerging sectors—specifically businesses involved in eCommerce. Though the Policy has not been considered and approved by Parliament, the Kenya Revenue Authority has already captured its intent to focus on these sectors in its 2021/2022 strategic plan. Presumptive tax is among the measures proposed to bring the agriculture and informal sectors into the fold, as well as focus on digital tax yields from online marketplaces.

The Kenya Vision 2030 (the country's economic development blueprint), advocates for mainstreaming of MSEs in six sectors - namely, Tourism, Agriculture and Livestock, Wholesale and Retail Trade, Manufacturing, Financial Services, Business Process Offshoring, and IT-Enabled Services. Efforts to encourage investment may stall if the intention to impose new taxes in Agriculture and Livestock, Wholesale and Retail Trade, and IT-Enabled Services (as per the draft Tax Policy) is not managed well.

4.2. Challenges Faced by MSMEs

Following is a summary of main challenges faced by MSME businesses:

Compliance with government regulations	Entrepreneurs find the cost of compliance to be high. Not only is it hard for them to estimate license costs, but they see little value in having them anyway—they don't understand their purpose and perceive any benefit as too small compared with other factors like capital expenditure or revenue. → Businesses must apply for and obtain multiple licenses during the course of a year. Some of these are static annual trade licenses; others are activity-based (like cess, movement permits), and sector-based depending on business type & size. The total cost could be too high for many businesses. → The registration requirements and procedures are not clearly explained; some must be followed at the national level, while others apply only to county residents. → County governments may have their own rules for businesses, which in some cases differ from those of the state. Because these differences are not always clearly communicated through mass

	media or during registration processes, new enterprises tend to flaunt them.
Business management know-how	Business owners/managers may not be able to adequately handle the challenges facing their enterprises because they do not have access to — and are therefore unable learn from or apply — the techniques used by their counterparts at large corporations. Today's business environment requires business managers, whether in small shops or enterprise-sized companies, acquires formal education and skill set. Majority of small business owners have not attained post-secondary education.
Access to finance	Many MSMEs do not have access to credit from banks or other financial institutions because most of them, due to their small asset base, are unable to provide collateral such as immovable assets. These enterprises often borrow money from family and friends. Any small business that aims to grow and acquire new technology needs funding beyond this type of finance.
Adaptation to business environment changes:	It is often said that communities and businesses are becoming increasingly reliant on digital technology for basic interactions. The adoption of new technology poses a big challenge to the growth of small enterprises, which may not have the resources necessary to implement it in their workflows. The Kenyan government and other stakeholders continue to introduce new regulations for industries, which impact enterprises. While such laws may be created with the goal of benefitting target sectors, they can often create complications for small businesses that were previously unaffected by these kinds of rules. The biggest challenges in meeting regulations are understanding the requirements and costs of changing business operations.

4.3. Government Support

The MSE Authority (MSEA) is the government agency responsible for formulating and coordinating policies that facilitate the promotion, development, and regulation of Micro and Small Enterprises. MSEA reports to the Directorate of Enterprise Development within the Ministry of Industrialization, Trade, and Enterprise Development (MOITED).

MSEA interfaces with Micro and Small Enterprises Associations to reach individual businesses. MSEs form associations that share a common interest or trade pursuit; for an Association to be registered, it must have at least 35 members. The MSE Associations Registrar is responsible for ensuring that the Association complies with its own rules. It is noteworthy that medium-sized businesses are excluded from this support framework.

In order to access interventions, incentives and benefits reserved for Micro and Small Enterprises (MSEs), a business must belong to an association. Individual associations may have unique sets of rules that businesses need to meet before admittance - provided such rules do not contravene sector laws or policies

The following table summarizes outcomes of the four policies most relevant in the delivery of government support to Small and Micro Enterprises.

