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**Tax Reform in Kenya: Policy and Administrative Issues**

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**Tax**

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## **Tax Reform in Kenya: Policy and Administrative Issues<sup>i</sup>**

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Kenya's tax system has undergone more or less continual reform over the last twenty years. On the policy side, rate schedules have been rationalized and simplified, a new value-added tax introduced, and external tariffs brought in line with those of neighboring countries in East Africa. At the same time, administrative and institutional reforms have taken place. Most notable among these was the creation of the semi-autonomous Kenya Revenue Authority (KRA) in 1995, which centralized the administration of tax collection.

Kenya has the trappings of a modern tax system, including, for example, a credit-invoice VAT, a PAYE individual income tax with graduated but arguably moderate rates, and a set of excise taxes focused on the usual suspects (alcohol, cigarettes, gasoline, etc.). However, with up to 70 percent of GDP produced and possibly as much as 75 percent of labor employed in the informal sector, the ability of the tax system to raise sufficient revenue with minimal distortions

is severely circumscribed. In such an environment, raising around one-fifth of GDP in tax revenue is likely to impose very large distortionary costs on the economy. Continued reform of both the policy instruments and the administrative and enforcement capacity of the tax system is therefore imperative.

The aim of this paper is to provide a broad overview of the Kenyan tax system, the reforms that have occurred over the past two decades, and the administrative structures in place. To properly assess the distortionary costs of the current tax system, we intend to undertake micro-econometric analysis of the effects of the tax reforms pursued by the government, using individual-level tax return data when available. We discuss the proposed methodology for this subsequent research in the conclusion to this paper.

### **Tax Reform in Kenya**

From independence in 1963 until the early 1980s, public spending in Kenya was financed through a somewhat uncoordinated set of taxes and fees inherited from British rule and supplemented by foreign aid inflows.

The oil shock in the early 1970s led to the country's first significant fiscal crisis, in response to which some relatively minor tax reforms were undertaken. Sales taxes were

introduced as a means of generating extra revenue, and trade taxes were used in an attempt to reduce the ballooning balance of payments deficit. One motivation for the relatively heavy reliance on good-specific sales and excise taxes was the belief that the government could “get the prices right,” especially through its use of trade taxes in the pursuit of first, import-substitution policies and then export-led growth strategies.

Personal, and to a lesser extent corporate, income taxes were seen as serving primarily redistributive roles in the 1970s.<sup>iv</sup> During the period 1974 through 1985, the tax rates on both personal and corporate income were high.<sup>v</sup> Marginal personal income tax rates ranged from 10 percent on the first shilling to a top rate of 65 percent. The tax rate applied to income of domestic corporations was 45 percent in 1974, while foreign corporations faced a rate of 52 percent. Analysts have observed (e.g., Karingi et al. 2004a) that little personal income tax was collected in the top brackets of the tax schedule. This could have been due to low labor productivity – few people could hope to earn incomes high enough to put them in the top bracket. But it is likely that both the absolute size of the top personal income tax rate, and the fact that it was 20 percentage points higher than the corporate tax rate, contributed to the lack of reported income by taxpayers at the top end.

In the early 1980s, growing budget deficits began to loom. Following the second oil price shock, and fueled by uncontrolled public spending, the budget deficit ballooned to average over

6% of GDP between 1986 and 1993.<sup>vi</sup> Perhaps in anticipation of these developments, in 1986 the Kenyan government approved the Tax Modernization Programme (TMP) aimed at broadening the tax base, and in 1987 it adopted the Budget Rationalization Programme intended to place controls on public spending.

The primary aim of the TMP was to raise the revenue-to-GDP ratio from 22% in 1986 to 24% by the mid-1990s, although this target was increased to 28% in 1992 (Muriithi and Moyi 2003). These targets have so far proved elusive (see below). The intent of the reform was, in some respects, similar to that of the Tax Reform Act of 1986 in the US – the revenue increase was to come about through lower tax rates, broader tax bases, and closed loopholes.<sup>vii</sup> Whether Kenya was on the wrong side of the Laffer curve before the TMP began is unclear, although the high marginal income tax rates suggest it could have been.

On the other hand, broadening the tax base and closing loopholes would require bringing more individuals and businesses into the tax system, itself a challenge given the administrative weakness of the existing tax system. The main organizational change aimed at strengthening administrative capacity was the incorporation of the Kenya Revenue Authority in 1995.

The KRA centralized tax collection activities which had previously been undertaken by departments in the Ministry of Finance (Muriithi and Moyi 2003). Over the last ten years, the

KRA has adopted internal management reforms aimed at combating corruption among revenue officers and improving taxpayer services.

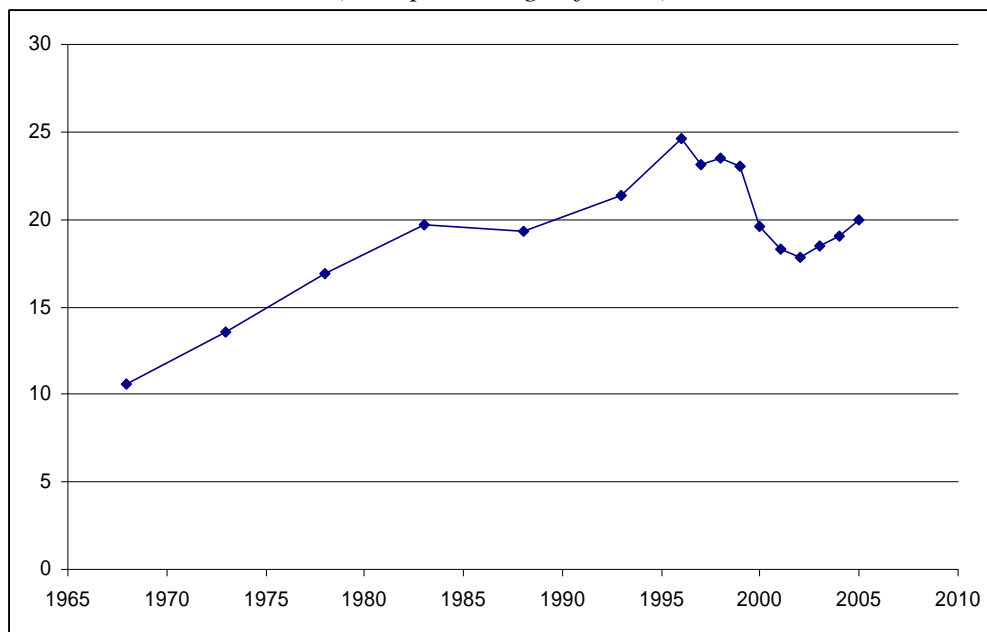
A number of East African countries have created tax collection authorities over the last decade. These institutions are semi-autonomous from government, and act under the supervision of a board of directors that includes bureaucrats, possibly a senior representative from the ministry of finance, and representatives from the private sector. They are meant to have a certain degree of financial and operational independence, for example to allow more flexible employment practices than exist in the public service, and as a means of providing insulation from unwarranted political influence and corruption. In the end, however, they rely on discretionary funding from the Ministry of Finance, so their independence from the government is not complete. Of course, the formulation of tax policy is rarely (and should not be) the responsibility of the revenue administration but remains a ministry, and government, prerogative.

