Institute of Economic Affairs

Political Economy Analysis of Taxation Policy in Kenya

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Outline

1. Intro & Background
2. Tax Code
3. Policy Concerns & Study Questions
4. Optimal Taxation?
5. PEA of Kenya’s taxation system
6. Powermap analysis
7. Pathway for Reform

Background on the Tax Policy Analysis

1. Citizen voices missing from debates on tax policy.
2. Limited effectiveness of policy engagements on tax policy by the public and Special Interest Groups (SIGs)
   - (Non-inclusive policies)
3. Complex, incoherent and non-inclusive tax policy
4. Need for public education to support citizen groups and build capacity for acquisition and use of evidence in engagement with policy makers to improve formulation, review and reform of tax policies

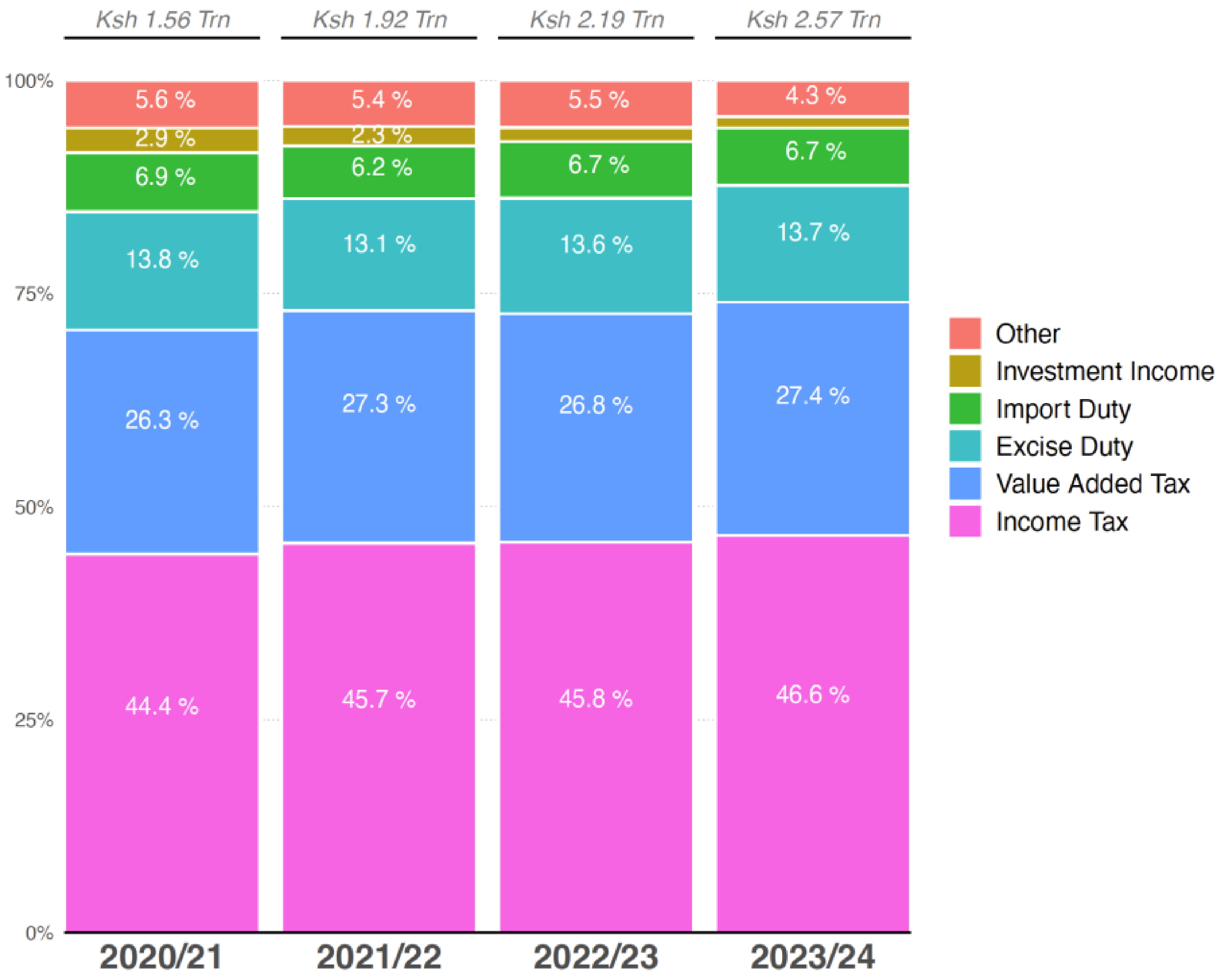
Introduction

- Kenya’s Tax Code is complex
- Policy Formulation of Tax Code is influenced by PEA factors which include incentives, institutional factors, which could be formal and informal
- The call for more taxes in Kenya has always been anchored on “More Development”
- Article 210, The authority to set taxes falls on Parliament

What Constitutes Tax Code Code?

