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KENYA ECONOMIC AND POLITICAL TRANSITION PROJECT FOR ECONOMIC RECOVERY

Fiscal Strategies and Poverty in Kenya: Agenda for Reform

Introduction

Historically, Kenya's development policy has combined the objectives of economic growth with equity and poverty reduction. These themes run through National Development Plans, Sessional Papers and other economic policy documents. Although there were improvements in social welfare indicators in the late 1980s, these achievements were not sustained. Consequently, inequality and poverty have worsened in recent years. Recent estimates reveal that the proportion of population living in poverty increased from 51 percent in 1997 to 56.8 percent in 2002. The situation may have worsened in the last two years given the slow economic growth relative to population growth.

This policy brief is based on a study: *Fiscal strategies and poverty in Kenya: Agenda for reform*. The study examines how the government spends and finances its expenditure, and how this has impacted on poverty and inequality in Kenya. The brief also draws from other KIPPRA research on *Budget mechanisms and public expenditure tracking in Kenya*, and on the *Public Expenditure Reviews 2003 and 2004* published by the Government of Kenya.

In the 1960s and 1970s, fiscal policy in Kenya focused on land redistribution and resettlement. Agriculture-led economic growth and import substitution strategy, together with favorable prices of coffee in the international market saw growth in output peak at 8 percent in 1977. During the period 1979-83, the development strategy focused on rural development and rapid rural transformation. The District Focus for Rural Development (DFRD) strategy launched in 1983 aimed at directing public resources to less developed areas and promoting participation in development initiatives at the grassroots level. However, this approach collapsed due to under-funding of local government, corruption and overall politicization of development. The Government started liberalizing the economy under the structural adjustment programmes from the mid 1980s.

Tax system and poverty reduction

Addressing poverty concerns through development of specific tax instruments is always seen as promising yet complicated. This is because tax instruments differ in their effectiveness in reducing tax burden on the poor. Internationally, countries use the individual income tax system to address poverty issues in one of three ways:

1) Using the tax system as part of a social welfare programme to provide cash transfers to low-income individuals;

2) Adopting a high threshold to exempt certain low-income individuals from being subject to income tax; and

3) Adopting provisions that seek to reduce the tax burden of low-income individuals.

Kenya's tax system has relied more on the second option. Equity and support for the poor has been addressed by adjusting the income tax threshold, personal relief and income tax brackets. The income tax threshold is currently four times Kenya's per capita income. In terms of Value Added Tax (VAT), zero-rating of a limited number of basic food commodities has been used to shield the poor. In addition, VAT rates have been rationalized and rates reduced. Other tax reforms, under the Tax Modernization Programme (TMP), focus mainly on shifting reliance on revenues from trade taxes and production to consumption taxes.

Weaknesses with the tax system in addressing equity and poverty

The tax instruments used in Kenya have been narrow in addressing issues of equity and poverty reduction. They have lacked the capability to shift the sources of taxable income towards lightly-taxed or un-captured activities such as services, small businesses and informal sector, and assets such as property and land. Second, tax evasion and avoidance have led to substantial under-collection of revenue, especially in the formal sector. The percentage of actual collections over potential taxation (tax effort) shows wide disparities. For instance, tax effort for corporate taxes is estimated at 35 percent, against 85.2 percent for excise tax on beer. Third, the pass through of tax incidence of *taxed* economic activity to *untaxed* economic activity has eroded the impact of taxation plans targeting exemptions and benefits to basic commodities and goods and services of the informal sector, which would have reduced inequality and poverty. In practice, goods and services that are exempted from tax or are zero-rated do not always escape the incidence of tax because of the effects of tax shifting and changes in consumer behaviour. Finally, tax impacts were probably accentuated during the era of import substitution industrialisation strategy of the 1970s and 1980s when agricultural incomes were disadvantaged through exchange rate over-valuation, tariffs and quantitative restrictions.