### **The Structure of Tax Revenues**

Tax revenues grew as a proportion of GDP from around 10 percent in the 1960s to about 20 percent by the early 1980s (Karingi et al. 2004b). In the years immediately following the introduction of the TMP revenues gradually increased, reaching 24.6 percent of GDP 1995-96,

after which they stabilized at around 23 percent until the end of the decade (KRA 2005 Annual Revenue Performance Report). In 1999-2000 revenues fell below 20 percent of GDP, and this decline continued until they reached a low of 17.8 percent of GDP in 2001-02. Since then there has been a slow increase to 20 percent of GDP in 2004-05. This evolution is illustrated in Graph 5.1.

**Graph 5.1. Tax Revenue, 1968-2005**  
*(As a percentage of GDP)*



Source: Karingi et al. (2004a) and KRA (2005).

Note: Figures for 1968-1993 are four-year averages.

The share of GDP currently collected in taxes is larger than that in many other sub-Saharan African countries. Kenya had a per capita GDP of about \$360 in 2000 (in current dollars), and many people eked out a paltry and miserable existence on less than a dollar a day (and continue to do so). The poverty rate by this standard was 22.8 percent in 2000, and 58.3 percent of the population lived on less than \$2 a day.<sup>viii</sup> Raising around 20 percent of GDP in taxes is either impressive or dangerous, depending on the distortionary costs and the productivity and efficiency of public spending.

The share of the economy that is either informal or untaxable for other reasons is likely large. For example, Table 5.1 shows the evolution of the sectoral decomposition of output since independence. These data do not translate precisely into measures of easily taxed output, but the fact that agriculture currently contributes 25 percent and other services 47 percent suggests a large share of output is produced in the informal sector.<sup>ix</sup>

**Table 5.1. Distribution of GDP by Sector**

|                 | <b>1964-73</b> | <b>1974-79</b> | <b>1980-89</b> | <b>1990-95</b> | <b>1996-2000</b> |
|-----------------|----------------|----------------|----------------|----------------|------------------|
| Agriculture     | 36.6           | 33.2           | 29.8           | 26.2           | 24.5             |
| Manufacturing   | 10.0           | 11.8           | 12.8           | 13.6           | 13.3             |
| Public Services | 14.7           | 15.3           | 15.0           | 15.7           | 14.8             |
| Other Services  | 38.7           | 39.7           | 42.4           | 44.5           | 47.4             |

Source: Karingi et al. (2004a, p.15).



Table 5.2 provides a more direct measure of the share of output produced in the informal sector, which by 2002 employed nearly three-quarters of the workforce. Of course, labor productivity in this sector is likely to be low. Nonetheless, getting 20 percent of GDP out of the rest of the economy suggests relatively high tax burdens and distortions thereon.

**Table 5.2. Recorded Employment**  
(*In thousands*)

|      | Formal sector  |                                  | Informal sector<br>(percent of total) | Total |
|------|----------------|----------------------------------|---------------------------------------|-------|
|      | Wage employees | Self-employed and family workers |                                       |       |
| 1996 | 1619           | 63                               | 2644 (61.1)                           | 4326  |
| 1997 | 1647           | 64                               | 2987 (63.6)                           | 4698  |
| 1998 | 1678           | 65                               | 3353 (65.8)                           | 5097  |
| 1999 | 1689           | 65                               | 3739 (68.1)                           | 5493  |
| 2000 | 1695           | 65                               | 4151 (70.2)                           | 5912  |
| 2001 | 1677           | 65                               | 4624 (72.6)                           | 6367  |
| 2002 | 1700           | 65                               | 5086 (74.2)                           | 6852  |

Source: Karingi et al. (2004a, p.18).

The broad structure of tax revenues has changed to some extent. Income taxes (including taxes on both corporate and personal incomes) accounted for about a third of revenues from the late 1970s to the late 1990s, although the share was as high as 44 percent in the early 1970s.

Reliance on import duties has fallen as the result of a move away from protectionist tariff

