Taxation and Tax Modernization in Kenya:

A Diagnosis of Performance and Options for Further Reform

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Executive Summary

Kenya introduced the Tax Modernisation Programme in 1986 with the hope that this would, among other things, enhance revenue collection, improve tax administration and reduce compliance and collection costs. Despite the tax modernization, there are concerns that the challenges that confront the Ministry of Finance and Kenya Revenue Authority today are not much different from the challenges that faced these revenue authorities before the reforms. There are also concerns that tax competitiveness in Kenya is low and the country remains among the most tax unfriendly countries in the world. This study reviews tax revenue performance as well as tax design and administration changes during the period 1996 - 2005 in order to identify priorities for further tax reform.

Empirical analysis reveals the adverse effect of inflation on tax revenues. The tax structure is less buoyant and possibly inelastic although indirect taxes, and not direct taxes, hold the capacity to improve the flexibility of the tax system. The challenges that confront tax design include taxation of agriculture and the informal sector, repeal of tax holidays, high effective protection, high dispersion of tariff rates, detailed and rigid custom rules, poor response of VAT to reforms, weak capacity to process large volumes of returns and refunds for zero-rated transactions. In addition, Kenya's tax system is burdensome in terms of time taken to prepare and submit tax returns.

The study concludes that further tax reforms should give priority to the following areas: first, taxation of the informal sector by designing simplified registration processes and giving the sector treatment other than that provided by the current methods and tax code. Second, there should be a policy shift towards internationally acceptable investment incentives such as accelerated depreciation for qualifying manufacturing assets. Third, tax productivity should be improved through simplifying the tax structure and reducing the tax rates, reviewing cumbersome custom procedures and enhancing the tax monitoring function. Fourth, lowering effective protection of Kenya's products by reducing tariffs with the goal of achieving broad-based uniform tariffs. Fifth, strengthen tax administration through developing integrated tax payer registration systems; simplifying tax laws, forms and procedures; developing frequently updated information systems on registered tax payers; and intensifying the use of automatic triggering mechanisms. Sixth, the response of VAT to economic and policy changes should be enhanced by strengthening the administrative capacity (personnel, computers and audits) to handle large volumes of returns and refunds; and continue to harmonize the VAT rates. Seventh, the tax system should be insulated from inflation effects by ensuring that adequate indexing procedures are applied to accurately account for full movements in prices.

Finally, there is need to build vertical accountability of the tax system by ensuring that tax payers are more involved in the formulation of tax policy and planning for any reforms.

1

Introduction

In Kenya, taxation is the single largest source of government budgetary resources. Between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants). Relatively, the importance of non-tax revenue is also significant in sustaining the public budget, although its importance is much less than the role of taxation given that it's share over the same period was 15.1%. Foreign grants play a minimal role as they have averaged only 4.5%. Given it's central role, taxation has been applied to meet two objectives. First, taxation is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. Second, it is used to mobilize revenue in ways that are equitable and that minimize its disincentive effects on economic activities.

Over time, Kenya has moved from being a low tax burden country to a high tax burden country[2], yet the country faces the obvious need for more tax revenues to maintain public services. Given the high tax burden, prospects to raise additional revenue seem bleak. In addition, Kenyans are yet to accept a tax paying "culture". On one hand, those with political power and economic ability are few and do not want to pay tax. On the other hand, those without political power are many, have almost nothing to tax, and do also resist paying taxes. Since no one enjoys paying taxes, there is mistrust between those collecting taxes and taxpayers. This mistrust generates a game theoretic co-existence between tax agents and tax payers, with agents perceiving taxpayers as criminals unwilling to pay their taxes, and tax payers wary of government agencies' high-handedness in collection of taxes (KRA, 2004). This creates the need for the tax agents to improve their image by building trust and public confidence.

Even though the tax system has continuously changed, in pursuit of the objectives of the *Tax Modernization Programme* that came into force in 1986, the challenges that confront the tax authorities today are not much different from the pre-reform challenges. With Kenyan firms reporting that about 68.2% of profit is taken away in taxes, tax competitiveness is low and the country remains among the most tax unfriendly countries in the world[3]. Tax evasion remains high, with a tax gap[4] of about 35% and 33.1% in 2000/1 and 2001/2 respectively (KIPPRA, 2004a). The tax code is still complex and cumbersome, characterized by uneven and unfair taxes, a narrow tax base with very high tax rates and rates dispersions with respect to trade, and low compliance (KIPPRA, 2004b). Additional challenges[5] include tax systems with rates and structures that (1) are difficult to administer and comply with; (2) are unresponsive to growth and discretionary policy hence low productivity; (3) raise little revenue but introduce serious economic distortions; (4) treat labor and capital in similar circumstances differently; and (5) are selective and skewed in favor of those with the ability to defeat the tax administration and enforcement system.

[2] The tax/GDP ratio was 9.7% at independence, 14.31% in 1970/71 and 21.1% in 2005.
[3] See www.doingbusiness.org
[4] Measures the difference between the tax that ought to be paid according to statutes and that which is actually paid.
[5] See Karingi *et al* (2004a).

This paper discusses some of the important issues related to tax administration, tax policy and tax modernization as implemented in Kenya. This is approached from both macroeconomic and microeconomic viewpoints using data from 1996 to 2005. The macroeconomic perspective focuses mainly on issues of tax yields and structure of taxation while the microeconomic perspective looks at specific issues of tax design and tax administration.

The rest of the paper is organized as follows. Section one provides the rationale and scope of the study. Section 2 describes Kenya's tax reforms including the challenges that are facing further reforms. Section 3 reviews the trend in tax revenues as well as the structure of taxation. Tax structure design issues are discussed in section 4 while tax administration issues are discussed in section 5. The study is concluded in sections 5 and 6 which provide policy prescriptions and areas for further research, respectively.

2

Why Tax Reform?

Tax reform is the process of changing the way taxes are collected or managed by the government[6]. It may involve the adoption of a Value Added Tax (VAT), the expansion of the VAT, the elimination of stamp and other minor duties, the simplification and broadening of personal or corporate income or asset taxes, or the revision of the tax code to enact comprehensive administration and criminal penalties for evasion (Mahon, 1997). Institutional aspects of tax reform involve the Semi-autonomous Revenue Authority Model, where traditional line departments are separated from the Ministry of Finance and granted the legal status of semi-autonomous authorities. Tax reform involves broad issues of economic policy as well as specific problems of tax structure design and administration (Musgrave, 1987). At the theoretical level, tax reforms are initiated either following an economic crisis or as a response to international pressure (Mahon, 1997).

Beginning in the mid-1980's, tax reforms became part of the larger Structural Adjustment Programmes that were incorporated in the economic restructuring agreement between the Government of Kenya and the International Financial Institutions (Fjeldstad and Rakner, 2003). Unfortunately, such reforms focused on the Central Government tax system but left out local government tax reforms. Substantial tax reforms followed fiscal crises that were being experienced at the time and the resulting pressures for reform from the IMF and World Bank. The pressure to liberalize happened simultaneously with the realization within the Government that the economic situation was untenable (Cheeseman and Griffiths, 2005). Thus, Kenya's tax reform was adopted voluntarily to gain favor with powerful international donors.

Prior to the reforms, especially in the 1964-1977 period, the country's fiscal operations were somehow less troublesome. The Government incurred minimal fiscal deficits and was able to contain its expenditure (current expenditure and part of development expenditure) within the recurrent revenue limits. The lower fiscal deficits were also as a result of a generous flow of donor grants and aid. However, the onset of internal and external shocks in the late 1970's seriously upset the budget balance and resulted into fairly large fiscal deficits.

Given the destabilizing effects of the deficits and the fact that they were becoming unsustainable, the Government through Sessional Paper No 1 of 1986 (GOK, 1986)) came up with measures to address the problem. The most notable fiscal policy proposals were the *Tax Modernization Programme* (TMP) that was adopted in 1986 and the *Budget Rationalization Programme* that followed in 1987 (Muriithi and Moyi, 2003). The former programme was aimed at enlarging the government revenue base whereas the latter involved regulating expenditure through strict fiscal controls. According to Sessional Paper No 1 of 1986 (GOK, 1996), the TMP had the following policy goals;

[6] http://en.wikipedia.org/wiki/Tax_reform

- Raise the tax revenue-GDP ratio from 22% in 1986 to 24% by the period 1999/2000[7].
- Promote saving and investment by placing a greater burden on taxation of consumption and removing any disincentives to investment.
- Devise a tax structure that distributes income equitably and promotes rural-urban balance.
- Make industry more competitive through reviews of import duties and export compensation.
- Design a buoyant and elastic tax system that keeps revenues expanding at the same pace with income growth without annual changes in rates.
- Reduce compliance and administrative costs through low and rationalized tax rates, wider tax bases, self-assessment systems and taxpayer education and services.
- Improve tax administration by sealing leakage loopholes, making wider use of computers and enhancing audit surveillance and establish effective data management systems;
- Invigorate the growth of the fledgling capital market.

As part of the reform package, the Kenya Revenue Authority (KRA) was incorporated in 1995. KRA was designed with autonomy (self-governance) enhancing mechanisms, including self-financing mechanisms, a Board of Directors with high-ranking public and private sector representatives, and *sui generis* personnel systems (Taliercio, 2004). Thus, KRA amalgamated the five main revenue departments that were initially in the Ministry of Finance namely Customs Duty, Excise Duty, Sales Tax, Income Tax and Corporate Tax). By running on business principles and by being semi-autonomous, KRA was designed to be less vulnerable to political interventions and to have the leverage to recruit, retain, dismiss and promote quality staff by paying salaries above civil service terms. This was intended to motivate staff and reduce corruption. But there are concerns that KRA exists mainly to respond to the demands of IMF and World Bank and not domestic concerns over equitable taxation and the disincentive effects of taxation on economic activity. It is estimated that in the fiscal years 2000/2001 and 2001/2002, respectively, only 65 per cent and 66.9 per cent of the potential income tax revenue was collected by the Kenya Revenue Authority (KIPPRA, 2004a).

Has reform been without challenges? One of the most prominent challenges to reforms is the presence of a large untaxed informal sector as well as high levels of revenue leakage. Similarly, VAT has responded very poorly to reforms yet it is the most important indirect tax. There has been the problem of ambitious and rapidly changing tax/GDP targets that are externally induced as well as the failure to reform local government taxation. One of the mistakes of the Kenyan tax reform program was poor sequencing, which resulted in policy reforms preceding administrative tax reforms (Karingi et al, 2005). Whereas tax policy reforms commenced in 1986, administrative reforms were initiated in 1995 when KRA was established. This discrepancy resulted in lagging collections amounting to Ksh 61.8 billion for income tax and Ksh 27.7 billion for VAT by 2004.

There was also the problem of domestic resistance to reforms including the opposition by local sugar producers to the liberalization of the sugar sub-sector to COMESA imports and the opening up of the cereals sector under the Free Trade Area agreements. In 1998, the Minister of Finance proposed to increase the tax levied on subsidized loans to bank employees as a way of broadening tax base through taxing employer provided benefits. In response, around 12,000

[7] In 1992, the objectives were revised to include raising the tax revenue/GDP ratio to 28%. This has been further revised by the Economic Recovery Strategy for Wealth and Employment Creation to maintain tax revenues above 21% of GDP (GOK, 2003).

bank employees began a nation-wide strike. As the strike entered its sixth day, paralyzing businesses, their employers announced that the striking workers would be sacked. In response, Kenya's trade union federation threatened to call a national strike and, recognizing the difficulty of the situation, the Minister was forced to reverse the decision.

The KRA introduced Electronic Tax Registers (ETRs) in 2005 to ensure full remittance of VAT by retailers. This was resisted openly through strikes and street demonstrations in major towns in the country. Currently, ETRs are the subject of court battles between KRA and Traders (under the United Business Association). The introduction of Simba 2005 system, an online value declaration customs system, has been strongly resisted, especially after it became evident that some imported vehicles had escaped the net following collusion between importers and customs officials.