Policy	**Delivery Against Objectives**
National Industrialization Policy 2012	→ Micro and Small Enterprises Bill, 2012 was enacted and is currently operational → The Public Procurement and Asset Disposal Act 2015 opens business opportunities to local entities → The National Construction Authority Act 2011 and the National Construction Authority Regulations 2014 mainly limit activities of foreign entities in the country → Technical and Vocational Education and Training Act, of 2013 provides for the establishment of a technical and vocational and training system.
Kenya National Trade Policy (2016)	→ Single permit business license to all SMEs operating in designated market places/workspaces → The National Treasury together with the Central Bank of Kenya, Office of the President – SME Advisory Unit, Ministry of Trade, Kenya Bankers Association, Association of Micro Finance Institutions, donors, and other stakeholders launched the Credit Guarantee Scheme (CGS). → Establishment of Cross-Border Trade Associations (CBTAs) to provide an institutional framework for small-scale cross-border traders to lobby the national and county governments and regional organizations on issues affecting cross-border trade. → One-Stop Border Post (OSBP) was set up at Busia and Malaba borders with Uganda; and Holili/Taveta and Namanga borders with Tanzania. → KenTrade's online trade information portal is linked to the EAC Trade Information Portal (TIP)
Kenya Youth Development Policy 2019	→ Implementation of Ajira Clubs across universities. Ajira Clubs are designed to equip students with vital skills needed to access digital and digitally-enabled job opportunities → The Central Bank of Kenya suspended the listing of Credit Referencing Bureau (CRB) borrowers owing less than KSh 1,000.
Kenya Micro and Small Enterprises Policy 2020	→ MOITED has prioritized building capacity in product value addition in six value chains: coffee, horticulture, honey, fish, milk and mangoes. → The Business Sector Programme Support (BSPS) is an active project in MOITED. The focus of the programme is to support the creation of enabling business environments, pilot value-addition projects, product development, market diversification, and enhancing SME competitiveness. → The Kenya Industry and Entrepreneurship Project (KIEP) running from 2019 to 2024 to increase innovation and productivity through financial grants and technical assistance. → Kenya Industrial Property Institute (KIPI) enhanced intellectual property rights protection through opening of intellectual

Policy	Delivery Against Objectives
	property desks at Universities and developed a benefit sharing framework. → Website aggregating AGPO opportunities and eligibility requirements are in place. → MSE has partnered with UNDP to develop the MSE registration management system. To be registered, an MSE must belong to an MSE Association → MOITED has been constructing and equipping Constituency Industrial Development Centres (CIDCs) at constituency level to provide worksites and tools for the youth to pursue gainful employment. → Biashara Centre project implementation is currently in progress. Project partners include: county governments, KEPSA, Kenya Association of Manufacturers, National Chamber of Commerce, micro-finance institutions, banks and development organizations

4.4. Support by Non-State Actors

Enterprise Support Organizations provide small businesses with access to resources that help them grow. An effective ESO is one that aggregates resources (human, capital and material) as well as technology—and makes it available at a low cost to its clients.

One of the most important roles of an ESO is to help a small business solve problems in key areas such as supply chain management, product development, marketing strategy and financial planning. There is little evidence of success by ESOs operating in Kenya, and more needs to be done.

In India, the Department of Small-Scale Industries (SSI) has set up Enterprise Support Organizations that have been implemented by state governments and central ministries. In Brazil, SEBRAE has established itself as the authoritative ESO in the country's MSME ecosystem.

Implementations in India and Brazil have shown that to succeed, ESOs must bring together private and public entities involved in compliance, and business research—to deliver meaningful support to small businesses.

- → An ESO with broad membership and a widespread network of service centres is well positioned to drive the MSME agenda.
- → Having a wide reach gives an ESO the flexibility to address emergency situations that arise in various counties.

5. Start-ups and Innovative Industry

5.1. Kenya Start-up Ecosystem

Start-ups are generally associated with young innovative tech companies or new businesses that leverages on technology to solve a problem or pain point of a population segment.

Start-ups world over are increasingly playing a critical role to a country's socio-economic development through development of innovation as well as aid in optimization of current economic sectors.

On development of innovation, start-ups focus on solving problems focusing on new technology and cutting-edge innovation as compared to legacy institutions that focuses on incremental innovation or improving on existing technologies through improved efficiency.

Kenya's start-up ecosystem has been active driven by both state and non-state actors. Government start-up support has been driven by Kenya National Innovation Agency (KENIA) with notable event being the inaugural Kenya Innovation Week as well as Konza Techno-City. Non-state actors have been led start-up stakeholder associations being Association of start-up and SME enablers of Kenya (ASSEK), Association of countrywide innovation hubs, East Africa Venture capital association (EAVCA) among others.

Kenya's government has been involved in start-up ecosystem development since 2013, with the launch of Konzo Techno-City, a tech park project built outside of Nairobi. Global tech giants like Google, Microsoft, Samsung, and Intel are also located in the capital city. Further Kenya is in the process of enacting a start-up bill that aims to recognise start-ups and related support organizations, offer framework to catalyse significant growth of start-ups as well as offer fiscal support. Kenya's start-up bill has been passed by the senate and has been introduced in the national assembly.

