VAT Gap Analysis and Kenya's Experience

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Outline

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2. Findings
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Estimation of VAT Gap

- **VAT gap** for a particular year is defined as the difference between revenues collected for a given year and the potential revenues that could have been collected given the economic activities that took place during that year.
- The IMF report shows the results of applying the Revenue Administration Gap Analysis Program (RA-GAP) value-added tax gap estimation methodology to Kenya for the period 2016-2017.
- The RA-GAP methodology employs a **top-down approach** for estimating the potential VAT base, using statistical data from national accounts on value-added generated in each sector.
- The two main components to this methodology for estimating the VAT gap are estimation of the potential VAT collections for a given period; and determination of the accrued VAT collections for that period.
- The difference between the two values is the VAT gap, which provides estimates of the compliance gap and the policy gap.

Estimation of the VAT Gap…

- **Overall VAT gap** - The difference between the potential VAT if all final consumption were taxed at the current standard rate and actual VAT revenue. The overall VAT gap is the sum of the compliance gap and the policy gap.
- **Compliance gap** - The difference between the potential VAT given the current policy framework and actual VAT revenue. The compliance gap is the sum of the assessment gap and the collection gap:

(i) ***Assessment gap*** *- The difference between potential collections, given the current policy framework, and the VAT declared or assessed.*

(ii) ***Collection gap*** *- The difference between VAT declared or assessed and actual VAT revenue collected.*

Estimation of the VAT Gap…

- **Policy gap** - The difference between the potential VAT if all final consumption was taxed at the current standard rate and the potential VAT given the current policy framework. The policy gap is the sum of the expenditure gap and the non-taxable gap.

*(i). **Expenditure gap** - The difference between the potential VAT where most of final consumption is taxed at the standard rate, but where a set of minimal standard exemptions are maintained, and the potential VAT given the current policy framework.*

*(ii). **Non-taxable gap** - The difference between the potential VAT if all final consumption were taxed at the current standard rate and the potential VAT where most of final consumption is taxed at the standard rate, but where a set of minimal standard exemptions are maintained. Also known as the efficiency gap.*

Key Findings

- International Monetary Fund (IMF) carried out a VAT gap analysis in Kenya and found out that the overall VAT gap was **10.2 per cent** of the GDP in 2017 compared to **9.2%** of GDP in 2014. This rose slightly, from **9.7 per cent** of GDP in 2016 to **10.2 per cent** of GDP in 2017.
- The overall VAT gap is composed of *compliance gap* and *policy gap*.
- the VAT compliance gap was about **48 per cent** of the revenue potential in 2017. This was estimated to be at **4.2 per cent of GDP**.
- The policy gap was at about **6.1 per cent of GDP** in 2017.
- The policy gap is higher than the compliance gap. The increase in the policy gap since 2014 is attributed to the re-introduction of tax exemptions.

Key Findings…

- The average policy gap measured for emerging market economies under IMF's RA-GAP framework is close to 4 per cent of GDP; the policy gap in Kenya was significantly higher than this level.
- Both the policy gap and compliance gap for Kenya are higher than the average for a middle-income emerging market economy.
- The sectors with the highest compliance gap include manufacturing, wholesale & retail trade, construction and transport & storage.
- The large compliance gap in the manufacturing sector is unexpected and could indicate a systemic breakdown in tax morale.

Recommendations from the IMF Study

1. Investigate reasons for significant amounts of VAT collection not being attributable to economic sectors – is this a compliance risk or poor control of the registration process?
2. Improve control of the registration process, to provide better information on the nature of taxpayers; and de-register taxpayers that are not trading.
3. Investigate sectoral compliance gaps, particularly in manufacturing, but also in construction, trade and transport sectors.
4. Find missing data on withholding declarations in 2017 so as to have complete micro-data for that year.
5. Follow up large end-of-year additional assessments and investigate why they are not paid.
6. Very large additional assessments of VAT creditable made in 2014-2016 need to be assured for validity.
7. Investigate the reasons for divergence between officially reported VAT on imports and that derived from administrative data provided to RA-GAP, particularly in 2016.
8. Review tax exemptions re-introduced after the VAT Act 2013.

VAT Gap Reduction Strategy

- In FY2019/20 KRA prepared a strategy to implement the recommendations and has been monitoring the initiatives thereof.

- The strategy has been implemented over a period of three years – FY 2020/21 and FY 2022/23.

1. Strategic Goals

- To reduce the VAT gap in Kenya, the Authority sought to pursue the following strategic goals:

1) Carry out a comprehensive audit of the sectors with significant VAT gaps
2) Enhance the simplicity and certainty of the VAT system
3) Enhance the accuracy of the VAT data
4) Tackle VAT Fraud.

Strategic Initiatives

1. Comprehensive audit of the sectors with significant VAT gaps

(i). Investigate the reason for significant amounts of VAT collection not being attributable to economic sectors.