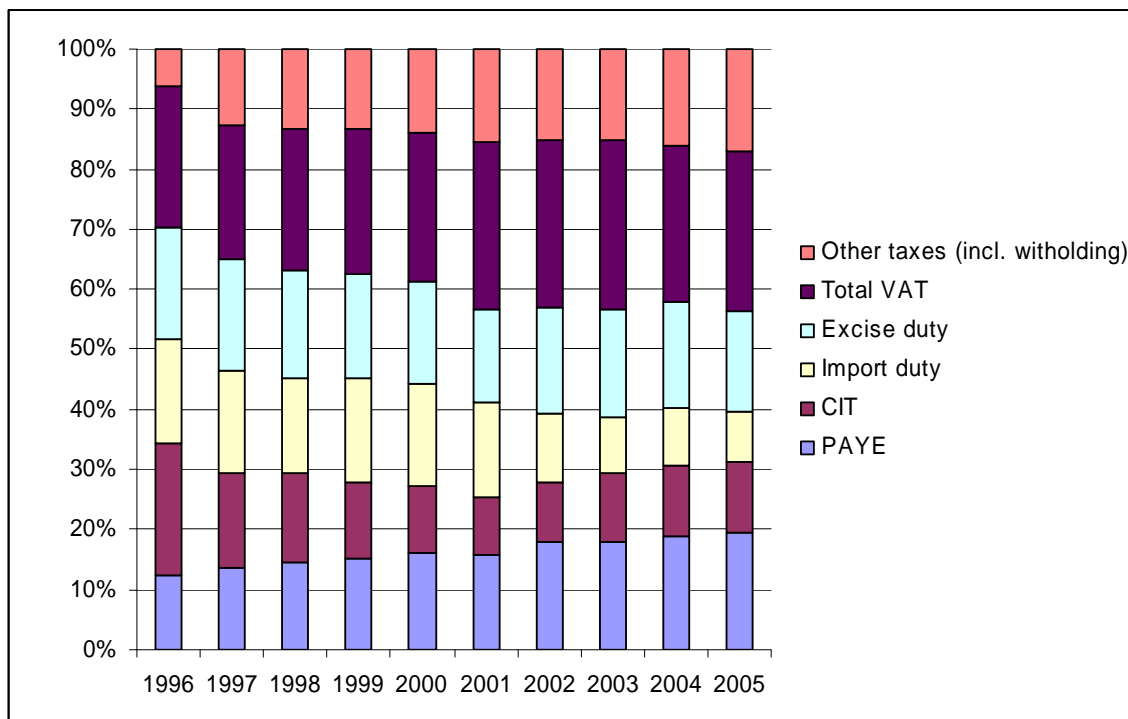
policies and the integration of East African economies. They accounted for about one-quarter of revenues immediately before the TMP, but had reached only 15 percent by the early- and mid-1990s. Excise taxes, primarily levied on alcohol, tobacco, and petroleum products, offset some of this change rising from 10 to 16 percent of revenues over the same period. Finally, VAT revenues accounted for 25 percent of taxes by 2001, down from 36 percent in the early 1990s when the tax was first introduced. Falling VAT rates during this period can account for some of this shift, but evasion and moves into tax-exempt activities could also be at work, as well as improvements in corporate income and PAYE tax collections. Before the introduction of VAT, the sales tax (which the VAT replaced) had contributed between a quarter and a third of revenues from the mid-1970s to the late 1980s.

A more detailed view of recent developments is shown in Graph 5.2, which shows the evolution of the structure of tax revenues since 1995, when the KRA was established. A clear feature is the increase in the relative importance of PAYE income tax withheld at source, offset by a reduction in the share accounted for by corporate tax revenues. Indeed, in 1995-96 corporate tax revenues were 1.8 times PAYE taxes, but by 2004-05, the ratio was only 60 percent. It is tempting to attribute this change to a convergence of the top personal income tax rate and the corporate tax rate, although one might expect to see such a relationship between corporate tax revenues and personal income taxes paid by higher-income individuals who are less likely to in

the PAYE group. However, the fact that the share of revenue from the two taxes (PAYE and CIT) combined did not change significantly over this period suggests that some of this kind of income shifting might have taken place.

Also from Graph 5.2, it is clear that import duties have fallen in relative importance over the ten-year period to 2005. Withholding tax revenues (on interest, dividends, and certain other sources of non-wage income) have been steady at between 4 and 5 percent of total taxes, but other taxes have increased from about 3 percent in 1995-96 to over 12 percent last year.

**Graph 5.2. Structure of Revenues, 1996-2005**



Source: Tables 7 and 23, KRA 2005, Statistical Bulletin.

### **Specific Policy Reform Measures**

In this section we discuss the features of the major tax instruments that are currently employed and how they have evolved over time.

### **VAT**

In 1989, the government passed legislation to introduce a credit-invoice value-added tax, which became effective on January 1, 1990. At this time the concept of tax policy simplicity had not firmly taken root in Kenya: the VAT was introduced with a standard rate of 17 percent, but with 14 other rates (the highest being 210 percent) that made the VAT appear more like a differentiated commodity tax regime. This multiplicity of rates was particularly difficult to rationalize in light of the fact that excise taxes on specific classes of goods were maintained during (and indeed after) the transition and implementation of the VAT.

The high and wide range of rates is thought to have led to widespread misclassification and other methods of tax evasion. In response to these concerns, the number of VAT rates was quickly reduced to four by 1993-94, when the top rate was set at 40 percent. Since then, the rates have been further lowered, and currently there is just a single standard rate of 16 percent, with some sales zero-rated and others exempt. (See Table 5.3.)

**Table 5.3. VAT rates in Kenya, 1989-2004**

| <b>Year</b> | <b>Number of VAT rates</b> | <b>Standard rate</b> | <b>Highest rate</b> |
|-------------|----------------------------|----------------------|---------------------|
| 1989-90     | 15                         | 17                   | 210                 |
| 1990-91     | 9                          | 18                   | 150                 |
| 1991-92     | 8                          | 18                   | 100                 |
| 1992-93     | 6                          | 18                   | 50                  |

|         |   |    |    |
|---------|---|----|----|
| 1993-94 | 4 | 18 | 40 |
| 1994-95 | 4 | 18 | 30 |
| 1995-96 | 4 | 15 | 25 |
| 1996-97 | 3 | 15 | 15 |
| 1997-98 | 3 | 17 | 17 |
| 1998-99 | 4 | 16 | 16 |
| 1999-00 | 4 | 15 | 15 |
| 2000-01 | 4 | 18 | 18 |
| 2001-02 | 4 | 18 | 18 |
| 2002-03 | 4 | 18 | 18 |
| 2003-04 | 3 | 16 | 16 |
| 2005-06 | 1 | 16 | 16 |

Source: Karingi et al. (2004b), KRA.

