Economic Freedom and Taxation: Finding the Right Balance

Jackline Kagume

Leo Kipkogei Kemboi

Constitution, Law and Economy Programme

May 31, 2023

Outline

1. Background and introduction
2. Defining Economic Freedom
3. Understanding Taxation (purpose and objectives)
4. Balancing economic freedom and taxation (Analysis of various tax laws; key highlights)
   - Income Tax Act
   - VAT Act
   - Excise Duty Act
   - Customs Duty Act
   - Tax Procedures Act
5. Lessons and recommendations/conclusions

Background

- Recent developments > Insufficient recognition of need to balance between economic freedom and taxation policy
- (Finance Bill 2023)
- Arbitrary violation of canons of taxation > Implications for growth & revenues
- Need for policymakers to consider the impact of taxation on economic freedom when designing tax policies

Defining Economic Freedom

Economic Freedom:

The ability of individuals to make their own economic decisions without interference, coercion or limitations by government (Heritage Foundation& Fraser Institute)

- Key components of economic freedom
  - Property rights
  - Rule of law
  - Free trade
  - Limited government intervention

Understanding Taxation: Purpose & Objectives

Taxation:

- Imposition of mandatory charge or other levies by government on individuals or legal entity primarily to raise revenue for govt expenditures

-Mandatory payment or charge collected by the State from individuals or businesses

Purpose of taxation:

1. Revenue generation
2. Provision of public goods
3. Redistribution of wealth

(Reducing income inequality, and promoting social welfare)

4. Economic stabilization

Balancing Economic Freedom and Taxation:

Canons of Taxation

1. Equity
2. Certainty
3. Convenience
4. Economy

- Challenges of striking the right balance between economic freedom and taxation
- **Excessive** taxation:
  - Hinder economic growth
  - Discourage investment/entrepreneurship
  - High tax rates >> diminishing returns >> potentially reduction in overall tax revenue

Taxation Policies for Economic Freedom

- Explore taxation policies that promote economic freedom;
  - Lower tax rates
  - Simplified tax systems-predictable and uniform
  - Broadening the tax base
  - Taxation should meet objectives

Balancing Economic Freedom and Taxation: (Analysis of various Tax Laws)

1. Income Tax Act (Proposed Amendments)

Section 9 (Finance Bill 2023)

Objective of the amendment is to broaden the scope of the turnover tax by including businesses with a turnover ranging from **KES 500,000 to KES 1 million**, which were previously exempted. Additionally, the proposal suggests raising the turnover tax rate from **1% to 3%.**

Proposal aims to boost tax revenue, but there is a concern that it could inadvertently drive informal businesses even further towards adopting strategies to evade compliance.

Section 24(b)1 (Finance Bill 2023)

Increasing taxes on employees earning more than KES 500,000 per month to shore up tax revenue may have a negligible impact on revenue given that majority of employees earn below KES 100,000 per month.

Could create disincentives for high earners, increase the risk of tax avoidance and evasion, and potentially hinder economic growth.

Section 24 (b)7 (Finance Bill 2023)

-Amendment requires that persons making payment to digital content creators be required to withhold and remit 15% withholding tax

To ensure fairness and equity, government should establish a graduated tax rate that distributes the burden of taxation proportionately.

Encourage growth of the digital industry >> contribute to growth in tax revenue.

Change of due date for withholding tax

- Increases compliance burden

Increases cost of compliance >Requires level of automation to comply,

Reduces preference of Kenya as an investment destination

Reclassification of the exportation of services from standard rated to exempt status

- An implication of this proposal is that any input VAT cost incurred by an entity exporting services outside Kenya would no longer be recoverable
- This would result in the input VAT cost becoming an additional expense for the exporting entity.

Creates inefficiencies

Excise Fees on Financial Transactions

- Excise Taxes levied on all fees charged by Financial Institutions
- Excise Taxes levies on all fees charged by Digital lenders

Increases the cost of borrowing and financial transcations, violate pigouvian rule

Excise Taxes – Mobile Telephony, Internet & Fees on Money Transfers

- Increase in excise duty on fees charged for transfer services by cellular phone may lead to a decrease in the number of transactions
- Levying excise duty on telephone, internet, and fees charged on money transfer services by banks, money transfer agencies and other financial services

Increases cost of financial transfers, inefficient trade off

Security on Appeal to High Court

- Before filing an appeal with the High Court, the Bill proposes to amend the Act to require a deposit of 20% of the tax in dispute or an equivalent amount with the Commissioner.
- Requires amount be settled in 30 days

Goes against Supreme Court Decision (caselaw), Prejudicial, could incur further liabilities (interest)

Amendment of an assessment

- Widens commissioners powers in an ammendment (could allow multiple assessemnets and ammendments)
- Changes to word "original" to assessments that commissioner may ammend

Taxations Powers are constitutional powers and constrained, fails test of fair administration, creates unpredictability (unlike in free markets)

Housing Levy

- Mandatory/Forced Savings Schemes
- Design≉Tax (legal mandate)
- Many unknown issues in design

Affects personal choices, voluntary exchange, competes with GoK Regulation role, affects competition in markets, free markets, embeds inequity through redistribution

Select Evidence of Distortionary effects of Taxes

- Romer & Romer
  - Tax increase of 1 percent of GDP lowers real GDP by about 3 percent after about two years.