Main Legislation	Main Legislation	Legislation governing the application of the tax code	Subsidiary Legislations
Constitution of Kenya, 2010	• Income Tax Act 1973 (Revised 2022) • Value Added Tax, 2013 (Rev 2022) • Excise Duty Act 2015 (Rev 2022) • Customs duties and other import and export duties	• Tax Procedures Act 2015 • Kenya Revenue Authority Act • Public Finance Management	Most of these regulations were drafted by CS National Treasury to operationalize the main legislation

Kenya's Tax Heads



What does this PEA seek to address?

a) What is the nature of Kenya's political ecosystem in which taxation policy is developed and implemented?

b) What are the structural and institutional factors influence tax policy formulation and implementation?

c) To what extent does evidence guide Kenya's tax code?

d) What are the specific incentives towards optimal tax rates

e) What are the asymmetries of information in access and influence in these processes?

f) What formal and informal processes shift the direction of policy changes towards optimal taxation?

Policy Concerns and Study Questions

- Kenya's taxation system is not buoyant, i.e., Kenya's taxes and tax base do change in proportion with the growth in the economy
- Existence of hard to tax sectors
- Increase in tax rates can no longer increase
- Kenya Tax Code is misaligned with country’s economic structure

What is Optimal Taxation?

- Optimal taxation refers to the design of a tax system that maximizes social welfare while minimizing economic distortions and equity concerns.
- Optimal taxation theory, in technical and economic terms, often revolves around determining the tax rates and frameworks that lead to efficient resource allocation and fair outcomes without excessively restraining economic activity. This may involve intricate modelling of economic behaviours and preferences, considering aspects such as income distribution, spending habits, and savings rates. (Mankiw et al., 2009).
- Diamond and Mirrlees (2016) explain that the overall goal of optimal taxation is to keep taxes low and moderate while still generating sufficient revenue for government expenditures and public goods.
- Key principles of optimal taxation that we have developed using Diamond & Mirrless and Mankiw et al. typology:
  1. Efficiency: Taxation should minimize disturbance to economic decision-making and reduce inefficiencies.
  2. Equity: The tax system must be just, with individuals contributing based on their financial capacity.
  3. Simplicity: The tax system must be easy to comprehend and adhere to to reduce administrative and compliance expenses.
  4. Transparency: Taxpayers need a clear understanding of tax regulations and how taxes are computed.
  5. Administrative Efficiency: The taxation framework should be straightforward and cost-effective for administration.
  6. Neutrality: Taxes should strive not to favour one type of economic activity or decision unless non-neutrality is part of the policy objective (e.g., taxing negative externalities).
  7. Flexibility: The system needs to have the ability to adjust to changes in economic conditions without necessitating major revisions.

PEA of Kenya’s Taxation System

1. Problems with Finance Bill

- There are two issues with the Finance Bill
  - The bill being omnibus has problem of;
    - Omnibus bills have the potential to limit debate and scrutiny because of their comprehensive nature

- The bill is mandatorily required to be tabled in Parliament and this is a problematic issue because;
    - The legal issues contained in the bill revised the tax code on an annual basis annually without an analysis of what the previous revisions to the tax code have yielded.
    - Ideally, you would expect the National Treasury to only revise the tax code in the medium term (3-5 years) after a robust check of the evidence whether
      - (i) the tax was not significantly distortionary
      - (ii) evidence showing the need for revision of rates whether upwards or downwards.