(ii). Investigate causes of sectoral compliance gaps and come up with measures to seal the loopholes.

(iii). Follow up on large end-of-year additional assessments and investigate why they were not paid.

2. Enhance the simplicity and certainty of the VAT system

(i). Reduce the exemptions and simplify the classification of goods for VAT purposes.

3. Enhance the accuracy and reliability of the VAT data

(ii). Clean the VAT data.

4. Tackle VAT Fraud

(i). Address non-compliance in the electronic commerce.

(ii). Utilize Big Data in combating fraud.

(iv). Build a tax system in which cheating does not pay off – enhance cooperation between the departments.

Achievements from Strategy Implementation

Strategic Initiatives	Initiatives Implemented
1. Comprehensive audit of the sectors with significant VAT gaps	
Investigate causes of sectoral compliance gaps and come up with measures to seal the loopholes	• Enhanced sector-based risk analysis to establish the compliance loopholes and reasons for non-compliance in the manufacturing, wholesale and retail, construction, and transport & storage sectors • Tightened enforcement measures such as issuing agency notices and sticking to the timelines as per the law and procedure manuals
2. Enhance the simplicity and certainty of the VAT system	
Reduce the exemptions and simplify the classification of goods for VAT purposes	• Reviewed the VAT Act and proposed changes to the VAT Act on the reduction of VAT exemptions.
Enhance Tax Education to boost tax awareness and morale	• Conducting targeted Taxpayer Education forums in the manufacturing, wholesale and retail, construction, and transport & storage sectors - through mapping of taxpayers based on their location (area of business), and sub-sectors
3. Enhance the accuracy and reliability of the VAT data	
Clean the VAT data	• Improved the VAT registration process (e.g sector classifications etc) • Cleaning of the iTax tax register in progress • Customs & DTD data matching and risk profiling using the matched data implemented – to address the divergences between officially reported VAT on imports and that derived from DTD administrative data
4. Tackle VAT Fraud	
Address non-compliance in the electronic commerce	• Implemented the digital service tax (DST) since 2021 • Developed a simplified registration regime to ease compliance in the e-commerce sector
Utilize Big Data in combating fraud & Build a tax system in which cheating does not pay off	• Implementation of eTIMS • Integration of the iTax and iCMS systems in progress - to work on a real-time basis, and to identify loopholes for tax frauds such as missing trader • Multi-agency collaborations to combat tax fraud

Performance on VAT Gap Reduction

- The estimated VAT Compliance gap at the beginning of the FY2021/22 was **46.7** per cent down from **47.1** per cent for the previous FY 2019/20. At the close of the FY2021/22, the VAT Compliance gap had significantly reduced to **38.9** per cent.
- The table below shows the estimated VAT Compliance gap in the last four years using the rebased figures and the Economic Survey 2022

VAT Compliance Gap (after rebasing)	2017/2018	2018/19	2019/20	2020/21	2021/22
	45.0%	41.5%	47.1%	46.7%	38.9%

Performance on VAT Gap Reduction Continued

In the FY 2021/22, the overall VAT Gap reduced significantly relative due to:

- ✓ The **reversal of the tax policy changes** that were in place from April 2020 to December 2020 – the tax measures had an adverse impact on the policy gap in the previous FY 2020/21.
- ✓ **Economic Recovery** - improved final consumption and actual VAT collections as the economy transitioned through the Covid-19 pandemic. The pandemic had a negative impact on the actual VAT collections in FY 2020/21.
- ✓ **Strategic measures** being undertaken by the Kenya Revenue Authority to reduce the VAT gap in the country.

Achievements FY2021/22

- ✓ Proposed and approved changes to the VAT Act on reduction of VAT exemptions. For instance, the Finance Act 2022 removed from the zero-rating supply of protective apparel, clothing accessories, and equipment. It also removed the requirements for the turnover threshold of five million shillings effectively requiring all suppliers of imported services to register for VAT.
- ✓ Successful integration of the iTax and iCMS systems.
- ✓ Implementation of taxation of digital market place supplies (VAT-DMS)
- ✓ Adoption of the simplified registration framework by DTD.
- ✓ Continuous data cleaning of VAT data and data migration from legacy to iTax by SIRM and DTD
- ✓ Robust investigations and enforcement.

Way Forward

- Analysis of tax gap for other key tax heads.
- Corporate income tax gap already done
- Personal income tax gap – analysis ongoing
- Excise tax gap analysis being planned
- Development and implementation of strategies to reduce the tax gaps.

Collaboration with Development Partners

- IMF – For RA-GAP capacity building and technical assistance on tax gap analysis
- IMF – Development of the Medium Term Revenue Strategy
- World Bank – Tax Policy Studies to rationalize tax policy and enhance compliance under CIT, VAT and PIT.
- WB, IMF and other Development Partners – Development of the National Tax Policy.

Thank you