# Digital Service Tax: How Incoherent Regulation Turns Predatory

**By Maryanne Nduati**

A coherence check is an evaluation of the extent to which legal instruments such as the Digital Service Tax (DST) achieve their own stated objectives with efficacy, effectiveness and efficiency. As the economic slump bites and Kenya's debtors start calling, the extent to which the Kenyan government is coherent in its regulation is directly linked to Kenya's social and economic stability. While government regulation can be convoluted, the coherence check framework makes clear what the meaning of regulation is to you.

The DST, which came into effect on the 1st of January 2021, is a 1.5 per cent tax on the gross transaction value of all digital products and services in Kenya. The inexhaustible scope of products and services covered by this tax ranges from downloadable content to data analytics services. Stripped down to its core regulatory intent, the DST is a transfer of wealth from private actors in the digital sector to the government. The short-run purpose of the DST is to grow the tax base while the long-run objective can be considered as to boost tax revenue. How coherent then, is a 1.5 per cent tax on digital products, services and marketplaces to its own objectives?

I meet Ndunge at her second-hand clothes stall in a busy part of the city, as I collect a piece. Since the first COVID-19 lockdown, she has had to create an account on a popular social media application to find new markets, ensure that she doesn't lose her long-term clients and most importantly, to survive the slump in demand in her sector. Ndunge's online clothing sales are technically subject to the DST. She dismisses my questions about the DST with "vile itakam" (whatever will be). Ndunge is required to submit DST returns by the 20th of each month but she will not be doing so. She is strikingly disengaged from a fiscal rule that is imbued with the potential to destroy a business she has painstakingly built. Our digital service provider explains that the government is not justified in its pursuit of 1.5 per cent of all her business, a view that she assures me is almost ubiquitous amongst her colleagues. The dismissive bitterness that frames her opinion of the government and its taxes is a sign that her political disillusionment is morphing into something altogether more sinister.

> The DST is a transfer of wealth from private actors in the digital sector to the government.

At the philosophical level, Ndunge entered into a social contract with the Government of Kenya when she started her business. She wittingly or unwittingly expected to receive a public services bundle – political decision-making access and a voice in the distribution of the tax burden in exchange for her taxes. Her perceived imbalances in this transaction, coupled with the persistent allegations of corruption within government have created a legitimacy gap. Legitimacy is the key ingredient in the administration of tax or any coercive law. It motivates compliance, encourages group discipline in rule following and significantly reduces enforcement and monitoring costs for regulators. Without legitimacy, the incumbent government must use violence, legal or otherwise to achieve its compliance objectives, and I guess in Ndunge's case, they will have to.

To violently compel Ndunge and the 86 per cent of Kenya's informal sector workforce to comply with the DST, the government will undoubtedly need to invest significant resources in the requisite tax infrastructure to register, motivate and monitor compliance. As the DST is an experimental tax, even in jurisdictions with robust tax infrastructure and legitimacy, this significant public investment will have to be undertaken without a clear return on investment.

Based on the foregoing, the first question that arises about the DST is its efficacy**.** The decision to regulate must first be informed by the evaluation of how much coercive force is required to achieve the objective of a greater tax reach and an increase in tax revenue. As illustrated by the above, the government's legitimacy gap, the required investment in tax infrastructure and the unclear return on investment raise questions on the feasibility of the DST.

The DST is designed as a prescriptive rule by the Kenya Revenue Authority (KRA) that requires the regulatory target (digital products and service providers) to register and submit their monthly DST returns in compliance with the Finance Act 2020. However, a glaring design flaw is the DST's blanket provision of 1.5 per cent of the transaction value for all digital business, without the differentiation of income/turnover thresholds. The KRA's inability to prioritize regulatory targets or identify classes of digital services/products to earmark is, first and foremost, punitive to local micro, small and medium-sized (MSMEs) digital enterprises. Pitting the compliance capacity of multinational digital content providers against the limited resources of MSMEs is not only amoral, but it sabotage's the KRA's objectives.

