Value-added Tax in the Pharmaceutical Industry: what does it really mean for Kenya’s industrialisation?

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Introduction

A key issue for many countries is how to manage trade taxation policy in such a way that necessary public revenue can be acquired but not at the cost of long term industrialisation. An important area here is that of VAT and how best to levy it with respect to the pharmaceutical industry. The two pieces of regulation in point here are the VAT Act 2013 which was effective from 2nd September 2013, and its amended form, the Value-added Tax (Amendment) Act 2014 which came into effect from 29th May 2014. The former aimed at maximising tax revenue by minimising the number of products eligible for VAT exemption (only finished pharmaceutical products remained exempt from VAT) while the latter amends this to exempt “inputs or raw materials” for the manufacture of medicaments by pharmaceutical manufacturers in Kenya. The aim has been to ensure that the competitiveness of locally manufactured pharmaceuticals is not undermined by the enactment of the 2013 Act.

Local manufacturing of pharmaceutical products in Kenya is focused on generic medicines on the Kenya Essential Medicines List 2010. This orientation of the industry offers the possibility of improving affordability, availability and quality of essential medicines. As such, the local industry has an important role. The 2014 Amendment Act aims to protect low income citizens from rising prices of basic essential medicines. However, there still remains ambiguity regarding implications of the indirect tax regime on local manufacturing. This short paper argues that there are still a number of unresolved issues which merit further attention.

Key issues:

• Changes made to exempt “inputs or raw materials” from VAT remain ambiguous
  Do “inputs or raw materials” only include listed raw materials (934 active pharmaceutical ingredients and excipients) and 47 packaging materials?

• The question of “hidden costs” remains unclear
  A further lack of clarity with regards to “inputs” relates to hidden costs. Suppliers of inputs to the industry may pass on the VAT through higher costs to the pharmaceutical manufacturer.

• Supplements can be life saving for example in cases of malnutrition, leukaemia and other chronic diseases
  The tariff codes identified as exempt from VAT do not relate to supplements. Furthermore, supplements attract 7% excise duty or 25% customs duty in addition to VAT.

• What about the role of technological inputs in improving competitiveness?
  The indirect taxation strategy does not pave the way for advanced manufacturing insofar as technological inputs are concerned.
The pharmaceutical industry: a driver for Kenya’s industrialisation?

The national industrialisation policy 2011-2015 identifies the pharmaceutical industry as one of the priority sectors earmarked to drive the industrialisation process of the country. Currently, locally manufactured pharmaceuticals meet about 28 per cent of the local demand (excluding donor-funded “demand” for pandemic medicines). The industry is thought to have potential for substantial growth to address both local and regional demand. Direct sales in the domestic market account for about 40 per cent of local production. The national pharmaceutical policy aims to “encourage local manufacture of essential medicines for self-sufficiency in the domestic market and promote growth in pharmaceutical exports.” The expected outcome is a reduction in cost of pharmaceutical products.

VAT and local pharmaceutical manufacturing

Previously imports of inputs were duty and VAT exempt and local inputs including packaging materials were zero rated and therefore eligible for VAT refund. Arguably, there was a need to rationalise Kenya’s VAT, which was largely viewed as “complex, inefficient and not productive”. However, prospects of developing a dynamic and competitive industry were curtailed by the VAT Act 2013.

The VAT Act 2013 exempted only finished products; this meant that locally manufactured products were far less competitive than imports because inputs including raw materials required for manufacturing were liable to 16 per cent VAT.

Zero rated tax incentives for the pharmaceutical industry scrapped The VAT Act 2013 exempted only finished products; the zero rated tax incentive for the pharmaceutical industry was scrapped with the enactment of VAT Act 2013. Only VAT tax exemption of identified products was maintained for the pharmaceutical industry.

As a result, locally manufactured medicines had become up to 22 per cent more expensive than imported medicines. As such, changes brought in by the 2013 ACT were in direct contradiction with the country’s strategy to unlock the potential of the pharmaceutical industry to achieve better health returns and drive industrialisation.

