ENHANCING MICRO, SMALL & MEDIUM ENTERPRISES:

ANALYSING THE IMPACT OF THE FINANCE BILL 2024 ON MSE GROWTH IN KENYA

Viffa Consult
Unlocking Africa's Entrepreneurship Spirit

SME BIZHUB

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ABOUT VIFFA

Viffa Consult is a Kenyan based SME and Startup research and policy think tank whose core mandate is conducting in-depth research on issues affecting Kenyan SMEs and Startups, analyzing existing policies and propose evidence-based recommendations to improve the business environment for SMEs and Startups, engage with government, private sector, and civil society stakeholders to advocate for policy reforms and initiatives that support SME and Startup growth and disseminating research findings, policy recommendations, and best practices through publications, mainstream media and online platforms among others.

Viffa is a member of the Association of Start-ups and SMEs Enablers of Kenya (ASSEK) and Association of countrywide innovation hubs and a very active knowledge partner in the Kenyan SME and start-up ecosystem.

Viffa has worked with a wide spectrum of stakeholders in design and delivery of MSME and Startups programs such as ; AUDA-NEPAD, Government of Kenya ministries and county government, development partners (GIZ, Foreign, Commonwealth and Development Office-FCDO), business member organizations (Kenya National Federation of Jua Kali Associations, Association of startup and SME enablers of Kenya (ASSEK) , Association of countrywide innovation hubs, Block chain Association of Kenya, Digital Financial Services Association Of Kenya among others)

INTRODUCTION

The Government of Kenya has unveiled the proposed Finance Bill 2024, aimed at widening the tax base and reducing the fiscal deficit. The Finance Bill, an Act of Parliament, plays a critical role in amending laws related to various taxes and duties and outlines the revenue-raising measures for the national government. Presented to the National Assembly alongside a policy statement, the Finance Bill details how the national budget will be funded.

The Finance Bill 2024, which must be approved by Parliament by June 30th, 2024, is set to become operational on July 1st, 2024. This bill introduces crucial measures impacting the digital economy, such as taxing digital marketplaces, which will significantly affect sectors like agriculture and MSMEs.

The Economic Landscape

Kenya's economic landscape has shown remarkable resilience and growth, underpinned by robust performances across various sectors. Real Gross Domestic Product (GDP) expanded by 5.6 per cent in 2023, up from revised growth of 4.9 per cent in 2022. This positive trajectory was observed in several key sectors, including Agriculture, Forestry, and Fishing, which grew by 6.5 per cent in 2023, a significant recovery from the 1.5 per cent contraction in 2022. Favourable weather conditions contributed to this agricultural resurgence, underscoring the sector's critical role in Kenya's economy.

The Nexus Between Agriculture, MSMEs, and the Digital Economy

The 2024 Budget Policy Statement underscores the pivotal role of agriculture in Kenya's economic transformation, aiming to provide employment opportunities and livelihoods for most of the population. According to the 2024 Economic Survey, agriculture remains the dominant sector, contributing 21.8 per cent of the total GDP.

Simultaneously, the government is leveraging digital innovation to empower MSMEs, vital engines of socio-economic growth, especially for marginalised population segments. Real economic transformation is anchored in integrating digital technologies to enhance productivity, efficiency, and inclusivity across the agricultural value chain.

By implementing digital solutions, the government can streamline agricultural processes, improve market access for farmers, and create new opportunities for MSMEs, fostering a more inclusive and prosperous economy.

Empowering MSMEs Through Digital Innovation

MSMEs play a crucial role in Kenya's socio-economic transformation, particularly for economically excluded segments of the population, such as youth, women, and persons with disabilities. Establishing the Financial Inclusion Fund, known as the Hustlers Fund, exemplifies the government's commitment to addressing financial barriers and fostering entrepreneurship. Digital platforms have enabled MSMEs to access credit more easily, with the Hustler Fund disbursing KES 36.6 billion by the end of November 2023. The Fund's success, with a 73 per cent repayment rate, highlights the potential of digital financial services to drive economic empowerment.

Digital Superhighway: Catalysing Kenya's Digital Economy

Kenya's digital economy has emerged as a frontier of opportunity and productivity. The government's commitment to expanding the digital superhighway is evident in the increased investment in fibre optic infrastructure and the digitization of government services. However, there is a noticeable preference for promoting online jobs for the youth, such as data entry and call centre services, over fostering local innovation. We advocate for tax incentives to develop innovation hubs that can unlock the potential of integrating digital technologies to enhance productivity, efficiency, and inclusivity across agricultural and manufacturing value chains.

Motivation for Our Submission

Viffa Consult Limited, a Nairobi-based management consultancy, is dedicated to empowering Micro, Small, and Medium Enterprises (MSMEs) and start-ups across Africa. We believe in the transformative potential of MSMEs to drive socio-economic progress through profitable trade and business endeavours.