An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms. The political elite, who posses high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. This is what happened in November 2006, when Parliament rejected some of the June 2006 budget proposals by the Minister of Finance. The proposals rejected included a tax on entertainment and house allowances for holders of constitutional offices, a tax on yearly donations to political parties exceeding Ksh 1 million, tax on sale of houses by individuals (capital gains tax), an increase in tax on fortified wines from 45% to 65%, a proposal to tax cigarettes differently, and the proposal to shift the 7% sugar cane development levy from consumers to farmers.

3

Level and Structure of Tax Revenue

3.1 Trend in Tax Yields

Between 1996 and 2005, total tax revenues increased from Ksh 127.03 billion to Ksh 298.9 billion (see Annex Table 1). However, in real terms, tax revenue increased from Ksh 127. 03 billion to Ksh 145.81 billion. This is depicted in Figure 1. The figure shows that whereas nominal tax revenues increased throughout the period, real tax revenues fell below the 1996 levels from 1999 to 2004 and only recovered in 2005.

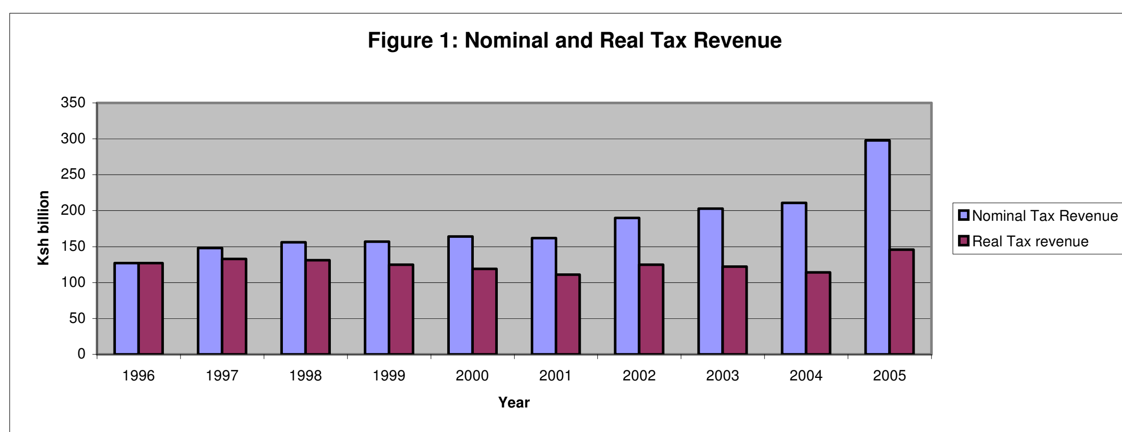


Table 1 shows that the nominal annual growth in tax revenues during this period was 3.19%. In terms of individual taxes, the tax with the fastest annual growth (in nominal terms) was VAT, which grew at 4.21% annually while the most stagnant tax was income tax revenues, which grew by 3.23% annually. Custom revenues shrunk by 0.84% annually over 1996-2005. The fall in customs revenue can be mainly explained by the protracted trade liberalization processes under the structural adjustment programme and the regional and multilateral trade agreements.

Table 1: Annual Growth Rates in Tax Yields and Bases, 1996-2005

Tax	Growth in Tax Yield		Proxy Base	Growth in Base	
	Nominal	Real		Nominal	Real
Income Tax	0.0323	-0.0003	Domestic Factor Incomes	0.0461	0.0146
VAT	0.0421	0.0095	Private consumption	0.0468	0.0154
Custom Duties	-0.0084	-0.0410	Imports	0.0410	0.0084
Excise Duties	0.0390	0.0064	Private consumption	0.0468	0.0154
Total taxes	0.0319	-0.0007	GDP	0.0458	0.0131

Source: Computed from log trend estimates using both constant and nominal figures.

Nominal measures can be deceptive, because they can mask effects of changes in the rate of inflation. Table 1 reports real annual growth rates. It is clear that aggregate tax revenues have shrunk by 0.07% while custom revenues have shrunk by 4.1%. The only taxes that have grown

in real terms are VAT and excise tax revenues. These results suggest that inflation has had a potentially adverse effect on tax revenues in Kenya. Analysis shows that except for import tax revenues with a correlation coefficient of –0.346, all the other tax revenues are highly correlated with inflation. Correlation coefficients were 0.933 for total taxes, 0.891 for income taxes and 0.985 for VAT. There is a low but negative correlation between import taxes and the consumer price index.

Table 1 also reports the growth rates of the various proxy tax bases. The respective proxy bases are domestic factor incomes (income tax), private consumption (VAT), imports (custom duties), private consumption (excise duties) and GDP (total taxes). The results indicate that all the proxy bases grew at rates exceeding 4% in nominal terms. However, in real terms, all the tax bases grew at rates falling below 1.6%. Similarly, a comparison between the expansion in tax bases and the respective tax revenues in real terms reveals interesting findings. First, all the tax revenues lagged behind the real expansions in their bases. This can be explained by the inelasticity of the tax system, existence of tax evasion and the effects of a large untaxed informal sector. Second, whereas income taxes and custom duties shrunk in real terms, their bases grew. Third, whereas real GDP grew by 1.3%, total taxes decreased by 0.07% annually. These discrepancies between the growth in tax bases and the tax revenues reflects poor tax design and weak policy formulation to the extent that the tax system fails to adequately capture any changes in economic activity. Were taxes progressive enough, then any growth in incomes would automatically be matched by increases in tax revenues.

In relative terms, the share of total tax revenue in GDP was 24% in 1996 but this fell to 21.1% in 2005 (Table 2). This fall was mainly due to tax policy changes that sought to lower the tax burden. Notably, the policy target in 1986 was to achieve a tax/GDP ratio of 24%. This was revised in 1992 to 28% and in 2003 to 24%. In terms of broad categories, the ratio of income tax to GDP varied between 5.5% and 9.1% between 1996-2005 although slowly declining over time. The VAT/GDP ratio seems to have stayed almost constant at about 5.6% over the period. However, there is a notable decline in excise duties and import duties. The ratio of excise duties to GDP fell from 4.5% to 3.9% between 1996 and 2005 while the ratio of import duties to GDP fell from 4.3% to 1.8%. Thus, there is a clear shift way from international trade taxes towards taxes on domestic goods and services.

Table 2: Share of Tax Revenues in GDP, 1996-2005.

	Total Taxes	VAT	Income Tax	Excise Duties	Import Duties
1996	0.240	0.056	0.091	0.045	0.043
1997	0.237	0.055	0.089	0.046	0.044
1998	0.224	0.056	0.080	0.041	0.041
1999	0.211	0.055	0.072	0.038	0.038
2000	0.170	0.052	0.055	0.029	0.030
2001	0.159	0.050	0.055	0.031	0.021
2002	0.186	0.056	0.066	0.042	0.019
2003	0.179	0.052	0.062	0.042	0.019
2004	0.165	0.049	0.061	0.035	0.017
2005	0.211	0.056	0.082	0.039	0.018

Source: Own computations

At the macroeconomic level, it has been often argued that Kenyans are highly taxed. Is this really the case? The literature has attempted this question by making international comparisons. Results have shown that Kenya's tax/GDP ratio has stayed above the SSA average for a long time (Tanzi, 1987; Wagacha, 1998; Amin 2000). For instance, World Bank's Africa

data base (2004) shows that Kenya's tax ratio of 18% exceeds the ratios reported for comparator countries such as Mauritius (15.5%), Mali (11.1%), Tanzania (10.8%), Madagascar (9.3%), Gambia (11.2), Mozambique (12.5%), Ethiopia (16.7%), Zambia (17.6%) and Malawi (16.3%). This high tax/GDP has been interpreted to reflect an excessive tax burden and high efficiency costs of taxation (Wagacha, 1998). This implies that policy should focus on the distributive impact of the tax burden. Similarly, there is need to understand whether expenditure side has in-built mechanisms that could forestall the disincentives created by taxes.

3.2 Composition of Tax Revenue

The most important taxes in Kenya are taxes on goods and services. The share of these taxes in total revenue has remained consistently high at over 47% during the fiscal period 1991/2 to 2003/4 (Table 3). This reflects achievement of the TMP objective of promoting saving and investment by transferring a greater burden on taxation of consumption. According to Musgrave (1987), consumption should be the preferred tax base because, unlike income taxation, consumption taxation is associated with low deadweight loss or efficiency losses and do not discriminate in favor of present consumption over future consumption.

Despite the policy shift towards indirect taxation, taxes on income and profits have continued to play a significant role in Kenya's revenue structure. Income taxation allows the tax authorities to introduce some progressivity into burden distribution. In 2003/4, taxes on income and profits constituted about 37% of total revenue. However, between 1991/2 and 2003/4, the share of taxes on income and profits fluctuated within the range 32% and 40%, making it the second most important element of the tax structure. However, when taxes on goods and services are broken down, VAT contributes the largest share (over 60%) of taxes on goods and services. The importance of taxes on international trade in Kenya's revenue share has been declining in line with trade policy shifts away from protectionism. For instance, tariff rationalisation started in 1988/89 reduced the number of tariff categories from 25 to 17. These changes led to lower import duty rates in line with trade liberalization regime (Karingi, 2004b).

Table 3: Tax structure (share of total tax revenue), 1991 - 2004

	91/2-92/3	93/4-94/5	95/6-96/7	97/8 -98/9	99/0 -00/1	01/2 -02/3	03/4
Taxes on income and profits	0.36	0.40	0.39	0.37	0.34	0.35	0.37
Taxes on goods and services	0.53	0.43	0.43	0.45	0.47	0.52	0.50
Value-added tax	0.39	0.27	0.23	0.25	0.28	0.31	0.3
Local manufactures	0.14	0.13	0.12	0.14	0.15	0.16	0.17
Imported manufactures	0.25	0.14	0.11	0.12	0.14	0.15	0.13
Excise duties	0.14	0.15	0.19	0.19	0.18	0.19	0.19
Other taxes and licenses	0.00	0.01	0.01	0.01	0.01	0.01	0.01
Taxes on international trade	0.12	0.18	0.19	0.19	0.20	0.14	0.13
Import duties	0.12	0.17	0.18	0.18	0.18	0.12	0.11
Other taxes	0.01	0.01	0.01	0.02	0.02	0.02	0.02
Total Tax revenue	1.00	1.00	1.00	1.00	1.00	1.00	1.00

Source: Own computations

3.3 Buoyancy of Revenues

An important property of the tax system is to generate automatic growth in fiscal revenues over time without necessarily resorting to discretionary policy or inflationary financing (Martinez-Vazquez, 2001). Such a system allows revenues to grow faster than the growth in GDP.

Changes in tax revenues result from; (a) tax bases grow with the economy or because changes in the tax laws broaden the tax bases, (b) increase in tax rates, (c) better enforcement of an existing tax structure. When all these changes occur, the effect is captured by the buoyancy, which measures the responsiveness of the tax system to changes in economic activity as well as changes in discretionary policy[8]. However, elasticity is a more refined measure than buoyancy as it measures the responsiveness of the tax system to changes in economic activity (GDP) alone.

Table 4 shows the buoyancy index and the marginal propensity to tax (MPT) of Kenya's tax system. The results suggest that the overall tax system had a buoyancy of 0.662. Specifically, the tax system yielded a 0.662% change in tax revenue (resulting from both automatic changes as well as discretionary policy) for every 1% change in GDP. Thus, a decreasing proportion of incremental income was transferred to the government in the form of taxes, implying that the tax system was less buoyant. The MPT for the overall tax system is 0.148. Thus, a one shilling increase in GDP resulted in 15 cents increase in tax revenue. The tax with the highest marginal taxation is the income tax (6 cents).

Table 4: Buoyancy and Marginal Taxation, 1996 - 2005

Tax	*MPT*	*Buoyancy*
Income Tax	0.057	0.652
VAT	0.050	0.909
Customs Duty	-0.004	-0.154
Excise Duty	0.033	0.791
Total Taxes	0.148	0.662

Source: Own computations using regression analysis and applying the following definitions;

- $Buoyancy = {Y\Delta T}/{T\Delta Y}$ where Y and T are, respectively, GDP and tax revenue. ΔT and ΔY is the change in tax revenue and GDP.
- $MPT = {\Delta T}/{\Delta Y}$

Notably, all the taxes exhibit buoyancy indices below unity, which reflects inflexible individual taxes. In terms of individual taxes, VAT had the highest buoyancy index followed by excise duty and income tax. Customs duty was the most rigid tax with the lowest and negative buoyancy index. Thus, for every 1% increase in GDP, customs revenues shrunk by 0.004%. This implies that it is indirect taxes, not direct taxes that are likely to improve the buoyancy of the tax system in Kenya. Tax policy should therefore put more emphasis on indirect taxes especially VAT and excise tax.