All businesses with annual turnover greater than KSh 3 million are supposed to register as VAT taxpayers and submit monthly returns.<sup>x</sup> In addition, certain traders and members of certain professions are required to register independently of their turnover, but this requirement is not well enforced.<sup>xi</sup> The number of businesses registered for VAT is currently about 54,000, up from 36,000 two years ago. However, only about 30,000 VAT returns were received each month in 2004-05, suggesting that many firms are dormant (have fallen below the threshold, but have failed to deregister, which itself can be a costly process) or non-compliant. The large, and possibly inefficient, increase in the number of registered firms is thought to be due to a number of issues, including the requirement that any firm seeking a contract with a government agency must be VAT-registered (even if it falls below the threshold, and even if it ends up not winning a

contract), and the VAT withholding regime, discussed presently. This distribution of VAT payers and collections is shown in Table 5.5 in the Appendix.

In most VAT systems, the seller of a product is required to remit tax on sales. In practice, there are a number of ways in which the system can be implemented. First, the seller might base the calculation of tax payable on an explicit accounting of value added. Alternatively, the seller assesses VAT on gross sales but claims a credit for VAT already paid on inputs. Under both these systems, only the net amount of VAT is sent to the tax collection agency. Alternatively, the seller may be required to write a check for VAT assessed on gross sales, and claim a refund for VAT paid on inputs.

In Kenya, the responsibility for paying VAT on certain sales rests not only with the seller but also with the buyer, a system referred to as VAT withholding.<sup>xii</sup> VAT withholding was first introduced in late 2003 and applied to government agencies that purchased goods and services subject to VAT. There was a concern that the government, through these agencies, was paying VAT-inclusive prices to suppliers, who were not necessarily remitting the revenue to the KRA. Subsequently other purchasers were brought into the withholding regime, and in 2004-05 there were about 2000 so-called VAT withholding agents – purchasers who were required to withhold VAT. In that year, about 40 percent of VAT revenue was collected from these agents.

One concern with withholding is that it can provide too strong an incentive for firms to

register for the VAT. Suppliers who fall below the turnover threshold but who sell to withholding agents are induced to register in search of refunds on inputs, clogging up the system.

The effect of withholding (see the Appendix for an illustrative example) is to put some businesses, in particular importers of oil, in a more or less permanent net credit position, in which they seek VAT refunds from the KRA each month. This, however, has led to compliance problems, as those subject to withholding rationally expect delays in receiving refund checks. The mentality of the KRA, given its focus on tax collection, is one of revenue maximization, and refund payment is low on its list of priorities. This policy is of course self-defeating if compliance falls enough. One view among tax administrators is that the VAT-withholding system has complicated tax collection and created perverse incentives for tax collectors. The implication is that direct improvements in enforcement (on which the withholding system was first focused) – e.g., through the auditing of suppliers to government agencies – are preferable.

The government is currently considering the introduction of a presumptive tax, referred to as a Unified Tax System (UTS).<sup>xiii</sup> The intention of this policy is to target untaxed business income by bringing into the tax net those businesses that neither pay income tax nor are part of the VAT system. Included in the latter are businesses which are currently required to register as VAT payers but choose (illegally) not to and those which have annual turnover less than the existing registration threshold (KSh 3 million). In principle, any business that is not required to



register for VAT, and does not choose to do so, should be covered by the presumptive tax. That is, the VAT/income tax system and the presumptive tax system are intended to be mutually exclusive, although some businesses can choose under which regime to operate.

It is proposed that the tax, which is yet to be introduced, will be related to gross turnover or, where such information is not available, it will be lump-sum. The proposal is that the lump-sum liabilities will be differentiated geographically and by sector. This two-dimensional stratification, along with the turnover component, is likely to add a degree of complexity to what is supposed to be an administratively simple tax.

For those businesses that currently fall under the VAT threshold, there may be some incentive to register under the presumptive tax regime, depending on penalties for non-compliance and the “benefits of formality.” One would expect little participation response, however, from those that currently have turnovers above the KSh 3 million VAT threshold but choose (illegally) not to register. Indeed, some fear that the presumptive tax could induce informality – in this case defined as deregistration for VAT – as it legitimizes opting out of the VAT system.

## **Personal Income Tax**

Individuals pay taxes on earned income at graduated rates. By administrative necessity, personal income tax has traditionally only been levied on formal sector workers. Until 2003, most payers of personal income tax did not file a return, but simply had tax withheld at source. The requirement to lodge a return is believed by some to have increased compliance costs and administrative costs significantly, while having little impact on revenues.<sup>xiv</sup>

For example, there are currently about 600,000 individuals who submit an annual income tax return, but only 10,000 to 20,000 businesses that (should) withhold PAYE taxes. If many individuals had other sources of taxable income, individual returns might be necessary. However, only about 2,000 individuals submit returns with non-wage income that adds to taxable income. It is likely, although there are no data to confirm this, that many high-income individuals simply evade tax payments through non-reporting and choice of compensation strategy. Thus, while there is not much revenue collected from the personal income tax in excess of PAYE taxes, there could be a considerable amount of potential tax revenue from these sources. However, focusing on high-income, and politically well-connected individuals is particularly sensitive in Kenya.

In the late 1980s, personal income tax was levied at eight different marginal rates ranging from 10 to 65 percent. The top rate was reduced to 45 percent in 1990, 35 percent in 1996, and 30 percent in 2000, where it remains today. The current rates are 10, 15, 20, 25, and 30 percent.

Each taxpayer is eligible for a (non-refundable) credit known as personal relief, which amounts to a little more than the amount of tax that would be payable in the first tax bracket.<sup>xv</sup> Thus, in practice, the tax schedule is equivalent to one with a uniform exemption followed by rates ranging from 15 to 30 percent. Karingi et al. (2004b; Table 6) have estimated the maximum income an individual could earn before paying any personal income tax for the years 1995 through 2003. They find that this maximum income increased from 2.3 times to 4.1 times the national per capita income over this period.

Until recently, there were two forms of relief, or credit: a personal relief and a larger family relief. Non-married individuals could claim the former, and married men could claim the latter. Married men were required to pay tax on their combined household income. Although KRA income tax forms are currently divided into “self” and “wife,” the incomes of each are now taxed independently and each receives a single personal relief or exemption.<sup>xvi</sup>

Self-employment and partnership income is taxed under the same tax schedule as wage income. Non-wage incomes, in the form of dividends, interest and certain other incomes, including royalties and management, professional, and commission fees, are subject to a final withholding tax at source.<sup>xvii</sup> These taxes are effectively separate and at specific rates from the income tax. Given this arrangement, there seems little reason to require wage earners (most of whom have only a limited amount of interest or dividend income) to file formal returns.