Our submission aims to examine the features of the Finance Bill 2024 that are beneficial for MSME business growth and those that may be detrimental. Our objective is to provide constructive feedback to the Kenya National Assembly Committee on Finance & National Planning, ensuring that the bill supports the resilience and prosperity of MSMEs in Kenya, particularly in the realm of the digital economy.

DISCLAIMER

The Finance Bill 2024 proposes amendments to the Income Tax Act. Understanding the implications of these measures requires referencing the Income Tax Act. However, an updated edition of the Income Tax Act is not available for public access online. The version on the National Council for Law Reporting (Kenya Law) website is current only up to 31 December 2022. Therefore, tracking the amendments proposed by the Finance Bill 2024 for items introduced to the Income Tax Act via the Finance Act, 2023 is challenging.

TOTAL TAX PAYABLE BY A RESIDENT DIGITAL MARKETPLACE

A resident digital marketplace in Kenya is subject to several taxes:

1. **Income Tax:** Standard income tax rates based on turnover and net profits.

b. For businesses with a turnover between KES 1 million and KES 25 million, a 1% turnover tax is applicable.

c. For businesses with turnover exceeding KES 25 million, a 30% corporate tax on net income applies.

4. **Digital Service Tax (DST):** 1.5% of the gross transaction value.
5. **Digital Asset Tax:** 3% of the transfer or exchange value of digital assets (where applicable).
6. **Withholding Tax:** 5% of the gross amount.
7. **Value Added Tax (VAT):** Required for digital services, regardless of turnover threshold.

Tax Advantages of a Resident Digital Marketplace Over a Non-Resident One

1. **Lower Withholding Tax Rates:** Residents pay 5% on digital content monetization and digital marketplace income, compared to 20% for non-residents.
2. **Access to Local Tax Incentives:** Potential access to investment allowances and other local tax incentives that may not be available to non-residents.
3. **Advance Tax Deductions:** Taxes paid in advance (DST, Digital Asset Tax, and Withholding Tax) are deductible from turnover or corporate tax, potentially reducing the overall tax burden.

Tax Disadvantages of a Resident Digital Marketplace Over a Non-Resident One

1. **Higher Compliance Burden:** Residents must comply with multiple tax filings, including DST, VAT, withholding taxes, and income tax, increasing administrative complexity and costs – particularly for MSEs and Start-ups.
2. **Potential for Double Taxation:** Resident digital marketplaces operating internationally might face double taxation issues, whereas non-residents might avoid this through tax treaties.
3. **VAT Obligations:** Residents must register and comply with VAT on imported digital services, even if their turnover is below the threshold, adding to compliance costs. Other businesses with turnovers below KES 5,000,000 are exempted from VAT registration.

Detrimental Provisions for Resident Digital Marketplaces

1. **Higher Effective Tax Rates:** The cumulative tax burden for resident digital marketplaces could be significantly higher compared to non-residents due to multiple tax obligations.
2. **Complex Compliance Requirements:** The extensive compliance requirements for various taxes (DST, Digital Asset Tax, VAT, withholding taxes) can be onerous, particularly for smaller businesses.
3. **Encouragement of Non-Resident Platforms:** The higher tax rates and administrative burdens on

resident digital marketplaces may incentivize users and businesses to prefer non-resident platforms, which could offer services at lower costs due to lower tax liabilities and streamlined operations.

4. **Excise Duty on Non-Resident Services:** The imposition of excise duty on services offered by non-residents may not adequately level the playing field if resident digital marketplaces do not receive similar exemptions or tax breaks.

RECOMMENDATIONS

A. Positive Features of the Finance Bill 2024 for Digital MSMEs

I. Expanded Definition of Digital Marketplace

Finance Bill 2024 Reference:	Section 3
Income Tax Act Reference:	Section 3, subsection (3)
Recommendation	Retain

The proposed amendment to the definition of "digital marketplace" in the Income Tax Act offers several benefits to MSMEs:

1. **Increased Clarity:** The expanded definition explicitly lists various types of services and activities that constitute a digital marketplace. This clarity helps MSMEs understand whether their business activities fall under the taxable digital marketplace category, thereby reducing ambiguity and potential non-compliance due to misunderstandings.
2. **Inclusivity:** By enumerating specific services such as ride-hailing, food delivery, freelance services, and others, the amendment acknowledges the diverse nature of the digital economy. This inclusivity ensures that various MSME sectors are recognized and can better navigate the tax landscape.
3. **Encouragement of Digital Adoption:** The detailed definition encourages more businesses to adopt digital platforms by providing a clearer framework for their operations. MSMEs, especially those in traditional sectors, may be more inclined to transition to digital marketplaces, knowing they are adequately defined and regulated.