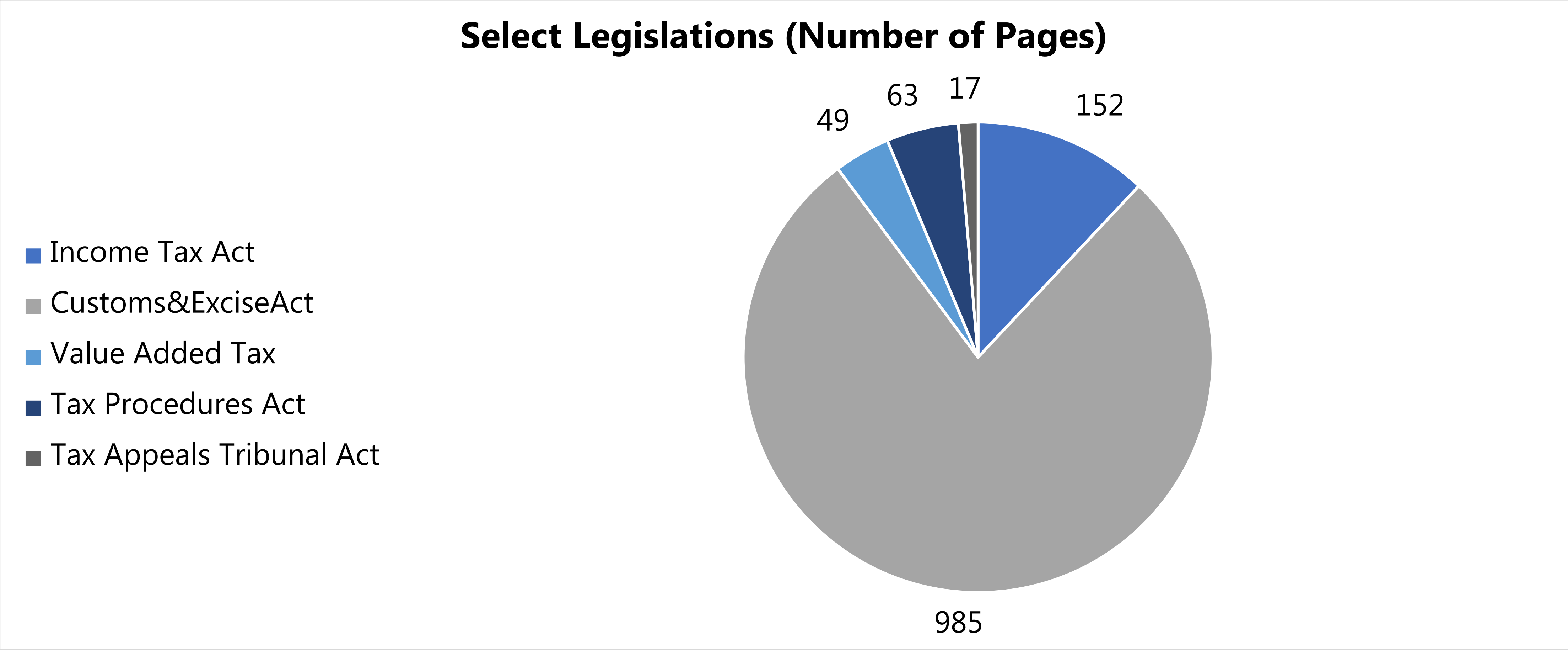
1.1. Unintended Consequences of Mechanism of Ammending Taxes through Finance Bill Annually.

..Frequent Revisions

Law	Date of Commencement	Date of Assent	Number of times repealed
Income Tax Act	1st January, 1974.	21st December, 1973.	49
Customs& Excise Act	13th October, 1978.	25th September, 1978.	45
Value Added Tax	2nd September, 2013.	14th August, 2013.	8
Tax Procedures Act	19th January, 2016.	15th December, 2015.	7
Tax Appeals Tribunal Act	1st April, 2015.	27th November, 2013	7

1.2. Unintended Consequences of Mechanism of Ammending Taxes through Finance Bill Annually.

…Growth of the Size of the Tax Code



2. Old Constitutional PFM Norms Still Exist in the 2010 Constitution Dispensation

- Parliament has been given all powers on determining revenue & spending
- KRA> Tax Admin, but engages in Tax Policy & Changing Direction of Policy
- Parliament’s role in Taxation has been donated
  - Arguments for Fiscal Expansion have been largely advanced by National Treasury
  - Role on Tax Abandoment

Other PEA Issues…

3. Mandatory Nature of Consideration of Finance Bill

4. Political Processes- For example, the messaging by the main political actors towards the electorate is on promises or the rewards they would get if they voted for their party.