Capital gains are exempt from the personal income tax in Kenya. Although there are arguments against the taxation of capital gains, it appears that the dominant reason for the exemption in this case is that one of the primary stores of wealth (and sources of capital gains) is real estate, the ownership of which is concentrated in the hands of the political elite.

Pension contributions up to 30 percent of pensionable salary are deductible against gross income, and a credit of 15 percent of the cost of life insurance premiums and education policies for family members (capped at KSh 36,000 each) is also available.<sup>xviii</sup> Mortgage interest payments up to KSh 100,000 (KSh 150,000 effective January 1, 2006) are also deductible.

During the period of reform, some attempts have been made to introduce a presumptive tax in lieu of the income tax to reach the informal sector, in particular agriculture. It is widely believed that these efforts have generally failed (Karingi, 2004a). Whether the presumptive tax in lieu of the income tax and as a supplement to the VAT will meet with greater success is yet to be seen.

### **Corporate Income Tax**

About 40,000 firms are currently registered as Corporate Income Tax payers.<sup>xix</sup> Tax rates on domestic firms have fallen from 45 percent in the mid-1970s to 30 percent currently. (Tax rates

imposed on foreign owned corporations were 52 percent, but have fallen over the last thirty years to 32.5 percent now.)

Corporations that locate in Export Processing Zones, which are found in Nairobi and Mombasa, and can show that they produce for export, are granted a generous ten-year corporate tax holiday.<sup>xx</sup> Firms outside the EPZs can deduct twenty percent of the costs of investment in (new or second hand) plant and equipment up front (equivalent to a 6 percent investment tax credit) and then amortize the remaining cost of the investment following specified depreciation formulae. Certain investments are given favorable treatment, such as hotel construction and some agricultural investment.

### **Excise Taxes**

Excise taxes are levied on (imported) oil products, as well as consumption of beer and spirits, cigarettes, matches, and tobacco. Before the TMP, excise taxes had been levied at specific rates, but moderate to high inflation induced a change to an ad valorem basis. Later, in the 1980s, the tax regimes were selectively switched back to specific charges in the face of undervaluation by traders.

Prior to 1990, taxes on cigarettes had provided more than half of non-oil excise tax revenues and beer about one-quarter. However coincident with the introduction of the VAT, the specific tax on beer was replaced with a 100 percent tax rate, and these shares were effectively reversed (Kiringai et al. 2002).

### **Administrative Structure and Reforms**

In this section, we discuss a number of administrative features of the Kenyan tax system, including the internal organization of the Kenya Revenue Authority, the auditing and refund processes, and penalty provisions. We end the section with a brief description of a tax amnesty that was adopted in 2004.

#### **Organization of the KRA**

Tax collection responsibilities are divided between two main departments in the Kenya Revenue Authority: the Domestic Tax Department (DTD) and the Customs and Excise Department (CED). The DTD covers personal and corporate income taxes, withholding tax, VAT on domestically produced goods, and some other small taxes. Until mid-2005, the CED was

responsible for all excise tax collection (on both domestically-produced goods and imports), all trade taxes, and VAT collected on imports. On July 1, 2005, responsibility for domestic excises was shifted to the DTD.

The Authority has seventeen so-called stations, or regional branches. Four of these stations are in the capital Nairobi (Nairobi North, South, East, and West) and two are in Mombasa, the main port. Although the responsibilities of the Nairobi stations are geographically determined, all four offices are located in the same building as the central KRA administration.<sup>xxi</sup> One of the seventeen stations is the Large Taxpayer Office, whose clients are not geographically determined (see below). In addition to the stations, there are a number of much smaller “satellites” that provide a limited range of services, including taxpayer registration, tax forms, and payment facilities with an additional nine satellite offices.

In 1997-98, the KRA created a Large Taxpayer Office (LTO) to specifically monitor and provide services to taxpayers that contribute the bulk of revenues. Fully 70 percent of taxes are remitted by around 500 taxpayers, although of course the incidence of these taxes, which include, for example, PAYE, VAT, and custom and excise taxes, is much broader.

The primary eligibility criterion for treatment as a large taxpayer subject to LTO control is annual turnover of KSh 1 billion (about US \$15 million). In addition, firms in certain lines of business, including banks, financial institutions, and finance companies, are subject to inclusion

in the LTO regardless of turnover. Finally, government agencies and certain parastatals are also included. Currently, there are approximately 300 companies subject to LTO treatment, and these contribute roughly 60 percent of revenue. A number of companies that meet the threshold are not included (for reasons unknown to the authors), and it is believed that doubling the number of taxpayers covered by the LTO would mean this office collected about 70 percent of revenues.

One internal problem with using a Large Taxpayer Office to focus auditing and taxpayer services on high-yield clients is that revenues from these companies are no longer collected through the relevant branch office, or station. The transfer of responsibility to the LTO meets some resistance from said stations, as they often lose a large fraction of their collections. While in principle, this should have no impact on incentives or performance – any explicit or implicit incentive schemes for regional branches should be easily corrected for the loss of identifiable large revenue earners – the expectation is that loss of such clients portends general loss of prestige and influence for the station.

The auditing strategy of the LTO is to audit about one-third of firms subject to its control each year. The coverage rate for medium sized taxpayers is much lower, but a target of about 10 percent is thought to be appropriate.

## **Auditing**



In principle, the tax system is moving in the direction of self-assessment, whereby individuals and firms calculate their tax liability directly and submit returns and payments. Administrative assessment, on the other hand, requires that each taxpayer's liability is calculated by a revenue official, using data supplied by the taxpayer. In practice, there is a continuum of systems between these two, distinguished by the probability of being audited. Auditing activities have recently been streamlined with the merger of the Income and VAT departments under the DTD. This consolidation has allowed joint audits of VAT and income taxes, including PAYE taxes that are the responsibility of the employer (who is often a VAT payer).<sup>xxii</sup> In 2004-05, two thousand audits were undertaken, raising KSh 5.5 billion (KRA 2005b). To improve compliance among taxpayers, the KRA has developed an audit handbook, and is engaged in continuing taxpayer education activities.