[(Christina Romer & David Romer, The macroeconomic effects of tax changes: estimates based on a new measure of fiscal shocks, 100 American Economic Review 763-801 (2010)]

- Alesina & Ardagna
  - Fiscal stimuli based on tax cuts are more likely to boost growth than spending increases.
  - Fiscal consolidations based on spending cuts and no tax increases are more likely to succeed in reducing deficits and debt and less likely to cause recessions than tax increases-based fiscal consolidations.

[Alberto Alesina & Silvia Ardagna, Large changes in fiscal policy: taxes versus spending, in Tax Policy and the Economy, Vol. 24 (Univ. of Chicago Press, 2010).]

- IMF Study
  - *That spending cuts are much less damaging to short term growth than are tax increases. They find a 1 percent spending cut has no significant effect on growth, whereas a 1 percent tax increase reduces GDP by 1.3 percent after two years*

[International Monetary Fund, Will it hurt? Macroeconomic effects of fiscal consolidation, in World Economic Outlook: Recovery, Risk, and Rebalancing (2010)]

Lessons & Recommendations

- Taxation affects economic freedom
  - Aggressiveness of tax administrator
  - Appropriation of disposal income
  - Changes behaviour (affects choices)
- More or Less Taxes is not an efficiency measure of GoK Dev Trajectory (Foundation Problem in Econ)
- Taxes have a distortionary effect, hence any tax proposed has an opportunity cost
  - Is it an efficient tradeoff btn more revenue & more choices for K & Y
  - Is it an efficient tradeoff btn more revenue & reallocation of K
  - Effects on Poverty and Inequality: National Treasury's public expenditure review 2017 (Page 43) found that **VAT and excise tax increase poverty** and have a **small, negative effect on inequality**.
- Provide Sunset clauses
- Tax code & structure of the economy
- Size of Govt & Tax Code
- Other issues affect revenues other than tax rates i.e tax bouyancy, shocks in the sectors of the economy
- Ammend section 41 of PFM Act 2021 to make it conditional for Parliament to consider Finance Bill *(Section 41 of the PFMA requires that not later than ninety days after passing the Appropriation Bill, the National Assembly shall consider and approve the Finance Bill with or without amendment*)

References

1. Finance Bill 2023
2. McBride W, 'What Is the Evidence on Taxes and Growth?' (*Tax Foundation*18 December 2012) https://taxfoundation.org/what-evidence-taxes-and-growth/
3. Egger, Peter, and Hannes Winner. "Economic Freedom and Taxation: Is There a Trade-off in the Locational Competition between Countries?" *Public Choice 118*, no. 3 (2004): 271-288. Accessed May 30, 2023. https://doi.org/10.2307/30026015.
4. Alberto Alesina & Silvia Ardagna, Large changes in fiscal policy: taxes versus spending, in Tax Policy and the Economy, Vol. 24 (Univ. of Chicago Press, 2010).
5. Christina Romer & David Romer, The macroeconomic effects of tax changes: estimates based on a new measure of fiscal shocks, 100 American Economic Review 763-801 (2010).
6. International Monetary Fund, Will it hurt? Macroeconomic effects of fiscal consolidation, in World Economic Outlook: Recovery, Risk, and Rebalancing (2010)
7. Kim, Anthony B. *2023 Index of Economic Freedom*, 2023. https://www.heritage.org/index/pdf/2023/book/2023_IndexOfEconomicFreedom_FINAL.pdf.
8. Kemboi, Leo Kipkogei, and Emmanuel Wa Kyendo. "Rule of Law and Economic Freedoms as the Key to Improve National Welfare." IEA Kenya, August 9, 2021. https://ieakenya.or.ke/blog/rule-of-law-and-economic-freedoms-as-the-key-to-improve-national-welfare/.
9. The National Treasury and Planning. "2017 Comprehensive Public Expenditure Review: From Evidence to Policy." Goverment of Kenya-State Department For Planning Monitoring And Evaluation Department, November 2018.
10. Kemboi LK, 'Policy Reforms on Process of Varying National Tax Code: Making the Submission and Consideration of the Finance Bill Conditional.' (*IEA Kenya*4 May 2022) https://ieakenya.or.ke/blog/policy-reforms-on-process-of-varying-national-tax-code-making-the-submission-and-consideration-of-the-finance-bill-conditional/