3.4 Revenue Stability

Good fiscal management requires that revenues are stable over time. Revenue instability can complicate fiscal management since revenues cannot be forecast quite easily and predictably. The coefficient of variation is used to examine how the different sources of revenue vary relative to their mean over the 1999 – 2005 period (Table 5). As the coefficient of variation increases, the relative dispersion or variability of the series increases.

[8] This encompasses changes in tax rates, legislative enactment and improvement in collection techniques.

Table 5: Stability of Revenue Sources

		Income Tax	*VAT*	*Custom Duties*	*Excise Tax*	*Total Tax*
1996-1999	S.D	3,320.02	4,994.30	2,913.53	2,428.79	13,802.27
	Mean	53,126.20	36,116.78	26,702.56	27,323.76	146,853.03
	C.V	0.0625	0.1383	0.1054	0.0889	0.0940
2000-2002	S.D	7,537.15	3,846.64	4,731.92	7,442.81	15,615.34
	Mean	58,939.96	52,759.20	23,427.47	34,355.31	172,291.06
	C.V	0.1279	0.0729	0.02020	0.2166	0.0906
2003 - 2005	S.D	23,875.20	10,370.64	2,371.06	5,382.42	52,917.13
	Mean	88,413.17	66,851.00	23,010.33	49,483.67	238,009.00
	C.V	0.2700	0.1551	0.1030	0.1088	0.2223

Source: Own computations

Note: S.D = Standard deviation; C.V = Coefficient of variation

Several results are notable in table 5. The total tax system has been generally stable with the coefficients of variation falling below 1. All the individual taxes tended also to be less volatile. This may be explained by the setting of revenue targets by the Ministry of Finance, which have ensured that tax revenues maintain an upward trend despite the economic circumstances prevailing. Although this may be the case, volatility analysis is insufficient to indicate to us whether the targets set are realistic.

4

Tax Structure Design and Administration

Kenya, like many other developing countries, seeks to apply the tax weapon so as to meet the objectives of raising enough revenue and ensuring that revenue is raised in ways that are equitable and that minimize the disincentive effects of taxation. The three main factors of production –labor, capital and land- are used in varying proportions in the productive process of the economy. The returns to these factors- wages, profits and rent –should therefore be taxed if the objectives of the tax policy are to be met.

In Kenya, the tax system has mainly concentrated on taxing individual income (Personal Income Tax-PIT), profits (Corporate Income Tax-CIT) and goods and services (VAT, excise duties). However, for purposes of administrative feasibility as well as for political economy reasons, a tax on land has not yet been well developed in Kenya. The main challenges facing the taxation of factors of production in a low income country like Kenya includes: (i) *Structure of the economy:* This makes it difficult to impose some taxes. The larger the size of the informal economy, the more challenging taxation becomes. (ii) *Administration*: Limited capacity in tax administration. (iii) *Tax data:* Poor quality of basic data to estimate optimal taxation, forecast revenues adequately, undertake micro-simulations and tax modeling; and (iv) *Politics*: An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms. The political elite, who posses high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. The above challenges prevent the setting up of an efficient and effective tax system.

4.1 Tax Design

4.1.0. Income Taxes

For income to become a major source of revenue of a country, the following conditions must be fulfilled. First, the economy should be highly monetized. Second, there should be high literacy levels among tax payers. Third, taxpayers accounting records should be accurate, up-to-date and reliable. Fourth, there should be large scale voluntary compliance among tax payers. Fifth, there should be no interest groups which can block tax proposals they consider a threat. Sixth, there should be efficiency in tax administration.

The following arguments have been given against the income tax: First, due to its income elasticity revenues may decline during economic down turns. Second, it is prone to bracket creep due to inflation. Third, the tax is often used to give special preferences to certain groups or certain income types, thus disrupting the equity and efficiency advantages of the tax. Fourth, tax payers (employers, employees and self employed) often feel that compliance with the tax is cumbersome and expensive. Fifth, the tax may require a high level of administration, which imposes costs on the tax administrators.

In Kenya, income tax has been designed to target corporate profits (Corporate Income Tax - CIT) and employment (personal income tax, PIT, and Pay As You Earn, PAYE). Income tax is charged directly on business income, employment income, rent income, pension earnings, investment income (dividends, royalties), commission and so on. Income from self-employment is subject to the PIT while employment income is subject to PAYE. The PIT and PAYE are charged at the same graduated scale while CIT is charged on profits on limited liability companies. Other income taxes include fringe benefits tax, advance tax, taxes under Widows and Orphans Act and Parliamentary Pensions Act.

At the theoretical level, income taxation is applied to achieve broad objectives of income redistribution and revenue mobilization. In practice, Kenya has relied heavily on income taxation on the basis of ease of collection rather than on the basis of abstract principles of equity. This explains why the pre-reform period was characterized by high top marginal rates, very wide brackets between the lowest and highest brackets, discrepancy between CIT and PIT rates, too many income tax brackets, and low levels of compliance. Given these features, the main challenges of income tax reforms were to reduce the maximum rates, reduce the dispersion between the minimum and maximum rates, and rationalize the income tax brackets.

4.1.1. Personal Income Taxes (PIT)

Personal income taxes are justified on the basis of several theoretical arguments. It is argued that that PIT is income elastic since its revenue grows in proportion to income. Second, it is argued that PIT is progressive in its distribution of tax burdens. Third, PIT can be relatively neutral in its effects on economic decisions, thus reducing distortions in the economy.

The incidence of PIT falls entirely on the salaried persons and wage employees working in the formal sector. Before the reforms, the PIT system suffered from several setbacks. These include high marginal tax rates, discrepancies between nominal and effective progressivity, complexity of the system and tax evasion. During this period, the incidence of high top marginal tax rates fell disproportionately on a small proportion of the tax paying population and may have eroded the saving and investment levels. The income tax brackets in 2005 were: 10% on the first Kshs. 121,968; 15% on the next Kshs. 114,912; 20% on the next Kshs 114,912; 25% on the next Kshs. 114,912; and 30% on all income over Kshs. 466,704 (annually).

As is evident from table 6, there has been regular adjustment (horizontal and vertical) to the tax brackets in order to cushion the taxpayers against the effects of inflation. The reform period has witnessed a steep fall of the top marginal rates from 65% in 1986/87 to the current 30%. This fall in the top marginal rates were expected to induce personal savings. In order to lower nominal progressivity of the PIT system, tax brackets were reduced from 6 in 1997 to 5 in 2005. There has also been a unification of the single tax and the married (family) relief and regular reviews of the income tax relief whose current level is Ksh 13,944. In turn, the various PIT reforms have had the effect of increasing the number of those registered under PAYE from 274,344 in 1992/93 to about 1.8 million in 1999/2000[9]. In the period July to December 2004, a total of 10,791 new tax payers for income tax were recruited. Measures to expand the PIT and PAYE base included taxation of employer provided benefits, PAYE amnesty (1993), presumptive taxation of selected agricultural produce and taxation of foreign exchange gains.

[9] See Karingi *et al* (2005)

One of the most pertinent challenges facing the tax authorities has to do with differential treatment of dividend and interest income; they attract different rates even for the same income. The next challenge remains taxation of agriculture and the informal sector. Despite the use of presumptive taxes, this has been a problematic tax weapon (it was abolished in 1993 and re-introduced in 1995). The performance of the tax has been poor, despite the reform efforts at introducing it.

Table 6: PIT Brackets and Marginal Rates

1995	***1 – 78,000***	***10***	***1996***	***1 – 78,000***	***10***
	78,001 – 156,000	15		78,001 – 156,000	15
	156,001 – 234,000	20		156,001 – 234,000	20
	234,001 – 312,000	25		234,001 – 312,000	25
	312,001 – 390,000	35		Over 312,000	35
	Over 390,000	37.5			
1997	***1 – 82,080***	***10***	***1998***	***1 - 90,240***	***10***
	82,081 – 164,160	15		90,241 -180,480	15
	164,161 – 246,240	20		180,481 – 270,720	20
	246,241 – 328,320	25		270,721 – 360,960	25
	328,321 – 410,400	30		360,961 – 451,200	30
	Over 410,400	35		Over 451,200	32.5
1999	***1 – 94,800***	***10***	***2000***	***1 – 104,400***	***10***
	94,801 – 189,600	15		104,401 – 208,800	15
	189,601 – 284,400	20		208,801 – 313,200	20
	284,401 – 379,200	25		313,201 – 417,600	25
	379,201 – 474,000	30		Over 417,600	30
	Over 474,000	32.5			
2001	***1 – 109,440***	***10***	***2002-2004***	***1 – 116,160***	***10***
	109,441 – 218,880	15		116,161 – 225,600	15
	218,881 – 328,320	20		225,601 – 335,040	20
	328,321 – 437,760	25		335,041 – 444,480	25
	Over 437,760	30		Over 444,480	30
2005	***1 – 121,968***	***10***			
	121969 – 236,880	15			
	236,881 – 351,792	20			
	351,793 – 466,704	25			
	Over 466,704	30			

Source: Karingi et al (2005) and various Finance Acts.

Has PIT been used for redistribution? Generally, the taxation approaches used to address inequalities include imposing taxes to directly fund either cash transfers or social welfare progammes and tax exemptions. Kenya has mainly made use of exemptions. In addition, the country has applied income tax bracket expansions, regular reviews to the income threshold and personal relief as the main instruments of re-distributive taxation. However, tax credits are

believed to be more cost effective than family allowances since the latter cannot be more generous than the benefit provided by the tax credit. Apart from social security taxes, the country has not tried the targeted transfers approach. Since tax systems may only avoid taxing the poor but cannot increase their incomes, public expenditure policies are a better instrument for redistribution.

The share of the informal sector in Kenya's economy is large- accounting for about 18% of GDP. Many small-scale but prosperous business people, who are mainly self-employed, have enormous scope for evading tax. Those who work for Government and for large-scale employers have tax deducted from their wages at source and have no scope for evading tax. In such conditions, income tax tends to be very inequitable and the more the government relies on income taxation the less equitable the system becomes.

Recent changes in the public transport sector were aimed at restoring order, enhancing the working conditions and improving tax compliance. Since the changes were made without proper consultation with industry players, it has become clear that some of the proposals are un-workable due to poor tax design. For example, Public Service Vehicles (Matatu) owners are required to register as employers and operate Pay As You Earn (PAYE). Matatu owners with one or two vehicles are unlikely to be well versed with PAYE compliance requirements. This may result in non compliance penalties which are punitive. The operators are also required to prepare accounts and submit self-assessment returns. The cost of collecting and ensuring compliance may also be higher than the actual tax collected. Increased harassment by police and "informal taxes" they have to pay to the police makes the operation of public transport very challenging.

Has it enhanced economic efficiency? Reforms in PIT, which have lowered the rates and rationalized the system are likely to have enhanced the efficiency through the reduction of administrative and compliance costs. However, the extent to which these reforms have reduced prospects for tax evasion are uncertain since by 2003, about 85.9% of taxpayers interviewed felt the PAYE tax rates were either high or very high. In addition, about 22.9% of the respondents indicated that advice from the IT department was either poor or very poor. About 52.6% rated IT exemptions as being either poor or very poor.

4.1.2 Corporate Income Taxes (CIT)

Theoretically, a positive case can be built for the imposition of a corporate tax. This is based on several factors: (i) On equity grounds; (ii) Ease of administration for those companies that comply with statutory accounting standards; (iii) Political considerations make it more prudent to tax corporations -which have no votes - than taxing individuals; and (iv) The benefit principle where corporations should pay taxes in return for the benefits conferred by incorporation.