The KRA, the Treasury, and KIPPRA<sup>xxiii</sup> recently fielded a survey to assess tax compliance issues in Kenya. Preliminary results show that 74 percent and 72 percent of respondents had been subject to a VAT and (corporate) income tax audit, respectively. Roughly one-third and one-quarter of respondents reported being audited annually for VAT and income tax purposes. These audit rates appear high, but as participation in the survey was voluntary, they may well be overestimates of actual audit rates.



## **Tax Refunds**

It is revealing that while most taxpayers surveyed reported being satisfied with the procedures for tax registration and payment, they also assessed the procedures for appeals, exemptions, remissions, and refunds as 'very poor' and 'unfair' (Tax Compliance Study). Typically, at least sixty days elapse before a refund is processed, and this delay can be as long as 120 days. All refunds, including those for VAT collected on imports, are processed by the DTD.<sup>xxiv</sup> (The CED processes all refunds of import excises and duties.)

All requests for refunds (e.g., for excess VAT paid) must be audited,<sup>xxv</sup> which may delay, and certainly adds to the cost, of receiving compensation for overpayment of net taxes. A further impediment to the speedy refund of excess payments is that such transfers are treated under the budget as expenditures, not as negative revenues. This distinction is important in practice (although of course not in theory) because it means parliament must pass an appropriation bill with funds earmarked for refunding. This leads to backlogs which are intermittently cleared, only to start growing again immediately. In addition there appears to be disagreement between the KRA and the Treasury over the size of refunds required, which again leads to delays. Refund policy should clearly be much more automatic, unless there are serious concerns over fraud that would be determined on a basis of risk assessment.



## **Penalties and Interest**

Penalties for non- or under-payment of taxes are defined by law, and interest of 2 percent per month is charged on tax arrears, calculated starting from the date the tax was due. While it is standard practice to punish non-compliance starting on the date the tax was due, long delays between the submission of a return and auditing tend to increase interest payments by those who are found to have underpaid. The relatively high (2 percent) monthly interest rate provides the KRA with little financial incentive to speed up auditing.<sup>xxvi</sup>

Some observers have identified a legislative source of inflexibility in the penalty system. In particular, penalties for non-payment of VAT, income tax, and customs and excise taxes are defined under three separate laws, which are difficult to coordinate and to adjust as changing circumstances require. Proposed legislation would integrate the penalty provisions and leave them to be implemented through regulations.

Eighty percent of respondents to the survey above claimed that penalties and interest were too high, but this is not surprising. Two things that are not clear from the survey are (a) whether the penalties and interest are imposed consistently, or whether tax payments are negotiated with revenue officials on a case-by-base basis, and (b) what effects these sanctions have on compliance and the choice to enter the formal sector.

The physical process of paying any bill in Kenya, where the postal system is notoriously unreliable, is costly and protracted, often requiring a personal visit to a far-away office. In light of this, the KRA has attempted to facilitate easier payment of taxes. It has opened a cash-receiving center for income tax payments in a regional center (Eldoret) and has expanded the number of points at which annual income tax returns can be collected and submitted. However, the process remains exceedingly labor intensive. Even with high unemployment and a low shadow wage, the congestion costs imposed by the mechanisms for interacting with the KRA must surely be large.

The situation is somewhat better for customs duties and VAT collections. Taxpayers are now required to pay self-assessed taxes directly to a bank, although this can simply push the problem on to the banking sector, which itself is not highly automated.

### **Tax Amnesty**

On June 10, 2004, the Minister of Finance announced a tax amnesty that permitted individuals, firms, and other corporate bodies to pay previously undeclared taxes or duties by the end of the calendar year without penalties or interest. The KRA reports the results of this exercise, as shown in Table 5.4. In the table, income tax payments reflect primarily corporate income tax

proceeds. It is somewhat difficult to interpret the figures, as the KRA did not report the baseline or counterfactual against which the estimates were calculated. Potentially more importantly, it is not evident what the dynamic effects of this amnesty will be on future incentives to pay tax in full and on time.

**Table 5.4. 2004 Tax Amnesty Results**

|                    | <b>Revenue (KSh. billion)</b> | <b>Number of Applicants</b> |
|--------------------|-------------------------------|-----------------------------|
| Income tax         | 2.98                          | 2,258                       |
| Customs and Excise | 0.32                          | 450                         |
| VAT                | 1.50                          | 865                         |
| <b>Total</b>       | <b>4.80</b>                   |                             |

Source: KRA 2005, Statistical Bulletin.

### **Conclusions and Directions of Future Research**

The fixed costs of running a modern tax collection system, coupled with the informal nature of much of economic activity, make it difficult to raise public funds in poor countries. Questions of

how to efficiently raise more revenue, and how to reduce the administrative and distortionary costs of raising existing revenue, are two sides of the same coin. Our descriptive summary of the Kenyan tax system above suggests a number of avenues of future research that might yield insights into these questions.

With the recent introduction of mandatory filing of personal income tax returns, the Kenya Revenue Authority is amassing a large amount of micro data that could be used to assess the incentive effects of taxes on labor supply and taxable income more generally. We see two separate avenues of research in this vein. First, we consider focusing on employees who traditionally did not file a return (and had PAYE taxes withheld). For these individuals, the change in filing requirement has effectively reduced the opportunity cost of claiming certain deductions, since previously, any filing costs were avoided by not making such claims.

Second, an analysis of the behavior of high-income taxpayers is desirable. Such individuals, to the extent they have had non-wage income, have been required to file individual tax returns since the inception of the KRA in 1995. We envision using the reductions in tax rates over this period – the top marginal rate fell from 37.5 percent to 30 percent between 1995 and 2000 – to estimate the responsiveness of taxable income to those rates, and the associated distortionary costs.<sup>xxvii</sup> Given the possibility of income shifting – from corporate to personal



income – the responsiveness of corporate tax payments would need to be incorporated into this analysis.