The Kenyan start-up ecosystem leads the East African region in innovation, takes position 2 and 61 in Africa and globally respectively based on start-up blink 2021 ranking. Nairobi and Mombasa are the most recognised innovation places out of the 47 counties with leading sectors being; Foodtech, Transportation Technology, and Energy & Environment Technology. Kenya has an estimated 209 start-ups, 4 accelerators and 17 coworking spaces.

Start-up Blink Ranking parameters

Score	Parameter
Quantity	→ No of start-ups → No of coworking spaces → No of accelerators → No of start-up related meetups
Quality of start-up & related organizations	→ Traction of over 70,000 entities in all ecosystems

Score	Parameter
	→ Presence of branches & R&D centres of International Technology Corporations → Branches of multinational companies (e.g. WeWork spaces) → Total private sector investment in thousands of start-up ecosystems → Number of employees per start-up → Presence of Unicorns, → Exits & Pantheon companies → Presence of Global Start-up Influencers → Global start-up events (e.g. WebSummit)
Business Environment	→ Ease of Doing Business & registering companies → Internet Speed → Internet Freedom → R&D investment → Availability of various technological services (payment portals, ride-sharing apps) → Number of patents per capita → Level of English proficiency

5.2. Global Innovation

India, Kenya, the Republic of Moldova and Viet Nam are still record holders for being innovation achievers for 11 consecutive years in the 2021 global innovation index. Kenya keeps its 3rd place in sub-Saharan Africa and scores above its income group in Institutions, Market and Business sophistication and Knowledge and technology outputs.

Kenya was ranked position 85 globally and 3rd in Africa in the global innovation index with innovation output outperforming inputs.

Kenya GII Ranking Trend:

Year	GII	Innovation Input	Innovation Output
2021	85	89	76
2020	86	92	78
2019	77	89	64

Year	GII	Innovation Input	Innovation Output
2018	78	91	64

Source: GII 2020

Although Kenya's ranking improved overall in 2021 to 85 as compared to 86 in 2020 as well as output outperforming input, the level of both output and input dipped.

A deep dive into Kenya's performance indicates best and weakest performance were knowledge and technology output and human capital and research respectively.

Kenya's Innovation performance pillars:

Indicator Name	Sub units	Strengths {***} Weakness {*}
Institutions	Business Environment {Ease of solving insolvency}	***
Human capital and Research	{Education} Education expenditure % of GDP {Education} Pupil teacher ratio-secondary Research & Development {Global corporate R&D investors, top 3, mn US$} Research & Development {QS university ranking, top 3}	*** * * *
Infrastructure	General infrastructure {Electricity output, GWh/mn pop} General infrastructure {Gross capital formation, % GDP}	
Market Sophistication	Credit {Ease of getting credit} Credit {Microfinance gross loans, % GDP} Investment {Ease of protecting minority investors} Investment {Venture capital recipients, deals/bn PPP$ GDP} Trade, diversification & market scale { Applied tariff rate, weighted avg}	*** *** *** *
Business Sophistication	Innovation linkages {University-industry R&D collaboration} Innovation Linkages {GERD financed by abroad} Knowledge absorption {Intellectual property payments, % total trade}	*** ***
Knowledge and Technology outputs	Knowledge impact {Labour productivity growth, %} Knowledge diffusion {Intellectual property receipts, % total trade} Knowledge diffusion {ICT services exports, % total trade}	*** *** ***
Creative Outputs	Intangible assets {ICTs and organizational model creation}	***

Indicator Name	Sub units	Strengths {***} Weakness {*}
	Creative goods and services {Cultural and creative services exports, % total trade}	*
	Creative goods and services {Printing and other media, % manufacturing}	***.
	Online creativity {Wikipedia edits/mn pop.	*
	Online creativity {Mobile app creation/bn PPP$ GDP}	*

Source: GII 2021

Start-ups and start-up ecosystem stakeholders need to be recognised and fiscally supported through tax incentives in order to unlock significant socio-economic potential as seen in their contribution to emerging markets such as Singapore with a national population of 6 million and 3,600 start-ups its estimated that start-ups GDP contribution will be 2 percent by 2035 with 10.9 Billion USD Invested in start-ups.

Start-ups need to be identified as part of a virtual special economic zone having to apply based on simple and clear framework backed with legislation such as start-up bill then qualify for fiscal incentives .