There are, however, negative sides to the imposition of corporate taxes. These include; (i) Corporation taxes have a retarding effect on he corporate sector to the extent that they discourage existing corporations from growing or deterring unincorporated businesses from adopting a corporate form or even encourage existing corporate to discard their corporate identity; (ii) Revenue yields from corporate income tax may be at the expense of private savings rather than consumption because corporate taxes mean that dividends are less than they should be; and (iii) Corporate income tax may become a deterrent to foreign capital inflow.

Prior to the reforms, the main problems of corporate income taxation included low levels of compliance, inefficient tax assessment and collection procedures of tax administration. Since enterprises are the engine of job creation and growth, lower corporate tax rates encourage investment, entrepreneurship and production by increasing the net reward for productive effort. In addition, lower corporate tax rates make Kenya tax competitive and therefore a suitable destination for foreign direct investment. Given this viewpoint, the most prominent feature of corporate tax reform was the reduction of the top rate from 45% in 1989 to 30% currently. Similarly, the top CIT rate and the top marginal PIT rate were unified as a means of increasing the disposable income for both corporate and individual capital investments. As well as reducing incentives for tax avoidance that results from differentiated top CIT and PIT rates. Similarly, the differentiated CIT rate structure was also rationalized by unifying the structure across all types of business. However, differentiated rates between local and foreign companies have persisted even during the reform period. This may act as a disincentive to local companies, which are not eligible for incentives that are available for their foreign counterparts.

The CIT system has also introduced incentives, designed to prop-up export-led industrialization and provide an enabling fiscal environment for Foreign Direct Investment. Foreign companies that invest in export processing zones (EPZs) are granted a 10 year corporate tax holiday[10], exemption from import duty, VAT (on all inputs except for motor vehicles) stamp duty and withholding tax over a 10 year period (see Annex Table 4 for investment incentives).

One of the challenges that CIT should address is the high tax burden. Firm level surveys as reported by the World Competitiveness Report 2004 – 2005 (WEF, 2004), indicate that Kenyan firms are highly taxed. Kenya's tax burden index[11] is 3.9 against a mean of 3.6 for the 104 countries reported. The highest and lowest scores were reported by Bahrain 1.5 and Malawi 4.8. Kenya is ranked in position 73 out of the 104 countries. In comparison, Uganda's and Tanzania's tax burden indices were both 3.5, slightly less than the mean. Mauritius had a score of 2.8. In relation to comparator countries, Kenya's tax burden is high by international standards, and is likely to impinge on the tax competitiveness of the country as a host for investors. This calls for lowering corporate taxation rates. This policy mitigates inflation effects because the company's taxable profit may differ greatly from its true earnings. The company may suffer an effective tax rate higher than the statutory rate. It may face large tax bills despite making inflation-adjusted losses. However, it should be observed that lowering the corporate tax rate faces the risk of revenue loss if the lower tax rate does not improve compliance to stimulate higher profit growth.

- ***Tax incentives issues:*** Some of the tax incentives applied in Kenya include tax holidays, investment allowances and tax credits, accelerated depreciation, investment subsidies, and indirect tax incentives. Tax incentives have been criticized for complicating tax administration, introducing inequities and being fundamentally interventionist. They favor

[10] OECD experience indicates that tax holidays have largely negative effects since they invite "round-tripping" or aggressive tax planning, which introduces inefficient competition. In Kenya, Kibua and Nzioki (2004) argue that EPZ's have become irrelevant in a liberalised environment and should be abandoned as there are minimal benefits to support incentives.

[11] This defined as the overall tax burden on the enterprise, including all associated costs (tax rates plus administrative and time costs, penalties, etc), is estimated (in per cent of net revenues) as (1= 0-4%, 2 = 5 – 15%, 3 = 16 – 25%,………8 = 81 – 100%).

new producers over existing business, they underwrite investment which cannot stand on their own merit in the absence of special tax breaks and favor capital-intensive projects over projects which use locally produced capital goods, favoring new production facilities over proper maintenance of existing ones. Surveys reveal that investors rate tax incentives rather low among the factors they consider in choosing between locations (Morisset and Prinia, 2001; EUR, 2001; Tanzi and Zee, 2000). Tax incentives make the tax system less transparent, less predictable and potential investors are likely to perceive taxation as less stable (i.e. they introduce a governance problem). Tax incentives for foreign investors shift the burden of taxation to immobile factors of production like labor. However, as noted by Tanzi and Zee (2000), tax incentives can only be justified if they address some form of market failure, most notably those involving externalities.

- ***Tax holidays:*** Tax holidays involve exemption for paying tax for a specified period of time. Although they are simple to administer, tax holidays have several shortcomings (Tanzi and Zee 2000). First, by exempting profits irrespective of their amount, tax holidays confer greater benefit to highly profitable firms that would have made the investment even if the incentive was not offered. Second, tax holidays provide an incentive for tax avoidance, as tax enterprises can collude with exempt ones to shift their profits through transfer pricing. Third, the duration of the tax holiday can be abused through creative redesignation of existing investment as new investment (for example, closing down and restarting the same project under a different name but with the same ownership). Fourth, time bound tax holidays tend to attract short run projects thereby distorting investment away from long-term towards short-term investments. Fifth, tax holidays create revenue losses for which treasury has no control, is not accountable, especially where the firms do not file tax returns. Sixth, they are distortionary and encourage capital to flow to where tax is lowest, rather than to where the economic return is highest.

- ***Tax credits and Capital allowances:*** Compared to tax holidays, tax credits and investment allowances have a number of advantages. They are designed to target particular investments and have the advantage of having a more transparent and controllable revenue cost. Capital allowances on machinery and plants used in farming, manufacturing, tourism and housing are generally generous and are issued faster than commercial accounts. However, these allowances may be abused in the absence of a capital gains tax, which could cater for balancing charges on sales. Assets subject to capital allowances may be charged at full prices and not on the original purchase price only. Second, they distort choice in favor of short-lived capital assets since further credit or allowance becomes available each time an asset is replaced. Third, qualified enterprises may attempt to abuse the system by selling and purchasing the same assets to claim multiple credits or allowances or by acting as a purchasing agent for enterprises not qualified to receive the incentive. Thus, the tax system should build safeguards to minimize these shortcomings.

- ***Accelerated depreciation:*** This incentive lacks any of the weaknesses associated with tax holidays and investment allowances. First, it is generally least costly, as the foregone revenue in the early years is at least partially recovered in subsequent years of the asset's life. Second, if the acceleration is made available only temporarily, it could induce a significant short-run surge in investment.

- ***Investment subsidies:*** Under investment subsidies, public funds are provided for private investment. They have the advantage of easy targeting although they involve may benefit nonviable as well as profitable ones.

Issues of double taxation: Taxation of profits and dividends creates the problem of double taxation.

- ***Withholding tax:*** In Kenya, tax is withheld at source for commissions paid by insurance companies to agents (15%), interest (10%), except when this is paid to banks and financial institutions, dividends (10%)[12], and sale of certain farm produce (5%). Under the present conditions, distributed earnings from company's ownership of a limited company are taxed twice: as a tax on company income and again as a tax on the distribution of dividends. This causes serious distortions.

- ***Triggering mechanism:*** An automatic triggering mechanism allows the investment to receive the incentive automatically once it satisfies certain clearly specified objective qualifying criteria. A discretionary mechanism involves approving or rejecting an application for incentives based on subjective value judgment of the incentive granting authorities. It is advisable to minimize the discretionary element in the incentive granting process.

- ***Customs Duties:*** The importance of custom duties in total revenues has continued to fall. Custom duties as a proportion of total tax revenues increased from 12% in 1991/2 to 18% in 1996/97. However, since 2000/1 there was a reversal in this trend – falling to 11% in 2003/04. This suggests that whereas initial liberalization increased revenues, further changes are likely to lead to sharp falls (Cheeseman and Griffiths, 2005). Custom duty reforms have involved; (i) tariff code rationalization, (ii) reduction of the average tariffs and, (iii) reduction of the number of tariff bands. Since the 1990s, reforms have been driven partly by development aid conditionality, preferential trade arrangements and efforts to comply with WTO regulations. Starting from 1990, there has been a gradual reduction in both the tariff rates - with special focus on imported intermediate inputs - and tariff bands. The main thrust of customs reform was implemented alongside trade liberalization whose main objective was to enhance trade openness by moving away from the restrictive import substitution strategy towards export-oriented industrialization.

Kenya's trade regime has been liberalized, apart from a small list of import licensing controls based on health, environmental and security concerns. The impetus for trade liberalization was provided by deteriorating export performance over the 1980's arising mainly from the low competitiveness of domestic industry. Trade liberalization started in earnest in 1987-89 by converting the quantitative or non-tariff restrictions to their tariff equivalents. This effort increased the simple average tariff rate from 40% to 46%. This was followed by a phased tariff reduction and rationalization of the tariff bands in 1990. These measures decreased the simple average tariff rate to 16.2% (from 46.3%) and the trade weighted tariff rate to 12.8% (from 25.6% in 1987-89) by 1997/98. Between 1987 and 1998, the top tariff rate was reduced from 170% to 25%, while the rate bands were reduced from 24 to 5 (including duty free). During

[12] But if the receiving company owns more than 12.5% of the voting power of the subsidiary concerned, the dividends received from the subsidiary are tax free.

the same period, there were duty rate declines on capital equipment (from 15%-25% to 5%) and several raw materials and intermediate products (from above 25% to 5%-15% range).

Generally, duty rates range from 5% to 45% while most capital equipment and raw materials are charged at 5% to 20%. Imports in excess of over US$5,000 are subjected to pre-shipment inspection controls and require a Clean Report of Findings by a government appointed inspection agency. Duties on capital goods, plant and machinery whose value is not less than Ksh 10 million can be remitted where investment is expected to have net foreign exchange earnings or savings for the country. Imported plant, machinery and equipment of CIF not exceeding Ksh 50 million intended for industries located outside major towns are charged custom duties at a lower rate of 10%. A 50% remission of duties and tax is granted to such industries established within designated boundaries of Nairobi, Mombasa and other urban centers.

High import duties and value-added tax pose trade barriers and provide protection to domestic producers, especially in the agricultural sector. Kenya's import regulations on agricultural products are altered to reflect fluctuations in domestic supply and demand. However, in the last three years the government has lowered the import duty for inputs and raw materials used in the manufacturing sector from 2.5 percent to zero. Duties on a number of raw materials and capital goods previously taxed at 5 percent were reduced to zero in the 2002/2003 budget. Import duties for fabrics are set between 25 percent and 35 percent, while duties on basic inputs such as yarn are zero. The current import duty on foodstuffs that compete with Kenyan products (like meat and meat products, poultry and poultry products, and dairy products) is 35 percent. Although this has a protective effect on domestic producers of the same, the effect on consumers is most likely negative.

In 1993, the country abolished import licensing requirements and foreign exchange controls – the two main pillars of customs reform. In addition, all current account and all capital account restrictions were lifted between 1993 and 1994. Export compensation was suspended in 1993 to save revenue to Government and forestall the prevalent abuse of the facility by corrupt local manufacturers. Export duties and export licensing were abolished to support export growth and lower bureaucratic delays for exporters. Further measures included the introduction of the manufacturing under bond facility (under export processing zones to encourage manufacturing in Kenya for world markets) where the following incentives were provided to both local and foreign investors: (1) exemption from duty and VAT on imported plant, machinery and equipment, raw materials and other imported inputs, and 100% investment allowance on plant, machinery, equipment and buildings.

The management of exemptions became tighter especially after 1991. These changes included reduction in the range of exempt goods, introducing duties on imports by parastatals, abolishing discretionary exemptions (from 1992), and eliminating exemptions on agricultural commodity aid (except under a situation of a national disaster). As from 1994, the NGOs became the focus of reforms by restricting their exemptions, by bonding their project aid-funded imports, and by insisting on their registration under Income Tax Act to be eligible for customs exemption.

Both internal and external customs control programs were put in place during the reform period. These included the re-introduction of the selective examination/rapid release system and re-establishment of the intelligence and investigative functions, strengthening transit

controls system, revising the pre-shipment inspection programmed (from 1994), introducing warehouse controls and strengthening cargo control at Mombasa port (from 1996).