II. Excise Duty Exemptions for East African Community (EAC) Products

Finance Bill 2024 Reference:	Section 42
Excise Duty Act Reference	The First Schedule to the Excise Duty Act
Recommendation	Retain

The proposed amendments to the excise duty descriptions have several positive implications for MSMEs:

1. **Regional Trade Enhancement:** By excluding certain goods from excise duty if they originate from the EAC Partner States and meet the EAC Rules of Origin, the Finance Bill 2024 promotes intra-regional trade. This move supports MSMEs by encouraging them to source and trade within the region, reducing costs associated with imports and boosting regional economic integration.
2. **Cost Reduction:** MSMEs that import these goods from EAC Partner States will benefit from lower

import costs due to the excise duty exemptions. This reduction in costs can improve their competitive edge, allowing them to offer more competitive pricing and enhance their market position.

3. **Encouragement of Local Production:** These exemptions incentivize MSMEs to partner with suppliers within the EAC, fostering local production and supply chains. This can lead to increased demand for local goods and services, stimulating growth within the region.
4. **Simplified Compliance:** Clear exemptions based on the EAC Rules of Origin provide MSMEs with a straightforward framework for compliance. This clarity helps businesses plan their sourcing and supply strategies more effectively, reducing the administrative burden associated with navigating complex tax regulations.

B. Detrimental Features of the Finance Bill 2024 for Digital MSMEs

I. Introduction of Motor Vehicle Tax

Finance Bill 2024 Reference:	9
Income Tax Act Reference:	Proposed new section 12H
Recommendation	The proposal should be dropped

The Finance Bill 2024 introduces a new tax mandating a Motor Vehicle Tax payable at the time of issuance of an insurance cover. This tax is to be calculated at a rate of 2.5% of the vehicle's value, with a minimum payment of KES 5,000 and a maximum of KES 100,000. The valuation of a motor vehicle is based on its make, model, engine capacity, and year of manufacture.

1. **Increased Operational Costs:** The introduction of the Motor Vehicle Tax will significantly increase the operational costs for digital MSMEs considering their heavy reliance on transportation for last-mile delivery. The additional cost imposed by the Motor Vehicle Tax will further strain their financial resources, potentially reducing their profitability and sustainability.
2. **Reduced Investment Capacity:** The higher tax obligations resulting from the Motor Vehicle Tax will limit the ability of MSMEs to invest in critical areas such as marketing, staff training, and equipment upgrades. With increased operational costs, the profits and cash flow of MSMEs will be adversely affected, making it more challenging to secure loans from banks and microfinance institutions (MFIs). Given that less than 20% of the loan book is allocated to MSMEs, primarily in the trade (45.2%), real estate (19.4%), transport and communication (11.3%), and agriculture (2.4%) sectors, higher input costs will exacerbate the difficulty of accessing affordable credit. This, in turn, will hinder their growth and competitiveness in both local and regional markets.
3. **Cash Flow Challenges:** Many MSMEs manage their cash flows by paying insurance premiums in instalments. However, the Motor Vehicle Tax must be paid in full upfront, which may not be affordable for many businesses. This requirement could force some MSMEs to either deplete their cash reserves or seek expensive short-term loans to cover the tax, further exacerbating their financial stress.
4. **Unequal Tax Burden:** One of the fundamental principles of taxation is equity. The proposed Motor Vehicle Tax disproportionately impacts MSMEs that depend heavily on vehicles for their operations, such as public transport companies, ride-hailing entrepreneurs, taxi services, and delivery companies. These businesses will bear a heavier tax burden compared to those that do not rely on vehicle fleets, creating

an unequal financial strain on different sectors.

5. **Impact on Climate Agenda:** The Motor Vehicle Tax may inadvertently undermine efforts to combat climate change. Faced with higher tax obligations on newer, more valuable vehicles, MSMEs and individuals might opt to retain or purchase older, less fuel-efficient vehicles with lower valuations to minimize their tax liability. This shift could increase the prevalence of high-emission vehicles on the roads, counteracting environmental initiatives aimed at promoting the use of fuel-efficient, hybrid, and electric vehicles.
6. **Questionable Public Service Benefit:** While the motor vehicle tax has the potential to enhance tax collection and contribute to road infrastructure improvements, it raises questions about its necessity and efficacy, considering that Kenya already imposes a Road Maintenance Fuel Levy (RMFL) of KES 8 per litre on petrol and diesel. This levy is allocated to various funds, including the annuity fund, road maintenance, rehabilitation, and development. The introduction of an additional motor vehicle tax could be perceived as redundant and burdensome, without a clear indication of the specific public services it aims to support.