6. Taxation Framework

6.1. Kenya Budget Process

The promulgation of the 2010 Constitution brought significant changes to the way that Kenya draws up its national budget. The new constitution reserves for wider stakeholder inclusion in revenue-generating and expenditure plans, which had formerly been an exclusively Executive Government function. The constitution further mandates the Executive to conduct public participation forums ahead of tabling the Budget Policy Paper in parliament.

There are four major stages of the budget process in Kenya: formulating a proposal, approving it, implementing it and auditing/evaluating its implementation.

Stage	Responsibility	Output
Formulation	Executive at National and County governments	→ Proposed Budget Policy Statement → Proposed County Fiscal Strategy Papers
Approval	Parliament at National level County Assemblies at County level	→ Approved Budget Policy Statement → Approved County Fiscal Strategy Papers → Appropriation Bill → Any other bills required to implement Budget Policy Statement and County Fiscal Strategy Papers
Implementation	Executive at National and County governments Controller of Budget	→ The Controller of Budget's quarterly budget implementation report → National Government quarterly budget implementation report → County Governments quarterly budget implementation reports
Audit and Evaluation	The Office of the Auditor-General The Office of the Controller of Budget	→ Financial accounts of the National and County governments → Report on expenditure by the National and County governments

MSMEs and Start-ups should be afforded more opportunities to participate in the taxation framework – particularly in the budgeting process. The current phase of the Tax Policy should exploit all opportunities available to demystify taxation to the market as well as collect feedback and other useful information for future phases. This role can be entrusted to recognized industry associations and ESOs.

Budgeting Process

MSME and Start-up Businesses Participation Framework

1. Formulation	2. Approval	3. Implementation	4. Audit and Evaluation
Input from MSMEs and Start-ups	**Representation in legislature**	**Compliance support and service delivery**	**Focused reporting on performance**
MSE Authority MSE Associations MSME & Start-up ESOs	Ensure alignment to MSE policies, MSE Act and Start-up Act	MSE Authority MSE Associations MSME & Start-up ESOs	MSE Authority MSE Associations MSME & Start-up ESOs

6.2. SMEs and Taxation

Studies reveal that taxation regimes impact an entrepreneur's decision to start, continue or close a business. They also have a bearing on decisions on participation in aspects of a value chain. More importantly, it determines the extent an entrepreneur is willing to declare business income. The tax regime, in this regard, refers to the tax rate applied and the administration of taxes.

Entrepreneurs in Kenya find the cost of regulatory compliance to be high.

→ Businesses procure multiple licenses throughout a calendar year and incur levies charged by county governments (depending on activities carried out).
→ Small businesses mainly employ sales staff to grow business revenues. They view hiring experts to file statutory business reports and tax returns as an unnecessary cost.
→ Taxation rates are high in comparison to margins made from sales of goods.

Entrepreneurs do not see value in taxes and levies charged by national and county governments.

→ The cost basis is unknown.
→ They are not predictable as the rates could be changed annually (during the national and county budgeting process) or at any time through special government notices.
→ The aggregate costs of licenses, levies and taxes are out of reach of micro-enterprises.

The issues raised above may provide insight into low registration levels, where the Kenya Revenue Authority reports about 6.1 million registered taxpayers against a potential base of 17.4 million employed persons and over 7 million small businesses. 68% of the registered base file returns, and 88% make required payments.

Tax administration in Kenya relies on the formalization of employment and business activities. It starts with the registration of the taxpayer – be it as a corporate or an individual. Upon registration, the recording taxpayer's activities follow suit.

→ Employment records determine whether a business needs to remit income tax or withholding tax on behalf of the employee. Add to these social security payments (NHIF and NSSF).

- → Business reports determine whether an enterprise is within the scope of a presumptive tax or ordinary tax regime. Add to this compliance with trade-related taxes such as VAT, excise duty, and other industry-based levies.
- → There are specific monthly deadlines for the remission of all mentioned taxes.

The informal sector is critical to Kenya's economy. It is instrumental in employment creation, production, and income generation - especially among rural communities. A review of the government policies informing the development of local enterprises shows a clear intention to support the development of micro-enterprises by, among other things, transitioning the majority to the formal sector. This paper finds that the draft National Tax Policy does not present opportunities for the formalization and development of small businesses through enabling tax policies. The next section of this paper presents policy proposals to change this outlook.

7. MSME Taxation Proposals

The draft National Tax Policy is a step in the right direction, but it falls short of providing actionable information for business owners. By offering minimal insight into taxation strategies, this document creates an uncertain business environment for businesses.