These reforms were effected in 1997 by the onset of a stabilization crisis that followed the collapse of the IMF program, an election spending-related budgetary crisis and the exchange rate instability accompanying the Asian crisis (Glenday, 2002). The measures that were taken to manage the crisis resulted in additional suspended duties being imposed starting in mid-1997, by raising the simple average tariff from 16.2% to 17.8% and the trade weighted average from 12.8% to 14% by mid 1999.

Despite there being a zero rating policy for agricultural sector inputs, there were reversals in 1995/96 towards protection of the agricultural sector (Karingi *et a*l, 2005). A suspended duty of 70% was charged on imports of agricultural products. Regarding industry, it had become clear by 1999 that customs reforms had adversely affected domestic producers of import competing goods. Suspended duties on commercial vehicles and textiles were introduced in an effort to protect domestic producers of the same.

Table 7: Nominal protection by end use and source, 2003

	DESCRIPTION	Total Value (Ksh mn)	EU		ROW		ESA	
			Value (Ksh mn)	Tariff (%)	Value (Ksh mn)	Tariff (%)	Value (Ksh mn)	Tariff (%)
Intermediate Inputs								
111	Primary Food & beverages for industry	6,115	588	32	5,453	35	74	4
121	Processed food & Beverages for industry	5,328	455	21	3,201	14	1,672	2
21	Primary Industrial Supplies	5,932	2,063	26	2,709	22	1,160	3
22	Processed Industrial Supplies	89,704	20,982	9	64,469	9	4,253	3
	Sub-total	*107,079*	*24,089*	*11*	*75,832*	*11*	*7,159*	*2*
Machinery and Equipment								
41	Machinery and other capital equipment	26,853	15,393	5	11,087	6	372	3
42	Parts and Accessories	8,038	4,859	10	3,119	12	60	10
	Sub-total	34,891	20,252	6	14,206	7	432	4
Motor Vehicles								
51	Passenger Motor vehicles	7,979	1,630	36	6,292	42	57	45
53	Parts and Accessories	7,631	2,758	14	4,508	19	364	3
521	Industrial Transport and Equipment	23,913	2,407	18	20,075	6	1,431	3
522	Non industrial Transport and Equipment	737	42	14	685	5	11	3
	Sub-total	40,260	6,836	21	31,561	15	1,863	4
Fuels & Lubricants								
31	Primary Fuels and Lubricants	25,881	7	6	25,874	0	0	22
322	Other Fuels and spirits	40,353	1,271	12	38,920	15	163	1
	Sub-total	66,233	1,277	12	64,794	9	164	1
Consumption								
112	Primary Food & beverages for household consumption	1,316	160	32	1,036	22	120	5
122	Processed F&B for household consumption	7,628	1,619	33	4,495	46	1,513	2
61	Consumer Durables	4,653	1,817	17	2,738	28	98	2
62	Consumer Semi durables	5,031	1,624	15	3,284	29	123	10
63	Consumer non durables	13,493	5,045	5	7,472	23	976	1
7	Other goods	919	882	10	38	15	0	5
	Sub-total	33,041	11,146	13	19,063	30	2,831	2
	Total	281,504	63,601		205,455		12,449	

Source: KIPPRA (2005)

Note: EU stands for European Union, ROW stands for Rest of the World and ESA refers to Eastern and Southern Africa.

Challenges: One of the main challenges facing complete liberalization are supply-side constraints, which limit the competitiveness of Kenyan industries in the global and domestic market, even for non-infant industries. It has been demonstrated that high tariffs especially on inputs inadvertently taxes production (value added) through tariff escalation, reduced competitiveness and may result in anti-export bias for domestic producers. It is for this reason that duty rates on imported raw materials, spare parts and intermediate inputs have been reduced to very low levels ranging between 0% and 5% compared to a scheduled tariff of 25% on finished goods. Overall, with the exception of specific agricultural commodities - sugar and cereals - and the occasional policy reversals on duty on fabrics, tariff liberalization has resulted in a significant reduction in tariff barriers.

Effective protection: Whereas trade liberalization has reduced the anti-export bias and encouraged the development of non-traditional exports, the tariff structure in Kenya reflects high and dispersed rates. As a result, effective protection is still high. There are also issues of more or less arbitrary classification of goods into categories of raw materials, intermediate and finished products. Since the same good can be classified as a raw material to one producer and a finished product to another, protecting the latter with say 25% rate automatically discriminates against the former. To address these issues, wide dispersion of tariff rates should be reduced with the goal of achieving lower and a broad-based uniform tariff.

In Kenya, customs rules are detailed and rigidly implemented, often leading to delays in clearance of both imports and exports. Table 8 reports the ranking of selected countries on the basis of efficiency of customs procedures. At the aggregate, Kenya's customs procedures are inefficient since Kenya's score (2.8) falls below the global mean (3.7). It is surprising that Uganda, a landlocked country that imports most of its products through Mombasa port, scored higher than Kenya.

Table 8: Efficiency of customs procedures

Country	Rank	Score	S.D
Kenya	77	2.8	1.2
Uganda	64	3.1	1.4
Tanzania	71	2.9	1.6
South Africa	41	3.9	1.4
Egypt	66	3.0	1.6
Mauritius	53	3.4	1.4
China	47	3.7	1.2

*Global Mean (3.7)
*For imports, inbound customs activities are (1 = slow and inefficient, 7 = among the world's most efficient.

Source: World Economic Forum (2004)

Value Added Tax: Value Added Tax (VAT) is now the most widespread consumption tax collection mechanism in the world[13]. Beginning 1990, VAT was introduced in Kenya to replace

[13] In the wake of trade liberalization which has a diminishing effect on import duties, the VAT is normally seen as a replacement tax for existing commodity taxes for three reasons :it broadens the tax base by including services which

the sales tax. It was believed that VAT would make indirect taxation more effective, more buoyant, more equitable and less distortionary (Thisen, 2003). By design, the tax follows multi-stage destination principle since it is charged on the sale of goods and services at all stages of production[14]. This characteristic endeared VAT to the authorities as this allows it to have higher revenue potential, higher efficiency and lower collection and administrative costs.

At the inception of VAT, the input credit system was adopted and the rate of 17% was applied. Under the credit system, each VAT registered business pays tax on the purchase of inputs and charges VAT on the sale of outputs. The advantage of this is that revenue is secured by being collected throughout the process of production (unlike a retail sales tax) but without distorting production decisions (as a turnover tax does). There were complexities in the structure, with 15 different rates and the maximum rate at 210%. Over time, there were numerous changes in VAT rationalization as described in Table 9 below. It is clear that between 1990 and 2004, the maximum rate fell from 150% to 16%, the standard rate from 17% to 16% and the rate bands reduced from 15 to 3. All these measures were aimed at increasing voluntary compliance and simplifying administration.

Table 9: VAT Rates Rationalisation

Year	No. of Rates	Rates	Standard Rate
1989/90	15		17%
1990/91	9	0%, 5%, 18%, 30%, 45%, 50%, 80%, 100%, 150%	18%
1991/92	8	0%, 5%, 18%, 25%, 35%, 50%, 75%, 100%	18%
1992/93	6	0%, 3%, 5%, 18%, 30% and 50%.	18%
1993/94	4	0%, 5%, 18% and 40%.	18%
1994/95	4	0%, 5%, 18% and 30%.	18%
1995/96	4	0%, 6%, 15% and 25%.	15%
1996/97	3	0%, 8%, and 15%	15%
1997/98	3	0%, 10%, and 17%	17%
1998/99	4	0%, 10%, 12% and 16%	16%
1999/00	4	0%, 10%, 13% and 15%	15%
2000/01	4	0%, 10%, 16% and 18%	18%
2001/02	4	0%, 10%, 16% and 18%	18%
2002/03	4	0%, 10%, 16% and 18%	18%
2003/04	3	0%, 10%, and 16%	16%

Source: Karingi et al (2005) and various Finance Acts

have not hither to been taxed; it eliminates the cascading usually involved in turnover taxes and some manufacturers sales tax systems; and it usually has higher compliance due to its self enforcing mechanism.

[14] VAT is a broad-based , multi-stage "general sales tax" which is collected in small doses as the product moves through production, processing and distribution ((Thisen, 2003).

Measures that were adopted to broaden the base of VAT included changing the retail-level sales to manufacturer level VAT including business services. Similarly, there were shifts of the tax point from the manufacturer to the retailer in several sectors including jewellery, household appliances and entertainment equipment, furniture, construction materials, vehicle parts, pre-recorded music etc. There were also redefinitions of "goods" to exclude the supply of immovable tangible and all intangible property and rental or immovable property. There were expansions of coverage of the service sector to include business services; hotel and restaurant services; entertainment; conferences; advertising; telecommunications; construction; transportation; rental, repair, and maintenance of equipment (including vehicles); and a range of personal services.

The minimum turnover level for compulsory registration was adjusted from Ksh 10,000 to Ksh 40,000. Similarly, there have been reforms, through stiffer penalties, to discourage late VAT returns, failure to issue VAT invoices and failure to keep proper accounting records. Owing to problems related to corruption and weak controls in the administration of the VAT refund system, there have been measures to tighten verification measures and eliminating backlogs of claims – although the refund system is still problematic.

The VAT has a high revenue generation capacity. As such, it has been labeled a "tax of the future" since it is broad based and has capacity to net taxes from the "hard-to-tax" informal sector operators to the extent that they purchase VAT-laden business supplies and VAT-laden consumption goods. The breadth of the tax base and its stability ensure that VAT can generate huge and predictable revenues to the Treasury. In addition, minor adjustments to the rate results in huge revenue yields. However, VAT can be designed to allow negative lists of basic commodities that are chosen to cushion the poor.

Since nobody enjoys paying taxes, economic agents deflect the tax burden by altering their economic choices, although this has adverse effects on efficiency and productivity. However, if VAT is sufficiently broad-based, the consumers have little scope to avoid the tax by changing their spending patterns. The credit mechanism and the destination principles[15] of VAT, combine to eliminate distortions and inequities that would otherwise characterize a sales tax. The credit mechanism helps to eliminate tax cascading. For instance, exporting firms are entitled to rebates of VAT paid on input purchases.

Challenges: The administration of VAT relies heavily on proper recording of transactions at each stage production, processing and distribution; as the product moves towards its final market. But this requires transparency in running business transactions and lengthens the compliance process. Long processes of verification, approval and validation create loopholes for rent-seeking. VAT also requires regular returns from a large number of firms. However, with proper record-keeping, one advantage of VAT is that it creates a clear invoice trail, making it much easier to detect and deter tax evasion. Similarly, the multistage structure of VAT induces firms to register voluntarily as taxpayers.

Zero rating refers to a situation in which the rate of tax applied to sales is zero, though credit is still given for taxes paid on inputs. Where a firm is provided with a full refund of taxes paid on

[15] The destination principle implies that tax is applied in the country where a good or service is used, not where it originates (see Thisen, 2003). The purpose is to ensure that domestically produced goods and services compete in the world markets without facing indirect tax disadvantages.

inputs, tax along the production chain is fully relieved. In a VAT designed to tax domestic consumption only, exports are zero rated, meaning that exports leave the country free of any domestic VAT.

Exemption is quite different from zero rating in that, while tax is also not charged on outputs, tax paid on inputs cannot be reclaimed. Thus, no refunds are payable. In this case, because tax on intermediate transactions remains un-recovered, production decisions may be affected by the VAT. Kenya, like many African countries, lacks the administrative capacity to handle large volumes of returns and refunds for zero-rated transactions. Hence, exemptions are widely granted as a matter of administrative expediency. Small businesses are exempted from compulsory VAT registration to cut down on administrative paper work by setting the threshold high.

The other challenge is that there are different rates of tax for various goods and services, which makes it difficult for average citizens to understand what is expected of them. The deduction of input tax is even more complicated given that not all input tax would qualify for deduction. This complexity increases chances of errors and hence the low level of compliance.