With no clear regulatory priorities, the KRA is faced with a system capacity overload, where regulatory resources are spread too thinly to successfully target, motivate and monitor compliance. The natural, resulting equilibrium is the committed non-compliance of MSMEs, the bedrock of Kenya's economy and the main regulatory target. Simply put, there is no incentive for a middling Kenyan lifestyle blogger with no technical capacity to calculate and engage with the regulatory requirements of the DST and comply. Moreover, the expectation that it should cost the same amount for the blogger as for Netflix is preposterous. The DST here is demonstrably ineffective in the pursuit of its own objectives.

In addition to alienating the core tax revenue-generating actors in this jurisdiction, the DST is bound to have a “chilling effect” on the sector. First, in the short term, there is loss of consumer welfare as those digital actors who can transfer the cost of the DST to consumers, have and will. The more perverse effect of the DST however, is the loss of the “silicon savannah”, the unregulated space of digital innovation, with global recognition and ramifications.

> Pitting the compliance capacity of multinational digital content providers against the limited resources of MSMEs is not only amoral, but it sabotage’s the KRA’s objectives.

There is a sickening but almost comforting familiarity to the ruination of exceptional things, people and spaces in this country. The sequence is clear: A new and disruptive idea, technology, market or product is created and the novelty is exploited by those most disenfranchised to create capital. The now productive sector catches the attention of the government, which directs its monopoly power to regulate. Gradually, the inefficiencies of “the Kenyan experience” emerge while incentives to innovate, grow and create are strangled. The capital previously owned and generated by the innovators, finds its way back to the political class and the sector withers, the status quo is maintained. This unfortunately is how “the cookie crumbles” in the digital products/services sector – the inefficiencies that have dogged other sectors are finally in the digital space. The distributive injustice of the DST to the youth, MSMEs and other disenfranchised groups is only more compelling when viewed in light of the rampant distortionary effects of corruption in this jurisdiction. In effect, this tax is a perverse re-distribution of resources from the most efficient interest group – disenfranchised private sector actors – to the government. The DST is in this case manifestly predatory while retarding growth in the sector.

As a policy analyst, I wonder what the strategic regulatory intent of the DST was when considering its cost/benefit spread. While the benefits of the DST accrue to the government, digital financial services providers are beneficiaries by exemption. It is noteworthy that digital financial service providers are the primary beneficiaries of a previously unregulated digital sector. Digital financial services providers developed their products in a regulatory vacuum and created the economies of scale that now allow them to compete internationally. As the most profitable economic entities in Kenya and possibly in the East-African Community, why should they be exempt from the DST? The economic rationale of this exemption is unclear as these financial service providers are experiencing profit gluts after recouping their digital infrastructure investments. Unmistakable interest group politics are at play here, bringing into question the regulatory intent of this tax.

> The more perverse effect of the DST however, is the loss of the “silicon savannah”, the unregulated space of digital innovation, with global recognition and ramifications.

A coherence check on the Digital Services Tax illustrates the inefficacy, ineffectiveness and inefficiency of its intent, design and effects. I find that the government’s legitimacy gap is likely to promote committed non-compliance among the regulatory targets. Therefore, in order for the KRA to achieve its regulatory targets, it must employ legal violence. Additionally, the DST’s blanket provision is a limiting design feature that discourages compliance, creates perverse incentives and retards growth and innovation in the sector. These distorted outcomes all ensure that the fervent attempts by the KRA to substantively increase tax reach, fail. Finally, the exemption of digital financial service providers from the scope of the DST is indicative of interest group politics in the sector that are destructive to growth and innovation.

Given the adverse effects of the DST, MSMEs and other interested stakeholders in the sector need to confront the rising tide of incoherent regulation by urgently organizing and engaging with the regulatory process. The recent increase in internet taxes (Finance Act 2021) is an indication that the government will not relent in its redistributive efforts. Digital service providers must form a clearly defined interest group because only by pre-emptive engagement with the Ministry of Information, Communication and Technology on its policies, positions and instruments can they have the analytical and relational capacity to insulate themselves from predation, in line with their contemporaries in the digital financial services sector.

---

*Published by the good folks at The Elephant.*

*The Elephant is a platform for engaging citizens to reflect, re-member and re-envision their society by interrogating the past, the present, to fashion a future.*

*Follow us on Twitter.*