The Policy provides for comprehensive reviews of tax laws at least once every five years. Stakeholders will have an opportunity to examine the market realities and align them with government priorities. Other economic plans, such as the Vision 2030 Medium-Term Reports and Economic Survey, can then be used to align taxation policies.

Tax policies should be a way of creating incentives for taxpayers to follow the rules. Making it easy for people and companies to comply with tax laws offers immediate benefits while making evasion difficult over time.

7.1. Ease of Doing Business

A number of countries have found benefit in applying Single Replacement Tax (SRT) approach to stimulate voluntary compliance. There are several taxes enforced in Kenya – majority of which are dependent on activities undertaken by a business. A business may be required to register with multiple state agencies to attain compliance and remit certain taxes. In addition, requirements are published using legalese language – making it difficult for MSEs to comprehend. It is thus easier for a business to flaunt rules than pursue a path to compliance. Implementation of a Single Replacement Tax could stem low compliance among small businesses in this regard.

Application of SRT can start at the business licensing level for microenterprises. All businesses are required to acquire annual trade licenses from their respective counties. These licenses are grouped according to sector (e.g. Agriculture, Trade, Health), business size (e.g. informal, small, medium, large), and location (e.g. rural, urban). There are activity-based licenses (e.g. mining, transport CESS) issued as well to businesses that require them. All the licenses are issued in advance of trading period.

- → SRT can be incorporated in the license fees for businesses up to a certain turnover value. Such a business can then be deemed to have paid their taxes for the year in advance once it procures a trade license.
- → Social security payments (NSSF and NHIF) can be incorporated into the SRT.

SRT will benefit all stakeholders as follows:

1) MSEs will know the real cost of doing business to entrepreneurs and therefore stimulate productivity.
2) Tax policy formulators can leverage gathered information for future taxation measures.
3) Sustainable increase in NSSF and NHIF collections
4) Improvement in entrepreneurs' quality of life through delivery of basic medical and social protection covers upon payment for trade licenses.
5) Simplicity of SRT scheme motivates voluntary compliance and reduces tax administration costs.

7.2. Public Procurement Opportunities

The National Tax Policy can play a role in simplifying a small business' journey to participation in public procurement.

- → The business licensing procedures (as proposed under Ease of Doing Business above) can be leveraged to identify businesses that pre-qualify for inclusion in public procurement programmes the government has in place. Thus, eligibility can be mapped to the nature of trade license a business qualify for and has procured.
- → MSEs participating in public procurement may be subject to turnover tax. The Policy could allow for such tax to be withheld by the procuring public entity – based on the value of the contract and other parameters that may apply. In some cases, some procurement opportunities allow suppliers to declare cost of goods/services and thus a margin. The tax could be applied on the margin.

Support for public procurement opportunities will have the following benefits:

1) Small business owners can be furnished with Tax Compliance Certificates (TCCs) upon payment for trade licenses under the SRT scheme. TCCs are important for purposes of pursuing business opportunities – particularly public procurement. It is noteworthy that the government has provided specific procurement opportunities for businesses owned by the youth, women and persons with disabilities.
2) By leveraging the licensing procedures, more businesses will be able to pre-qualify for public procurement opportunities and therefore make AGPO more inclusive.
3) Withholding turnover tax based on contract values will present opportunities for higher compliance while affording the businesses the latitude to plan their finances – now that the tax element would be been dispensed with.
4) Preferential taxation could be applied to locally produced goods and services.

7.3. Access to Market and Business Support

The Kenya Vision 2030 (the country's economic development blueprint), advocates for mainstreaming of MSEs in six sectors - namely, Tourism, Agriculture and Livestock, Wholesale and Retail Trade, Manufacturing, Financial Services, Business Process Offshoring, and IT-Enabled Services. The tax policy should direct specific tax regimes for each of the sectors so as to avoid sector-based imbalances in the costs or burden of compliance.

The tax policy should incentivise digitization of businesses.

- → Retail shops should be encouraged to adopt digital means of recording business sales and expenses through lowering costs of technology acquisition. The lowering of technology costs can be through providing tax breaks for fintech firms that implement digital tools for shops or treating the cost of acquiring the technology as a deductible cost – provided the reports of the digital platform align with taxation reporting requirements.
- → Business that conduct their business online could be subjected to lower taxes to cushion them against the onslaught of global online marketplaces that do not remit any taxes to Kenya.

The National Tax Policy should mandate implementation of help desks at incubator hubs and similar start-up enabler facilities. The help desks could be run by ESO staff that are well trained on taxation matters. The role of the desks will be to train and setup start-up businesses on a compliance path.