Excise Taxes: Excise taxes, also termed "sin taxes", are applied selectively on particular goods and services (see table 10). In theory, they are applied mainly for three main reasons (Okello, 2001); (a) their ability to raise substantial revenue at relatively low administrative and compliance costs; (b) to correct for negative externalities; and (c) improve the vertical equity of the tax system. The general principle of excise tax reform has been to make excise taxes (i) simple to administer by keeping few domestic production points; (ii) Fair by netting products that are not consumed by the poor; (iii) Efficient by targeting consumption rather than production; and (iv) to generate an ample flow of revenue by targeting high total sales value. In Kenya, excise duties are levied on soft drinks, cigarettes and tobacco, opaque beer, clear beer and electricity, automobiles e.t.c. This implies that excise taxes are levied in Kenya on the basis of low income elasticity rather than on purely welfare criterion of correcting for externalities.

Table 10: Excise Taxes in Kenya and Zambia (Per cent), 2002

Items	*Kenya*	*Zambia*
Soft Drinks	10	10
Opaque beer	10	35
Clear beer	105	85
Wine and Vermouth	45	125
Spirits	45	125
Cigarettes and tobacco	30,125, or 140	125
Gasoline.		60
Other hydro-carbon oils		15,30, 60
Petroleum		30
Electricity	10	7
Clothing	10	
Automobile	20 or 40	

Source: Thisen (2003)

Prior to the TMP, excise taxes were specific. However, beginning 1991/2, excise taxes were made *ad valorem*. Since 1991, the scope of excise duties was expanded from domestic

production to include imports, thus changing its scope from being a tax on domestic production to a tax on consumption. They were also extended to cover the luxury goods element on wine, beer, spirits, mineral water, tobacco products, matches, luxury passenger cars and minibuses. Automotive fuels and cosmetics were also introduced into the excise tax net (Muriithi and Moyi, 2003). Cigarettes, tobacco, and matches were charged VAT at the standard rate of 18% in addition to an excise tax.

According to Karingi et al (2005), the regime switch from specific to *ad valorem* did not remove discretion as would have been expected. This change was immediately followed by a rise in excise tax rates for alcoholic products. Excise taxes continued to be complex in terms of multiple tax rates. For instance, before 1993/94, cigarettes were subject to three different price-based excise duty brackets but in 1997/98, the excise duty on cigarettes was rationalized to a uniform rate of 175 per cent. However, this rationalization did not affect alcoholic products as there were differentiated rates for malt, non-malt and other locally made alcoholic products. Following regional integration efforts through the East African Community and the commitment of the three countries to reduce the taxation gap among them, Kenya reduced the *ad valorem* rates for malt beers, from 95% to 90%.

The country reverted to specific excise duties in 2003/4. A hybrid excise duty of a minimum specific tax and an additional *ad valorem* rate was introduced on domestic cigarettes and also on imported cigarettes. The hybrid system was aimed at reducing smuggling, tax evasion and under-declaration of tobacco products. The specific duty regime consisted of four bands, equivalent to an effective rate of 110%.

Challenge: The main challenge facing beer taxation in Kenya are the high tax rates. A study by Karingi et al (2001) revealed that beer taxation (contributing about 60 per cent of excise revenue) in Kenya was excessive since the revenue maximizing (optimal) tax rate was between 62.5% and 89.3%. In the case of tobacco excise taxation, revenue maximizing tax rate was 128% (Kiringai, 2002).

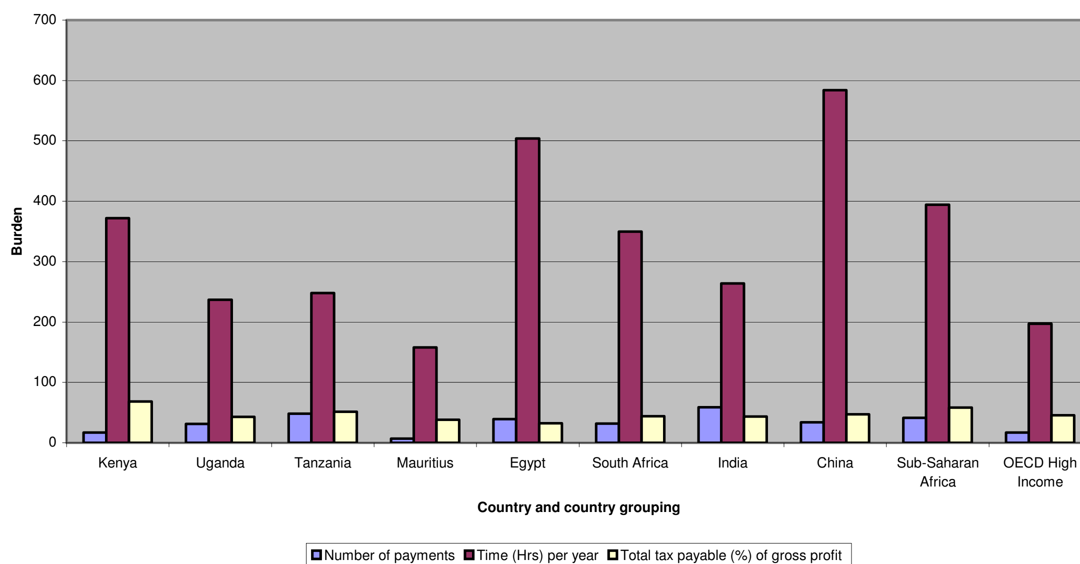
4.2 Tax Collection and Administration

Taxpayer enumeration and registration: A good tax administration system should identify all those required to pay taxes and issue unique identification numbers that are fed into a master file upon which updates are made and from which retrievals can be made. KRA has made some progress in this area by increasing the number of VAT taxpayers in its registry from 17,106 in 1997 to 26,591 in 2000 (an increase of 55%) (Talierco, 2004). According to KRA (2006), a total of 33,923 taxpayers and 33,141 taxpayers were recruited in 2003/04 and 2004/05, respectively. In 2005/06, a total of 40,537 taxpayers were recruited. Despite this, KRA has to contend with the problem of low filing compliance, which stood at 29% in 2000. Another challenge for KRA is integrating the processes of registration and filing. Since these processes are poorly integrated, most of the operations are still manual. Similarly, the registration function is yet to be integrated – different taxes still require separate identification numbers and different offices are charged with the registration function. KRA should move towards an integrated tax payer registration system where a uniform Tax Identification Number (TIN) would apply regardless of whether a tax payer is registering for Personal Tax, Corporate Tax or VAT.

Estimating taxable income and tax liability: "Self-assessment" systems enhance tax compliance by making it easy for taxpayers to assess their own tax liability, file a return, report that assessment and pay the taxes due. Compliance is less burdensome when tax laws are simple, tax return forms are easy to understand and taxpayers do not need the help of tax specialists to file their returns. Compliance surveys by KIPPRA, KRA and MoF (KIPPRA, 2004) indicate that 51% of taxpayers view the corporate tax rates as high while 29.8% view them as being fair. In addition, about 85.9% of taxpayers view PAYE rates being either very high or high. About 62.5% of tax payers hire paid accountants to prepare VAT returns while 64.9% hire paid consultants to prepare the IT returns. This implies that the income tax and VAT rates are punitive and lack in-built mechanisms that would enhance self-assessment. There is need to simplify tax laws, forms and procedures. Some of these have compounded the problem of high compliance costs.

Fig 2 shows how Kenya's tax system is burdensome in terms of time taken to prepare and submit tax returns. Comparatively, Kenya had done well in terms of number of tax payments. The country's score mimics the standards in OECD high-income countries. However, the country has done poorly in terms of the time it takes to prepare, file and pay taxes. Although the time taken by Kenyan firms matches the Sub-Saharan Africa average, it rises much higher than the OECD high-income country benchmark. In terms of the proportion of total profit that is taken away in taxes (also termed tax burden), Kenya's ratio is the highest and surpasses both the SSA and OECD high-income country benchmarks. This confirms the assertion that Kenya has one of the highest tax burdens in the world.

Figure 2: Tax Administrative Burden



Source: www.doingbusiness.org
Note: Time measures the time it takes to prepare, file and pay (or withhold) the corporate income tax, VAT and social security contributions.

Taxpayer services: In the current Strategic Plan, KRA reports an improvement in the service satisfaction rating from 40% in 2003/04 to 69% in 2004/05 (KRA, 2006). This reflects a shift in KRA's approach towards service-orientation. Despite this, there is scope for improvement. KRA should provide amenities in tax offices accelerate refunds and providing easy access to the

tax authorities for clarification of the tax laws and advance rulings on ambiguous regulations. Surveys indicate that KRA services require more improvement. KRA suffers from the problem of timely processing of VAT refunds.

Improving tax collection: This requires mechanisms for voluntary tax payment and coercing payment by non-complying taxpayers. It requires adequate withholding systems, an appropriate penalty structure, use of audits and provision of incentives linked to tax recovery, and taxpayer's incentives for prompt payment.

Enforcement of Tax regulations: Effective enforcement requires the identification of gaps between potential and declared taxes, declared and paid taxes, and taxes paid and payments received by the KRA. These gaps emanate from weakness in identification, filing, reporting of current income, payment, and transfer of payments to KRA. Tax audits are useful in uncovering deliberate evasion. But KRA still lacks adequate and frequently updated information systems on registered taxpayers. Computerization of taxpayer records is still incomplete. There is need to develop systems that can access third party sources of information, such as withholdings, bank transactions, foreign exchange transactions, transactions in securities and large transactions (involving real estate, cars, tax-deductible transactions, customs payments). Use of tax amnesties have proved useful by mobilizing taxes that would otherwise remain uncollected.

Organization of KRA: One of the most important tasks of the tax administration authorities is to set up internal control and accountability systems to detect errors in tax assessments. To ensure that taxpayers are not taxed incorrectly, the tax authorities must remedy deficiencies in laws, procedures, or practices that lead to errors. To deter corruption by tax officials, KRA sets tax targets for each tax official, each department, district tax offices and auditors; maintain detailed records of the eventual outcomes of assessments by tax officers. On the basis of best practices observed elsewhere (see Table 12), KRA should enhance administration through measures such as entrusting sensitive negotiations to special teams; minimizing contacts between tax payers and tax collectors and reducing the discretionary powers of tax officers; setting up supervisory systems with at least three hierarchical levels to reduce opportunities for collusion; and devise incentive systems that match public and private interests. There is the possibility of relying on banks in collecting taxes.

Table 12: Performance of Revenue Authorities in Africa and Latin America

	Collection cost*	VAT Productivity**	Audit coverage of large taxpayers	Range of autonomy	Other indicators
Kenya	1.2 (1995-2000)	0.19 (1996 – 2000)	38% (2001)	Completely autonomous (though some legal ambiguities)	Quasi-voluntary retrenchment Overall staff reduction. Financial support for staff training
Peru	1.9 (1996 –1998)	0.32 (1994-1998)	11% (1999)	Completely autonomous	Quasi-voluntary radical retrenchment. Substantial salary increase. Overall staff reduction. In-house training program.
Mexico	1.7 (1995, 1997-1998)	0.26 (1990 – 1997)	-	Board must have decisions approved by the Minister of Finance.	No retrenchment. No pay increases policy.
Uganda	3.6% (1991-2001)	0.25 (2000)	11% (2001)	Semi-autonomous (though some ambiguities)	Periodic salary increases. Increase in staff complement.
Venezuela	2.0 (1995-1998)	-	6% (1999)	Completely autonomous (initially, though eroded over time)	Voluntary retrenchment. Initial reduction in staff complement. Salary increases.
South Africa	1.1 (1998 -2001	-	-	Semi-autonomous	Salary increases. Special initiatives including performance bonuses Slight reduction in staff complement. Excellent training opportunities.

Source: Talierco (2004)
* Measured as the average collection cost as % of revenue collected.
** Measured as the ratio of GDP generated by the VAT to the VAT rate.

Table 12 compares several revenue authorities in Africa and Latin America. Overall, KRA emerges as one of the most successful revenue authorities in terms collection cost, audit coverage of large tax payers and human capacity development. This implies that KRA has undertaken certain measures that have lowered efficiency costs of taxation in Kenya. However, the biggest challenge facing KRA is to enhance the performance of VAT. KRA also faces the challenge of enhancing employee incentive structure through periodic salary increases, special performance bonuses (especially when the employees surpass their targets).