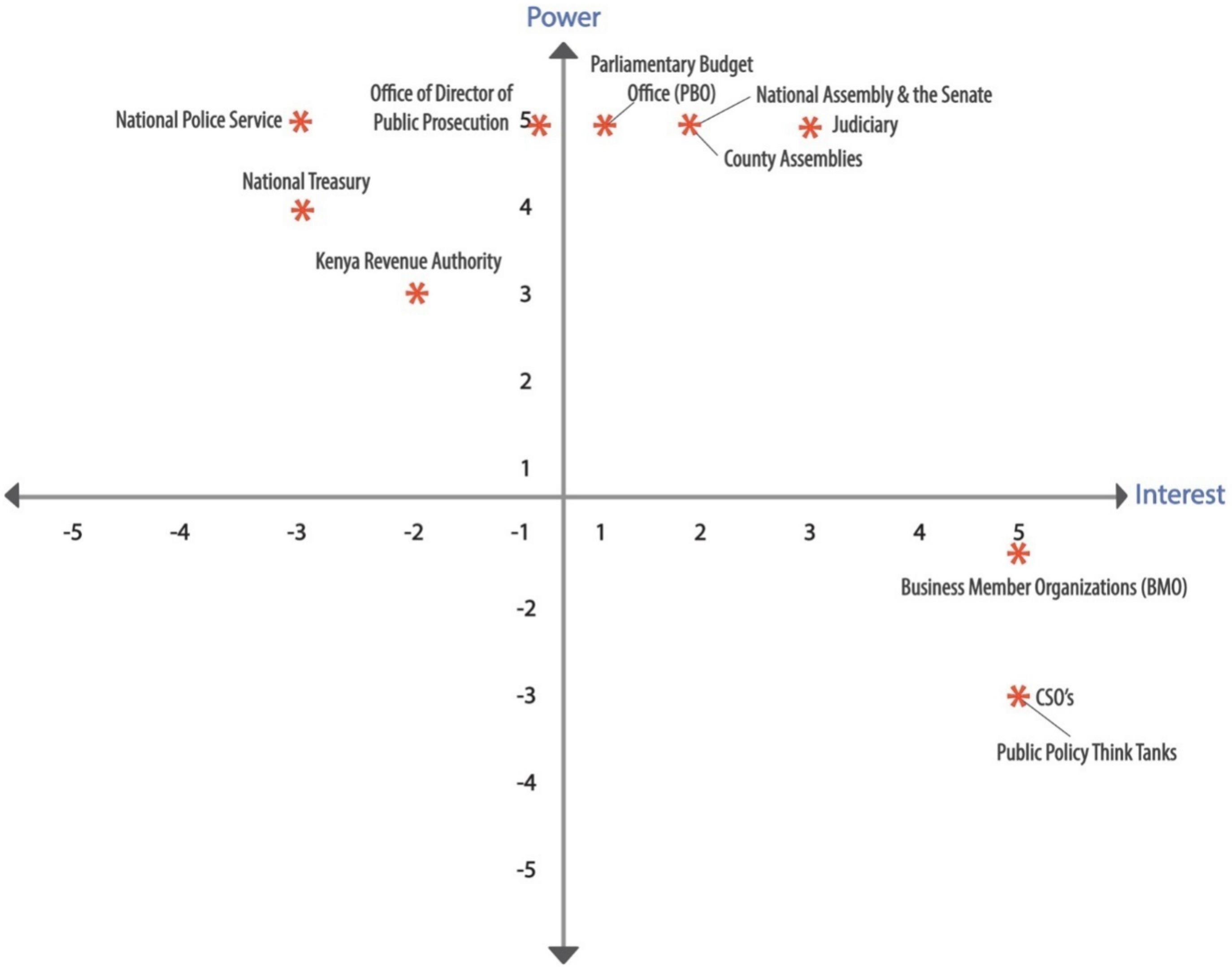
5. Convergence between Legal, Process, and Economic Problems

- **Interplay between Fiscal Policy, Taxation System and Economic Policy Agregates**
- **Type of Growth, extent of govt participation in the economy**
- changes in tax measures will not generate additional revenue if the tax system lacks tax buoyancy and elasticity and if tax rates fall outside the Laffer curve.
  - The responsiveness of tax revenue growth to changes in GDP is referred to as tax buoyancy. When a tax is buoyant, its revenue rises without raising the tax rate.
  - Tax elasticity quantifies the effect of changes in GDP on tax revenue.
  - According to the Laffer Effect, an optimal tax rate maximizes revenue because excessively high rates discourage economic activity and reduce tax revenue. E.g. Excise Tax on Beer, Cigarettes

Primary Players in the Formation of Tax Code in Kenya

1. **Parliament (National Assembly and the Senate)**
2. **National Treasury**
3. **Kenya Revenue Authority (KRA)**
4. **Political Parties**
5. **Business Member Organizations (BMO)**
6. **Office of Director of Public Prosecution**
7. **National Police Service**
8. **Parliamentary Budget Office (PBO)**
9. **County Assemblies**
10. **Judiciary**
11. **Universities**
12. **Public Policy Think Tanks**

Power Map Analysis



Pathway for Reform (Interest & Reform Focus)

	Interest	Reform Focus
Parliament	Sustainable Public Finances	Low and Moderate taxes/ Low deficits/Equity and Gender Analysis of Taxes/Require evidence in tax processes
National Treasury	Macroeconomic Stability	Bouyant tax system/use evidence to influence tax systems/ Low and Moderate taxes
KRA	Tax System dependendent on voluntary compliance	Confine its powers to only tax admin/Simple Tax Code

Other agencies in the pathway for Reform

- Judiciary
- County Assemblies
- ODPP
- PBO
- BMO
- CSO's
- Universities
- Think tanks

Conclusion

Areas for Reform

1. Review of the Length & Complexity of the Tax Code
2. Ensure checks and balances of agencies task with tax system
3. Improve use of evidence in tax system especially on introduction and variation of tax rates
4. To ensure predictability, tax rates should only be reviewed in the medium term
5. In the medium, ensure that Kenya’s tax system is bouyant
6. Conduct Fiscal Incidence Analysis to determine wether the tax system is equitable, and also has no gender bias

End!

Thank you!

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