This could include set-up of digital trading platforms that the start-ups intend to use for daily operations.

The benefits to be accrued include:
1) Development of a digital database that the government can use to craft targeted support for MSEs. There is hardly any reliable data that the government and ESOs can use to inform ways and means of delivering market and business support to MSEs.
2) Digitization of daily operations records will ease the burden of filing tax returns. The prevailing practice is that businesses use separate tools to conduct business transactions and file statutory reports. The use of separate tools has led to poor transfer of information from business records to tax filing system (iTax platform).
3) Ensuring tax compliance through routine trade activities will increase the eligibility of MSEs and start-ups for integration to large-scale business relationships and backward linkages with global value chains.

7.4. Impact on Tax Administration

This paper takes cognizance of the government's need to increase tax yield across board. However, before real tax yields are realized, two key market issues need to be resolved.

Theme	Issues	Solutions from MSME Taxation Proposals
Kenya's tax base is small in comparison to potentials. Registered taxpayers are constantly at risk of being overburdened	There are over 10M MSMEs and over 17 million employed persons, yet: → KRA has a roll of 6.1M taxpayers → NHIF has a roll of 8M members → NSSF has a roll of about 1.2M members Scope of turnover Tax has a floor of Ksh 1,000,000 in annual income thus excluding at least 80% of targeted hard-to-tax sector. Proposal to double DST as a means of increasing yield is evidence of the inadequacy of the tax base.	Leverage county-based licensing process to register MSMEs and Start-ups as tax payers. NHIF and NSSF could benefit from the drive. Incorporate SRT in trade licenses of informal and small businesses → At least 8 – 10M businesses in KRA, NHIF and NSSF databases upon roll out → Means of monitoring new businesses entering the market and those exiting based on license renewal activity. → Monitoring can be shared between KRA and County government resources – thus reducing overall tax administration costs.
There is inadequate data to effectively impose taxes on MSMEs and Start-up businesses	Unlike large corporations, MSMEs and Start-ups do not have the capacity to prepare elaborate financial reports. → It is not readily known if businesses within ToT scope can actually afford it. → It is not readily known the level of tax that would be affordable to the targeted hard-to-tax sector. → KNBS has conducted only one comprehensive survey on MSMEs – which was done in 2016. Given the changes in the business environment since then, the data is not fully reliable.	Incentivise digitization of businesses. → Provide tax breaks for fintech firms that implement digital transactional tools for small businesses or treating the cost of acquiring the technology as a deductible cost. → DST should be lower that ToT in the case of small businesses to motivate migration and eventual generation of useful data.

8. Conclusion

This paper recommends that for the National Tax Policy to deliver a sustained MSE Sector tax base, it is necessary to secure the buy-in of small businesses. The Policy should prominently speak to the benefits of compliance, articulating the benefits accrued by entrepreneurs who opt for formalization and compliance.

This implies a radical change in the culture of the Kenya Revenue Authority away from the traditional penalty-driven compliance enforcement towards a focus on the delivery of benefits to compliant taxpayers. Although penalties are a part of tax administration, various reports show that they have little impact on driving compliance within the MSE Sector.

The paper also recommends that for this new culture to take root within KRA and its partners, an engagement strategy should be adopted through which small business owners can receive feedback regarding their compliance with regulations and their perceptions on how they can improve their operational practices. This will help in building better relationships between KRA and MSE sector stakeholders, thereby leading to improved quality service delivery.

Virtual Workshop Participation

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David	Odera	Nairobi	KBW
Eddy	Eddy	Nairobi	Knight Castle & King.
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Florence	Kimata	Nairobi	Department of Business Reforms and Transformation
Florence	Mulei	Voi	Glory Counselling Centre
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Juliet	Maina	Nairobi	M-PESA Africa
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Rachel	Ndungu	Nairobi	Biashara Africa
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Raphael	Kuria	Nairobi	ABC
Robert	Mwaniki	Nairobi	Bob Realtor and Environmental Management Advisory Limited
Samuel	Mbaire	Nairobi	Student
Sheida	Chumba	Nairobi	Wagl
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Titus	Kimeli	Iten	Excelify
Twinamatsiko	Junior	Kampala	Farm Hub Ltd
Val	Njeru	Nairobi	Watosha Ltd
Victor	Otieno	Nairobi	Viffa Consult
Wanjiru		Nairobi	Dinbag Holdings Ltd

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