II. Deletion of Exemption for Electric Bicycles

Finance Bill 2024 Reference:	42
Income Tax Act Reference:	The First Schedule to the Excise Duty Act Part I - Excisable Goods
Recommendation	The proposal should be dropped

The Finance Bill 2024 proposes the deletion of the description "Motorcycles of tariff 87.11 other than motorcycle ambulances, locally assembled motorcycles and electric motorcycles" and the corresponding rate of excise duty. This effectively introduces VAT on electric bicycles, which were previously exempt.

1. **Increased Costs for Green Transportation:** The introduction of VAT on electric bicycles increases the purchase cost for digital MSMEs relying on this form of transportation for last-mile deliveries. Electric bicycles are a cost-effective and environmentally friendly option, especially for small businesses in urban areas that require efficient mobility for deliveries and other operations. The added VAT will raise the overall expenses, making it less affordable for MSMEs to adopt or maintain green transportation solutions.
2. **Hindrance to Sustainability Goals:** By imposing VAT on electric bicycles, the Finance Bill 2024 creates a financial disincentive for businesses to adopt sustainable practices. This move contradicts global trends and local initiatives aimed at promoting eco-friendly transportation to reduce carbon emissions and combat climate change. MSMEs striving to align with sustainability goals will face increased costs, which may deter them from investing in greener alternatives.
3. **Negative Impact on Innovation and Modernization:** The additional tax burden on electric bicycles could stifle innovation and modernization within the MSME sector. Businesses that might have considered upgrading to electric bicycles for their efficiency and environmental benefits may reconsider due to the higher costs imposed by the VAT. This reluctance to modernize could hinder overall sector growth and adaptation to modern, sustainable practices.
4. **Increased Operational Costs:** For MSMEs that have already incorporated electric bicycles into their operations, the new VAT will result in higher operating expenses. This increase in cost will affect the bottom line, especially for businesses operating on thin margins. The higher expenses may need to be passed on to customers, potentially making their services less competitive.

5. **Disproportionate Impact on Small Businesses:** Small businesses, particularly those in delivery services, retail, and small-scale logistics, will be disproportionately affected by this change. These businesses often rely on electric bicycles for their cost-efficiency and ease of use in congested urban areas. The additional VAT will place a heavier financial burden on them compared to larger businesses that have more resources to absorb such costs.
6. **Potential Reduction in Adoption of Electric Bicycles:** The increased cost due to VAT may lead to a reduction in the adoption of electric bicycles by MSMEs. This could slow down the shift towards greener transportation options in Kenya, which is essential for reducing pollution and enhancing urban mobility. The policy change could lead to a preference for cheaper, less environmentally friendly transportation options, negating progress made in promoting sustainable practices.

C. Proposed Additional Amendment: Investment Allowance for Digital Marketplace Platforms

Finance Bill 2024 Reference:	N/A
Income Tax Act Reference:	Second Schedule (Investment Allowance)
Recommendation	Start-ups should claim an investment allowance of 50% of the cost incurred in building a digital marketplace platform in the first year of use

Rationale

Building and operationalising a digital marketplace platform requires substantial capital investment. Just as manufacturers invest in factories to produce goods, digital entrepreneurs invest heavily in technology infrastructure, software development, and digital platforms to facilitate online commerce. Recognizing these investments as analogous to traditional capital expenditures can provide significant support to resident start-up entrepreneurs, fostering innovation and growth in Kenya's digital economy.

Proposed Amendment

To support the burgeoning digital economy, we recommend an amendment to the Second Schedule of the Income Tax Act to extend investment allowance benefits to the costs incurred in building digital marketplace platforms. Specifically, this amendment would classify the development of these platforms as qualifying capital expenditures.

Suggested Amendment Text

Amend Section 1(1) of the Second Schedule of the Income Tax Act to include digital marketplace platforms as eligible for investment allowance. The proposed text could be as follows:

Digital Marketplace Platform Development by an eligible start-up company: 50% in the first year of use.

Justification

1. **Encouraging Digital Innovation-** Providing investment allowances for the development of digital marketplace platforms will encourage innovation and entrepreneurship in the digital sector. This support is crucial for start-ups, which often face significant upfront costs with limited initial revenue.
2. **Economic Growth and Employment-** The Finance Bill 2024 proposes the removal of excise duty on

goods and services produced within the East African Community (EAC). The dual approach of providing investment allowances for digital marketplace platforms and removing excise duty on EAC goods/services will create a more favourable business environment, help create jobs, increase digital literacy, promote economic inclusivity, drive local production, and enhance regional trade.

3. **Level Playing Field-** This amendment will create a level playing field between traditional and digital businesses, ensuring that the tax system evolves in line with the changing nature of the economy. By recognising the substantial investment required to build digital platforms, the tax code will more accurately reflect contemporary business realities.

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Viffa Consult Limited
www.viffaconsult.co.ke
One Padmore Place, George Padmore Road
info@viffaconsult.co.ke
Tel: +254 769 713 936