Other studies would likely require survey data in addition to information from tax returns. For example, understanding the effects of the presumptive tax, if one is introduced, would necessarily involve collection of data on the nature and extent of informality. Nor are the normative impacts of the policy clear-cut. A revenue maximizing tax collector sees the benefits of reducing informality, but not necessarily the compliance costs imposed. More fundamentally, while entry into the formal sector is often assumed to benefit businesses by improving their access to credit and other financial markets, the extent to which (a) this is true, and (b) informal credit markets are crowded out, can only be assessed empirically.

We have said relatively little in this paper about the distributional impact of the tax system in Kenya. Due to the large proportion of individuals in the informal sector, as well as the personal relief (exemption) in the personal income tax schedule, the instruments that impose the highest direct costs on the poor are no doubt excise taxes and the VAT (despite zero rating and exemption of some products under the latter). Quantification of the burden requires more precise information on household consumption patterns by income category, as well as assumptions or evidence about the incidence of these taxes. We suggest however that an important distributional concern is not so much how much tax is paid by the poor (or more generally, what the effect of

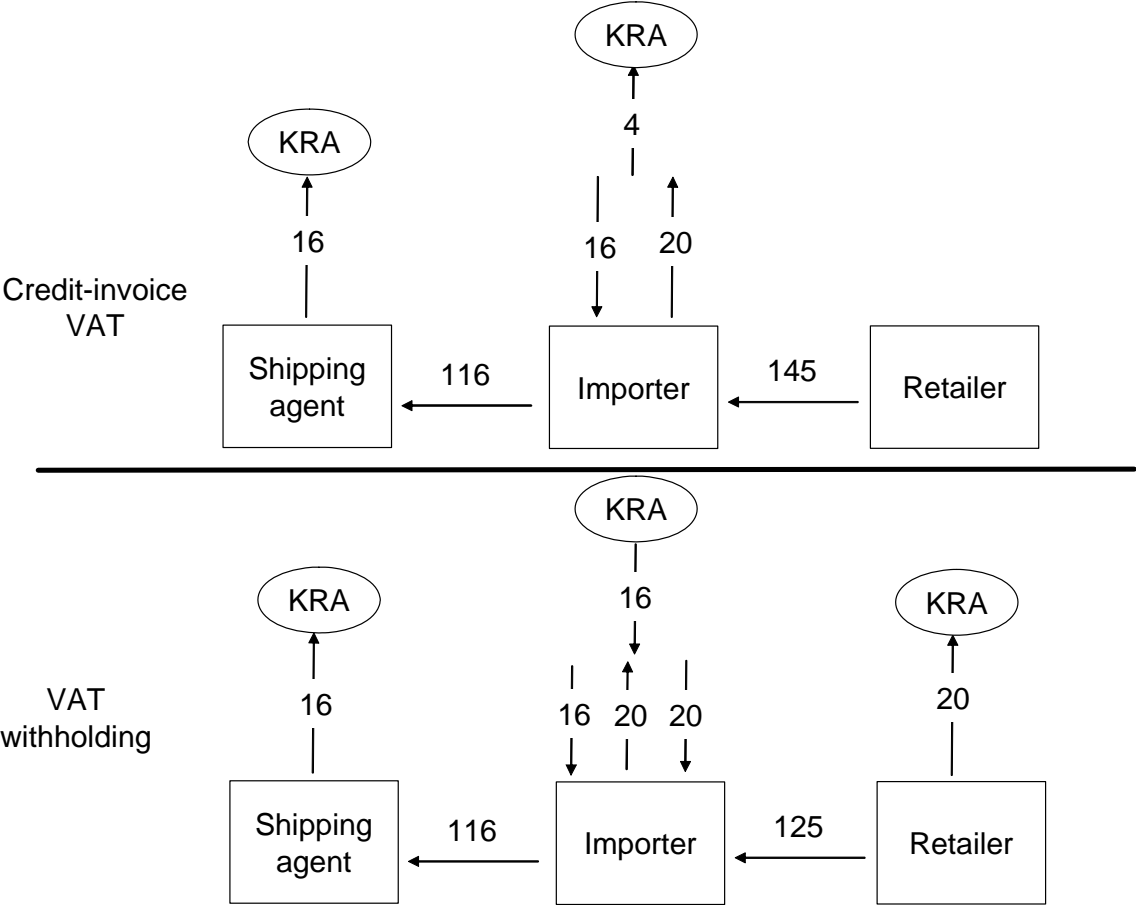
the tax system is on their welfare), but how little tax is paid by the rich, either due to tax avoidance, tax evasion, or direct manipulation of the tax laws and regulations by the elite.

### **Appendix: VAT Withholding**

Consider an importer who purchases oil for KSh 100. Ignoring excise and import duties, he pays VAT of KSh 16 for a total cost of KSh 116. The shipping agent remits a check for KSh 16 to the KRA. Suppose the importer's value added is KSh 25. Under a typical credit-invoice VAT he would sell the oil to a retailer for KSh 145, including KSh 20 (=16% of KSh 125). He would either remit a check for KSh 20 to the KRA and seek a refund of 16, or simply remit a check for the net amount, KSh 4. This is shown in the top panel of Figure 5.1.

Under VAT withholding, the importer again purchases the oil for KSh 116, but now sells to the retailer for only KSh 125. The shipping agent remits a check for KSh 16 as before, but now the *retailer* pays VAT of KSh 20 (=16% of KSh 125) on its purchase. In practice, the importer is liable for VAT of KSh 20, but receives a credit for KSh 20 paid by the retailer, as well as a credit of KSh 16 already paid on inputs. Thus the importer has an excess credit of KSh 16, which he must claim as a refund. This is shown in Figure 5.1.