Does the amendment ACT of 2014 address this matter?

First Schedule in Part I, Section A item 46 “Inputs or raw materials (either procured locally or imported) supplied to pharmaceutical manufacturers in Kenya for manufacturing of medicaments, as approved from time to time by the Cabinet Secretary for National Treasury in consultation with the Cabinet Secretary responsible for health”.

Value Added Tax (Amendment) Act 2014

Changes to VAT with respect to the pharmaceutical industry relate to the insertion of item 46 in the First Schedule in Part I, Section A.

This change is accompanied by a list of 39 manufacturers (producers of human and/or animal health products), 934 raw materials and 47 packaging materials. It would be useful to understand the specific processes and criteria for approval in relation to item 46. In addition, the frequency with which the lists of raw materials and packaging materials are updated is crucial.Competitiveness of the industry must not be impinged upon as more competitive options of materials enter the global market. That notwithstanding, item 46 raises a number of issues, five of which are stated here:

(i) Interpretation of “inputs” is restrictive

While the interpretation of the term “raw materials” may be relatively clear insofar as APIs and excipients are concerned the interpretation of “inputs” should be reviewed. Services are a crucial component of pharmaceutical manufacturing; they are inputs into the manufacture of medicaments. Therefore, they should be considered for VAT exemption along with other inputs.

(ii) VAT for critical inputs raised

It also remains unclear why the more favourable VAT terms on other vital inputs required for the manufacture of medicaments such as electricity were scrapped. The reduced VAT rate of 12 per cent that was applicable on electricity and heavy diesel was raised to 16 per cent.
(iii) “Hidden” VAT problematic

A further lack of clarity with regards to “inputs” relates to hidden costs i.e. when inputs are procured locally the VAT they will have attracted may be passed on to the pharmaceutical manufacturers as cost rather than VAT. The shift from zero rated tax to VAT exemption means that the entire supply chain is affected by VAT. There is now no clear way of distinguishing pharmaceutical manufacturers from other buyers of similar inputs.

(iv) Supplements matter for basic health need

The tariff codes identified as exempt from VAT do not relate to supplements; in addition, supplements attract 7% excise duty or 25% customs duty in addition to VAT. Supplements can be life-saving in cases of malnutrition, diarrhoea and certain chronic diseases. Supplements should be considered for VAT exemption.

(v) Technological inputs are crucially important

VAT on plant and machinery (chapter 84 and 85 tariff headings) does not point towards a trajectory that would strategically position the industry to actualise the potential for substantial growth to address both local and regional demand.

Machinery and equipment that is specific to the pharmaceutical industry such as (air handling equipment), and a requirement for meeting standards (safety, efficacy and quality), should be considered within the 5th Schedule of the VAT Act. Furthermore, imported spare parts, for example, attract PVoC costs. Whilst inspection by the Bureau of Standards is necessary to minimise the risk of unsafe and substandard products entering the local market, inspection costs charged to manufacturers can constrain competitiveness of the industry.

If Kenya’s pharmaceutical industry is to deliver on its potential, it must be ensured that policy instruments of the country’s broad economic policy strategies including fiscal policy do not undermine the pharmaceutical industry development strategies.

Does the VAT (Amendment) Act 2014 contribute to strategically positioning the local industry?

Kenya views local manufacturing of essential medicines as an important path to addressing domestic demand for pharmaceuticals. Kenya is also hyped as the largest producer of pharmaceutical products in the Common Market for Eastern and Southern Africa (COMESA) region; it is estimated that Kenya supplies about 50 per cent of the region’s production. In relative terms, however, this translates into a minute share of the COMESA market. Kenya’s exports contribute to well under 0.5 per cent of COMESA’s market. Prospects to increase Kenya’s contribution to both the domestic and regional market can be undermined by cognate strategies including indirect taxation.

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Acknowledgements: The research was funded by the Department for International Development (UKaid) and the Economic and Social Research Council, UK. The opinions expressed in this publication are the sole responsibility of the authors.

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