5

Summary of Issues and Priorities for Further Tax Reform

5.1 *Taxing the informal sector*

In Kenya, one of the main challenges of the TMP is the large informal sector. The MSE sector in Kenya is large and growing in numbers. The first National Baseline Survey of 1993 identified 910,000 micro and small enterprises (excluding agro-based activity) employing about 2.0 million people. The second National Baseline Survey of 1999 identified 1.3 million enterprises with about 2.4 million people involved. This sector requires treatment other than that provided by refined methods of tax administration and provisions in the revenue code. Small producers are notoriously difficult to tax and subsistence agriculture does not generate large surpluses. An experiment with presumption tax (abolished in 1993 and re-introduced in 1995) was a particularly notable attempt to formalize parts of the informal agricultural sector (Cheeseman and Griffins, 2005). Further attempts focused on the use of advance tax and tax on rental incomes. However, given the invisibility of the informal sector and scarce empirical work to understand tax-relevant information, the presumption tax approach and the advance tax approaches failed to achieve the intended objectives. It is not difficult to understand why they could not work. If the Government does not know about the income received by farmers, farm workers and small-scale entrepreneurs, it can have no prospects of taxing it. This creates the need for a proper income survey to determine the optimal tax yield and the ability to pay.

The need to tax the MSE sector is therefore obvious. It arises from the need to encourage compliance; de-institutionalize tax evasion as normal part of doing business; enhance credibility of the tax system and theoretically embed tax equity; encourage the sector to carry its fiscal responsibility, create dis-incentives for the formal sector to sub-divide into smaller business entities below tax thresholds and thus erode the realized tax base and endanger internal balance which goes to exacerbate economic distortions inherent in taxation.

Simplifying the registration process and reducing exposure to registration red tape will therefore be key towards this end. Consequently, there is need to design a special/simplified registration/formality package for the sector that takes into account the local peculiarities. Such a system should, in addition to providing the firms with legal protection, develop a tax paying culture, devoid of bureaucracy, amongst the participants; introduce good business practices and encourage existing businesses to grow and new businesses to be started by supporting a one-stop-shop approach to registration and tax administration.

5.2 *Policy shifts towards internationally acceptable investment incentives*

Tax holidays and other "ring-fenced" incentives that exclude local companies erode the tax base, distort investment choices, compromise the equity of the tax system and enhance

administrative costs of the tax system. The Ministry of Finance should shift away from tax holidays and other "ring fenced" incentives towards more effective and internationally accepted approaches to stimulating investments such as accelerated depreciation for qualifying manufacturing assets. Similarly, the Ministry of Finance should move towards "automatic triggering mechanisms" rather than discretionary mechanisms that are based on subjective value judgment.

5.3 Insulating the tax system from inflation effects

The results in this study have shown that there are wide disparities between nominal and real tax revenues, reflecting the adverse impact of inflation on tax revenues. The indexing procedure seems to have been ad-hoc because the adjustment in the brackets did not reflect changes in the CPI. For instance, in 2002 to 2004, the brackets remained the same, even when inflation was 2% in 2002, 9.8% in 2003 and 11% in 2004. The policy implication of this is two-fold. First, there is need for the monetary authorities to maintain single-digit inflation levels, preferably below the 5% mark. Second, the indexing procedure currently in use should be revised to accurately account for the full movements in prices.

5.4 Enhancing the productivity of the tax system

Although the tax system has been stable over the 1996-2006 period, partial results show that it was inflexible yielding a buoyancy index of 0.662. The tax system yielded a 0.662% change in tax revenue for every 1% change in GDP. In other words, the tax system failed to respond favorably to changes in economic activity as well as discretionary tax measures. There is need to prioritize base expansion measures. Such measures include greater use of tax amnesty, lowering registration and tax regulation hurdles; enhance public confidence and trust of citizens in KRA. Measures to seal corruption loopholes would enhance the tax base. These include further simplification of the tax structure and reduction of rates, removal of cumbersome procedures (e.g. import clearance), incentive schemes (remuneration, promotion, pensions, awards and prizes), monitoring (internal and external), professionalising management and reducing political intervention in day-to-day operations.

Early assessments of tax reforms tend to suggest that direct taxes responded better than indirect taxes. However, among the indirect taxes, VAT seems to have performed dismally despite the perception and the high expectations that followed its introduction. In Kenya, VAT has been perceived as a tax of the future and one that was to shift the tax structure away from direct taxation towards consumption taxation. Despite this, VAT productivity has remained low and falling and taxpayers perceive VAT rates as being excessive. The responsiveness of VAT to reforms has been poor. VAT reported the lowest elasticity indices- suggesting that it is the most rigid tax. These attributes are symptomatic of a tax structure that is eroded by corruption through collusion between taxpayers and tax collectors.

5.5 Build vertical accountability of the tax system

Since most Kenyans view payment of tax as a punishment rather than a duty, it is important to take into account the "taxpayer's voice" by building vertical accountability. The KRA should move away from using tax laws to "control and punish" but rather to "facilitate and ensure compliance". Priority should go towards espousing the participation and taxpayer ownership.

Taxpayers need to be more involved in the formulation of tax policy and planning for any changes. This would minimize resistance to reforms as has been the case in Kenya.

5.6 *Lower the rate of effective protection for Kenyan products*

There is no doubt that customs reform has reduced the anti-export bias and encouraged the development of non-traditional exports. Despite this, the tariff structure is characterized by high and dispersed rates and custom rules are detailed and rigidly implemented. There are also problems of arbitrary classification of goods into raw materials, intermediate and finished goods. Further customs reform should seek to reduce the tariff rates with the goal of achieving lower and broad-based uniform tariffs. Priority should go towards simplifying custom rules and regulation as well enhancing the clearance of both imports and exports.

5.7 *Improve tax collection and administration*

Tax collection and administration can be improved through measures such as;

- Shifting towards an integrated tax payer registration system where a uniform Tax Identification Number (TIN) would apply regardless of whether a tax payer is registering for Personal Tax, Corporate Tax or VAT.

- Simplify the tax code: Since income tax and VAT rates are punitive and lack in-built mechanisms that would enhance self-assessment, there is need to simplify tax laws, forms and procedures.

- Developing systems that can enhance access to third-party sources of information. KRA still lacks adequate and frequently updated information systems on registered taxpayers. Computerization of taxpayer records is still incomplete. There is need to develop systems that can access third party sources of information, such as withholdings, bank transactions, foreign exchange transactions, transactions in securities and large transactions (involving real estate, cars, tax-deductible transactions, customs payments). Use of tax amnesties can prove useful.

- Enhancing administration through measures such as entrusting sensitive negotiations to special teams; minimizing contacts between tax payers and tax collectors and reducing the discretionary powers of tax officers; setting up supervisory systems with at least three hierarchical levels to reduce opportunities for collusion; and devise incentive systems that match public and private interests. There is the possibility of relying on banks in collecting taxes.

6

Conclusions and areas for Further Research

6.1 *Tax progressivity analysis and the distribution of the tax burden*

Estimating the distribution of the tax burden involves the allocation of tax collections by income brackets. Given this information, taxes allocated to each bracket may then be expressed as a percentage of income in that bracket. The data required for such allocation involves the distribution of income by types of earning, expenditure patterns by income levels and the distribution of property. The challenge is to address the scarcity of data on income distribution, data on consumer expenditure and distribution of property and wealth. Another challenge arises from the fact that data on earnings of employees in the public sector and in larger private establishments are widely available, but data for the self-employed are not. The self-employed include small traders and farmers but also groups with substantial income in both the professions and trade. Household budgets surveys and firm level surveys of self-employed persons can be used to generate information that would allow such progressivity analysis.

6.2 *Local Government Taxation*

Although the Central Government Tax system has changed substantially under the reform period, there is little information on changes in taxes at the Local Authority level. This omission is surprising given that LA taxes have a large distortionary effect on resource allocation decisions and provide disincentives for business start-ups. Similarly, the levels and types of LA taxes often result in the tax burden falling more on the poor than on the relatively better off in LAs (Fjeldstad, 2003). LA taxes are subject to corruption and mismanagement. They are complicated (use huge number of revenue instruments) and non-transparent making it costly to administer. There is also little coordination between the various levels of Government. All these attributes provide the impetus for much more analysis of Local Government Taxation, especially on issues of revenue adequacy, economic efficiency, effects on equity.

6.3 *Taxation of land and property*

Kenyan policy makers have for a long time grappled with the issue of land and property taxation. This is mainly because of the simultaneous existence of the high inequalities in land ownership side by side with land shortages and low agricultural productivity. Proponents of land taxation lay claim to several advantages of the same, namely: (a) They are an ideal revenue source for local government; (b) Real property is immovable and property taxes are therefore less distortionary than levying taxes on sales or income; (c) Property taxes will often be capitalized into property values hence coming close to a benefit tax; (d) Property taxes –

especially if based on the potential monetary yield -will lead to more efficient use of valuable natural resource, and (e) Land taxes will encourage more efficient land use.

However, others argue against land taxes on account of the following arguments. First, it leads to increasing land concentration especially where risk is high and insurance markets are either absent or imperfect. Second, the information requirements for a land tax-size, value, ownership status, productive capacity and information costs of outputs and inputs-may be very costly. Third, administrative and political cost may be too high. Fourth, for proper administration it is important that a property tax law be put in place and that an administrative mechanism be put in place that can keep registers up to date and assess, collect and enforce the tax. Fifth, it is a highly visible tax therefore it is politically difficult to enforce. Sixth, the base of the property tax may be inelastic.

Research needs to be undertaken to ensure that viability of implementing land based taxes. Specifically there is need to ensure that the implementation of property taxes should take account of a number of issues:

i. Assessment for the tax: should it be based on area occupied, property value or a system of self assessment to ensure that the tax is neither distortionary nor administratively too costly to impose.
ii. Setting of tax rates: this has to do with whether the tax rates should be set locally or by central government.
iii. Tax administration: it is important that the administration is strong enough to ensure that it is not an impediment on property tax and that the collection costs are not too high.

6.4 Tax Incentives

Further work is required in quantifying the costs and benefits of tax incentives, with the objective of establishing their net worth. This is justified by the fact that overwhelming evidence has shown that investors rate tax incentives rather low among the factors they consider in choosing between locations (Morisset and Prinia, 2001; EUR, 2001; Tanzi and Zee, 2000). In Kenya, the EPZs have outlived their usefulness and need to be redesigned (Kibua and Nzioki, 2004). There seems to be weak evidence to support the continued operation of incentive packages for foreign investors. However, there is no substantive evidence to help us determine the costs of incentives to EPZs so far and the associated benefits. Work in this area is nascent.