**Figure 5.1. Credit-invoice VAT versus VAT withholding**



**Table 5.5. Distribution of VAT Taxpayers, 2004-05**

| <b>Annual turnover (KSh. million)</b> | <b>Number of taxpayers</b> | <b>Cum. %</b> | <b>Total turnover (KSh. million)</b> | <b>Average turnover (KSh. million)</b> | <b>Total VAT (KSh. million)</b> | <b>Average VAT paid (KSh. million)</b> | <b>Cum. % VAT paid</b> |
|---------------------------------------|----------------------------|---------------|--------------------------------------|--|---------------------------------|--|------------------------|
| > 250                                 | 501                        | 0.9           | 533,923                              | 1,066                                  | 18,375                          | 36.7                                   | 61.9                   |
| 100-250                               | 709                        | 2.2           | 106,775                              | 151                                    | 2,980                           | 4.2                                    | 72.0                   |
| 50-100                                | 840                        | 3.8           | 58,823                               | 70                                     | 1,918                           | 2.3                                    | 78.4                   |
| 10-50                                 | 3,690                      | 10.6          | 80,681                               | 22                                     | 3,057                           | 0.8                                    | 88.7                   |
| 5-10                                  | 2,343                      | 15.0          | 16,702                               | 7                                      | 827                             | 0.3                                    | 91.5                   |
| 3-5                                   | 1,942                      | 18.6          | 7,521                                | 4                                      | 407                             | 0.2                                    | 92.9                   |
| < 3                                   | 43,934                     | 100.0         | 8,954                                | 0.2                                    | 2,112                           | 0.1                                    | 100.0                  |
|                                       | 53,959                     |               | 813,379                              | 15.1                                   | 29,676                          | 0.5                                    |                        |

Source: KRA presentation, IMF-sponsored workshop on tax administration, Kenya School of Monetary Studies, Nairobi, November 29, 2005.

#### Notes

<sup>i</sup> Prepared for the Initiative for Policy Dialogue Tax Task Force. Thanks to Roger Gordon, Dickson Khainga, Jonah Ogaro, Andrew Okello, and Alice Owuor for providing information.

<sup>ii</sup> Georgetown Public Policy Institute.

<sup>iii</sup> Department of Economics. Currently on leave in Nairobi, Kenya.

<sup>iv</sup> The theory of optimal taxation (Diamond and Mirrlees, 1971a, b, Mirrlees 1971), including the choice between direct and indirect taxation (Atkinson and Stiglitz, 1976), was of course in its infancy in this period.

<sup>v</sup> There is a tendency in Kenya to lump discussion of personal and corporate income taxes in to a single income tax category. We will try to avoid this practice in this paper.

<sup>vi</sup> If we are to believe that one-half to three-quarters of GDP is produced in the informal sector, then estimates of output and any other quantities as a share thereof need to be interpreted with caution. However, as we do not have specific information on the way in which GDP is calculated, it is difficult to tell in which direction there is likely to be a bias, if any.

<sup>vii</sup> Something about the revenue-neutrality of TRA86 – was it? – compared with the intention of raising revenue in Kenya.

<sup>viii</sup> Per capita income had risen to \$480 in current dollars by 2004. These data are from the World Bank.

<sup>ix</sup> Some agriculture output comes from large tea, coffee, and pineapple plantations, which is relatively easily taxed.

<sup>x</sup> The government may change the filing requirements of smaller businesses, who would file bi-monthly instead.

<sup>xi</sup> Even though it is not enforced, many VAT taxpayers do have turnover less than the standard threshold, thereby bloating the system that the VAT register.

<sup>xii</sup> This terminology is consistent with the requirement that the purchaser of labor services be required to pay tax on wages paid under the more familiar income tax withholding.

<sup>xiii</sup> There is currently in place a presumptive tax on agriculture, which is a 2 percent tax on gross proceeds from sales to agricultural traders (middlemen), available to those who opt out of the personal income tax regime. Compliance is very limited, and tax collections are virtually zero.

<sup>xiv</sup> Individuals submit paper personal income tax returns, which are stored in hard copy by the KRA. On the other hand, the KRA stores electronic copies of PAYE returns by

employers, but there is no cross-link between employers' returns and individuals'. In particular, the employer returns have no means of identifying which employees have had PAYE tax remitted on their behalf. There is some evidence that the PAYE tax is being withheld by employers but not remitted to the KRA, a simple case of theft.

<sup>xv</sup> In 2004 the relief was KSh 12,672, while the bottom tax rate of 10 percent applied to the first KSh 116,160 of income.

<sup>xvi</sup> Married women have the option of filing separately.

<sup>xvii</sup> The withholding rates are 15 percent on gross interest earnings, 5 percent on qualified dividends, and 10 percent on ordinary dividends.

<sup>xviii</sup> It is believed that the requirement that all wage earners submit a personal income tax return could have led to a loss in revenue to the extent that individuals who were previously unaware of the deductibility of certain expenses began to take advantage of these preferences. Of course, the reduction in revenue (if any) does not mean that the welfare impact of this change in behavior was negative.

<sup>xix</sup> It is perhaps striking that there are about twice as many firms registered for CIT as there are paying PAYE taxes. One possible explanation for this is that many companies are created for reasons other than hiring employees, perhaps simply as investment holding companies, or as parent companies that own subsidiaries that in turn hire the employees.

<sup>xx</sup> There are about seventy firms in the EPZs. They are of course required to withhold and remit PAYE taxes during this period.

<sup>xxi</sup> The building that houses these offices, the Times Tower, was constructed specifically for the KRA. It is the tallest building in East Africa, and has no tenants other than the KRA.

<sup>xxii</sup> Prior to the merger, the Income Tax department was organized on a functional basis, with separate offices for each department, e.g., taxpayer services, auditing, etc. However, multiple tasks in the VAT department were carried out by all individuals, with little functional delineation. The new merged department has adopted a functional organizational structure.

<sup>xxiii</sup> Kenya Institute for Public Policy Research and Analysis.

<sup>xxiv</sup> Refund claims that are certified by accredited accountants are, according to KRA policy, supposedly fast tracked. This effectively outsources part of the verification process from the KRA at the taxpayer's expense – a kind of kind of price discrimination across tax payers. This policy is unique to Kenya.

<sup>xxv</sup> Similarly businesses are required to submit corporate tax returns accompanied by a set of audited accounts.

<sup>xxvi</sup> Except to the extent that a shilling in the hand is worth more than  $1.02^m$  in the  $m$ -month-old bush.

<sup>xxvii</sup> In a recent paper, Auriol and Warlters (2005) use a CGE model to compute the marginal cost of public funds for a (large) number of African countries. Our micro-level approach would be complementary to their macro simulation methods.



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