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Annex Table 1: Real and Nominal Tax Yields (Ksh million)

	Total Tax		Sales Tax		Income Tax		Excise Duties		Import Duties	
	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real	Nominal	Real
1996	127,030	127,030	29,850	29,850	48,375	48,375	23,687	23,687	22,594	22,594
1997	147,893	132,997	34,468	30,996	55,578	49,980	28,382	25,523	27,167	24,431
1998	155,524	131,244	39,205	33,084	55,235	46,612	28,733	24,247	28,444	24,003
1999	156,966	125,272	40,944	32,677	53,317	42,551	28,493	22,740	28,605	22,829
2000	164,112	119,094	50,221	36,445	53,429	38,773	28,318	20,550	28,804	20,903
2001	162,464	111,430	50,872	34,891	55,862	38,314	32,077	22,001	21,584	14,804
2002	190,297	125,443	57,185	37,696	67,529	44,515	42,671	28,129	19,895	13,115
2003	203,169	122,023	58,983	35,425	70,862	42,560	47,590	28,583	21,907	13,157
2004	211,957	113,955	62,967	33,853	78,777	42,353	45,304	24,357	21,392	11,501
2005	298,901	145,806	78,603	38,343	115,601	56,390	55,557	27,101	25,732	12,552

Nominal (current prices); Real (constant prices)

Annex Table 2: Real and Nominal Tax Bases (Ksh Million)

	Domestic Factor Incomes		**Private Consumption**		**Imports**		**GDP**	
	Nominal	**Real**	**Nominal**	**Real**	**Nominal**	**Real**	**Nominal**	**Real**
1996	449,621	449,621	359,442	359,442	168,486	168,486	528,739	528,739
1997	536,264	482,252	453,176	407,532	190,674	171,469	623,235	560,463
1998	596,539	503,409	513,249	433,121	197,789	166,911	694,028	585,677
1999	639,056	510,021	540,400	431,285	206,401	164,725	743,478	593,358
2000	685,436	497,414	609,862	442,570	247,804	179,829	967,838	702,350
2001	770,028	528,140	685,607	470,238	290,108	198,976	1,020,022	699,604
2002	850,910	560,916	693,171	456,935	257,710	169,881	1,022,208	673,835
2003	850,910	581,636	805,162	483,581	281,844	169,276	1,136,288	682,455
2004	850,910	608,477	954,649	513,252	364,205	195,809	1,282,504	689,518
2005	-	-	-	-	430,740	210,117	1,415,155	690,319

Annex Table 3:Tax Structure Design

Income Tax

- The top PIT marginal rates were reduced from 65% in 1986 to the current 30% while the tax brackets for PIT were reduced from about 8 in 1986 to about 5 in 2005.
- PIT and PAYE base expansion measures included taxation of employer provided benefits, PAYE amnesty (1993), application of presumptive tax on selected agricultural produce and taxation of foreign exchange gains.
- Reduction of the CIT top rate from 45% in 1989 to 30% currently.
- Differentiated CIT rate structures were rationalized by unifying the structure across all types of business.
- Tax integration included shifts away from the double taxation system towards single-stage taxation.
- Dividends, which were earlier subjected to double taxation, were limited to a final tax.
- System of paying tax on business income was changed from delayed payment to current payment.
- Withholding tax was widened to cover interest income from discounts on debt instruments, royalties, payments to contractors and self-employed persons without the PIN.
- Since 1993, the following investment incentives were instituted:
  - Investors in manufacturing and hotel sectors outside Nairobi and Mombasa were granted an investment allowance of 85% on plant, machinery, buildings, and equipment in the first year of business. Investments located in Nairobi and Mombasa qualify for the investment allowance at 35%. For MUB, the applicable rate is 100% for all locations.
  - Companies licensed to do business in EPZs qualify for a 10 year tax holiday and a flat 25% tax for the next 10 years, and a 100% investment allowance.
  - Liberal rates are allowed for depreciation of assets based on book value as for hotels (4% per year), industrial buildings (2.5% per year), plant and machinery (12.5% per year) and vehicles, trucks and tractors (25-37.5% per year) and computers and office equipment (30%).
  - Import duties on machinery and equipment may be reduced to 10% where the investment is expected to have net foreign exchange earnings or savings for Kenya. Imported plant and equipment intended for industries located outside major towns are also charged custom duties at10%. A 50% remission of duties and tax is granted to industries established within designated boundaries of Nairobi, Mombasa and other urban centres.
  - Materials imported for use in manufacture for export or for the production duty free items for sale domestically are eligible for duty remission, irrespective of the source of financing. The programme is open to all types of investment whether for expansion, replacement or rehabilitation or new manufacturing plants. The Export Promotions Office of the Ministry of Finance administers the scheme. Approved suppliers, who manufacture goods to be supplied to the exporter, are also entitled to the same import duty relief.
  - In-bond (MUB) programme instituted in 1988 guarantees (to both local and foreign investors) the following incentives ; (1) exemption from duty and VAT on imported plant, machinery and equipment, raw materials and other imported inputs. (2) 100% investment allowance on plant, machinery, equipment and buildings. Bonded manufacturing enterprises can be licensed to operate in Nairobi, Mombasa, Kisumu, Eldoret, Nakuru, Nyeri and Thika within the immediate environs of these towns.

Customs

- Trade liberalization started in 1987-89 by converting the quantitative or non-tariff restrictions to their tariff equivalents. This increased the simple average tariff rate from 40% to 46% followed by a phased tariff reduction and rationalization of the tariff bands in 1990. These measures decreased the simple average tariff rate to 16.2% (from 46.3%) and the trade weighted tariff rate to 12.8% (from 25.6 in 1987-89) by 1997/98.
- Since the trade policy review of 1993, the overall level of protection was reduced by simplifying the tariff structure through the reduction of the number of bands from 8 in 1994 to 5 (0%, 5%, 10%, 15% and 25%) and the lowering of maximum ad valorem rates from 60% in 1992 to 25% in 1999.
- Top tariff rate reduced from 170% to 25% (1987-1998) and rate bands were reduced from 24 to 5 (including duty free). Simple average fell from 40% in 1987 to 16% in 1998.
- Duty rates on capital equipment declined from 15%-25% in 1987/8 to 5% in 1998) and several raw materials and intermediate products (from above 25% to 5%-15% range).
- With the formation of East African Cooperation in January 2005, the number of Most Favored Nation (MFN) tariff rates were changed to conform to the three tariff bands of the common external tariff (CET): 0% for raw materials and capital goods, 10% for intermediate goods and 25% for final goods.

Sales tax/VAT

- Between 1990 and 2004, the maximum rate fell from 150% to 16%, the standard rate from 17% to 16% and the rate bands reduced from 15 to 3.
- VAT base expansion measures included (1) changing the retail-level sales to manufacturer level VAT including business services, (2) shifts of the tax point from the manufacturer to the retailer in several sectors including jewellery, household appliances and entertainment equipment, furniture, construction materials, vehicle parts, pre-recorded music etc, (3) Redefinitions of "goods" to exclude the supply of immovable tangible and all intangible property and rental or immovable property, (4) expansions of coverage of the service sector to include business services; hotel and restaurant services; entertainment; conferences; advertising; telecommunications; construction; transportation; rental, repair, and maintenance of equipment (including vehicles); and a range of personal services.
- Minimum turnover level for compulsory registration was adjusted from Ksh 10,000 to Ksh 40,000. Similarly, there have been reforms, through stiffer penalties, to discourage late VAT returns, failure to issue VAT invoices and failure to keep proper accounting records.
- Measures to tighten verification and eliminating backlogs of claims were introduced.

Excise Taxes
❑ Since 1991, the scope of excise duties was expanded from domestic production to include imports. ❑ Formation of the East African Community and the resulting tax intergration reduced the *ad valorem* rates for malt beers, from 95% to 90%. ❑ The country reverted back to specific excise duties in 2003/4. A hybrid excise duty of a minimum specific tax and an additional *ad valorem* rate was introduced on domestic cigarettes and also on imported cigarettes. The specific duty regime consisted of four bands, equivalent to an effective rate of 110%.

Annex Table 4: Legislative and Policy Changes
Income Tax
❑ Amendment to the Income Tax Act in 1992. ❑ Foreign companies that invest in export processing zones (EPZs) enjoy the following fiscal incentives: a 10 year corporate tax holiday, exemption from import duty, VAT (on all inputs except for motor vehicles) stamp duty and withholding tax over a 10 year period. ❑ Installment, self-assessment systems and personal introduction number (PIN) for tax assessment introduced. ❑ The capital gains tax was suspended in 1985, followed by the removal of stamp duty on transfer of listed securities. Interest rates were liberalised in 1991. ❑ Since 1995, foreign companies are allowed to buy stocks not exceeding 40 per cent of a listed company's total quoted shares, while foreign individuals may purchase up to 5 per cent.

Customs
❑ In 1995, the Government scrapped the Exchange Control Act, thus eliminating restrictions on profit remittances, local and international borrowing. ❑ Import licensing requirements and foreign exchange controls abolished in 1993. ❑ All current account and all capital account restrictions were lifted between 1993 and 1994. ❑ Export compensation was suspended in 1993, export duties and export licensing were abolished. ❑ Introduction of the manufacturing under bond facility which provided for (1) exemption from duty and VAT on imported plant, machinery and equipment, raw materials and other imported inputs, and 100% investment allowance on plant, machinery, equipment and buildings. ❑ Tighter management of exemptions especially after 1991 through the reduction in the range of exempt goods, introducing duties on imports by parastatals, abolishing discretionary exemptions (from 1992), eliminating exemptions on agricultural commodity aid (except under a situation of a national disaster). As from 1994, the NGOs became the focus of reforms by restricting their exemptions, by bonding their project aid-funded imports, and by insisting they register under Income Tax Act to be eligible for customs exemption. ❑ Re-introduction of the selective examination/rapid release system and re-establishment of the intelligence and investigative functions, strengthening transit controls system, revising the pre-shipment inspection programme (from 1994), introducing warehouse controls and strengthening cargo control at Mombasa port (from 1996) ❑ Kenya is amending some pieces of its legislation, including on antidumping, countervailing measures and intellectual property, to bring them in conformity with the WTO Agreements. ❑ Since the early 1990s, Kenya dismantled its quantitative restrictions and price controls on major products and the tariff is now the main trade policy instrument. ❑ Following three devaluations of the Kenya shilling in 1993, a managed floating exchange rate system was adopted in 1994. ❑ The East African Cooperation Free Trade area commenced operation in 2005. The countries adopted a common external tariff on goods entering the area.
Sales tax/VAT
❑ Beginning 1990, VAT was introduced in Kenya to replace the sales tax. ❑ Implementation of VAT Electronic Tax Registers since 2004.
Excise Taxes
❑ Prior to the TMP, excise taxes were specific. However, beginning 1991/2, excise taxes were made *ad valorem*.

Annex Table 5: Tax Administration Changes
❑ Kenya Revenue Authority was incorporated in 1995. KRA amalgamated the five main revenue departments were initially in the Ministry of Finance namely Customs Duty, Excise Duty, Sales Tax, Income Tax and Corporate Tax). However during the period 2003/4 – 2005/6, the plan period, Domestic Revenues namely VAT, Income tax and Excise Duty were merged into Domestic Taxes Department. Customs and Excise Department was renamed Customs Services Department. ❑ Installation of Computerized Risk management systems with risk profiling capabilities at the port of Kilindini in 2004. ❑ Tax payer education programmes: "Tax payers week", Bill Board Campaigns for Tax Amnesty in 2004. ❑ Pilot implementation of joint audits in domestic taxes since 2004, field audits in 1996 and adoption of investigative audits. ❑ Updating and uploading the Income Tax Act on the KRA website. ❑ Launch of the tax payer's charter in 2000. ❑ Launch of KRA's Corporate Plan (2003/4 – 2005/6) in 2003 and the adoption of the Balance Score Card for performance measurement. Performance contracts were introduced in KRA in 2005/06. Staffs were paid bonus for exceeding revenue targets for the financial years 2003/04 – 2004/05. ❑ A Tax Procedure Code (TPC) was developed to harmonize administrative procedures across tax heads during the 2003/4 – 2005/6 plan periods. ❑ Establishment of a the Customs K9 Un it at the Jomo Kenyatta International Airport during the 2003/4 – 2005/6 plan period and imported drug detector dogs to supplement the physical and scanning checks in the fight against narcotics and terrorism. ❑ Electronic Tax Registers (ETR) and the change of tax payment point for petroleum oil from various bonded customs facilities to the point of importation or release from the refinery were implemented during the 2003/4 – 2005/6 plan period. ❑ The Audit Manual and Computerized Audit Registers were developed and staff trained on their use. Audit Command Language (ACL) licenses were acquired and staff trained on its use to assist in conducting Computer Aided Audit Techniques (CAATs) in LTO and Internal Audit Department. ❑ KRA developed regulations for issuance of exemptions/remissions. ❑ Issuance of PSV licenses was decentralized to the regions and so was renewal of Transport Licensing Board (TLB) licenses except in some selected categories. ❑ Customer Care Desks were established in all KRA regions and major centers. ❑ The concept of Tax Clinics was adopted. Services such as issuance of PIN card, VAT registration, ETR, Income tax Returns, driving license, TLB, PSV Licenses for drivers and conductors, and transfer of logbooks were provided on site. ❑ Simba 2005 system (S2005S) reduced the single entry document for customs (C63) to two screen pages. ❑ Appreciation and recognition of top and complainant taxpayers through Finacial Reporting Awards and Taxpayers Day.