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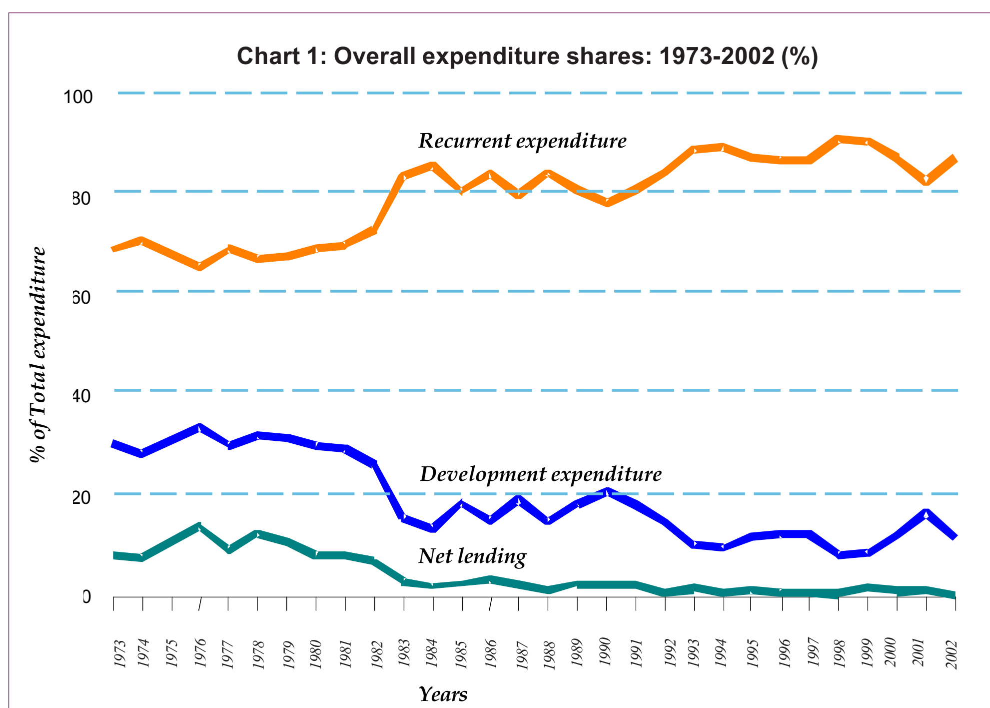
Public expenditure and poverty reduction

Budget allocations have over time concentrated on recurrent expenditure, especially payment of wages and interest, therefore squeezing development spending and compromising efficient delivery of public services. Consequently, Government contributions to public investment and expenditure on social services have been squeezed. Chart 1 shows the trends in the composition of public expenditure. The share of development expenditure fell drastically between 1973 and 2002. In addition, a large share of recurrent expenditure has gone to payment of wages, with little resources left for operations and maintenance. This has adversely affected public investment and service delivery. Public debt also increased during the same period.



To enhance pro-poor orientation of expenditure, the Economic Recovery Strategy for Wealth and Employment Creation, and before it the Poverty Reduction Strategy Paper (PRSP), identified pro-poor policies targeted at improving the status of the poor. These include policies to improve the status of their education, health and nutrition, HIV/AIDS, labor (employment), social security, food security, and security concerns, among others. There is is also special focus on the arid and semi-arid areas and among the most vulnerable groups in society. These designated pro-poor expenditures have been "ring fenced" in the budget as core poverty programs (CPPs). Their implementation is expected to impact directly and positively on the standards of living of the Kenyan society by increasing incomes for the poor. Despite the "ring fencing", however, recurrent spending still dominates development expenditure and there are divergences between actual overall spending and planned spending on CPPs. The reporting and monitoring systems are weak, and focus is more on inputs rather than outputs and outcomes to which the expenditures are directed.

To strengthen fiscal impact on inequality and poverty, there is need for fiscal reforms that are in tandem with economic, demographic, urbanization and institutional and technological changes that are impacting on society

In addition, the weak impact of fiscal strategies on poverty is partly due to weak economic performance, which has constrained anti-poverty benefits of expenditure in education, health and economic services, and weaknesses in public expenditure management, which undermines the efficiency and effectiveness of public expenditure. In 2003, for example, Kenya met only three out of 16 benchmarks for sound public expenditure management.

Conclusions and Recommendations

To strengthen fiscal impact on inequality and poverty, there is need for fiscal reforms that are in tandem with economic, demographic, urbanization and institutional and technological changes that are impacting on society.

To reduce poverty, the following reforms in the fiscal system should be considered:

- Widening of the tax base to capture new definitions of taxable income and wealth, such as income from services rendered, property, wealth, and inheritance taxes, and taxation of urban economic activities;
- On the expenditure side, the challenge on poverty reduction is to sustain social spending in education, health and agricultural services. This calls for well articulated fiscal targeting based on improved fiscal discipline and good governance in order to achieve a better 'fit' between strategic objectives, their costs and implementation of targets that are specific, measurable, achievable, realistic and time-bound;
- Improvement of public expenditure management standards in order to enhance strategic allocation of resources and efficient utilization;
- Control of domestic debt by focusing on maximizing foreign concessional financing. The strategy should lower the claims on interest in government finances while propelling financial sector development and better conditions for lending to the domestic private sector.

About KIPPRA Policy Briefs

KIPPRA policy briefs are aimed at a wide dissemination of the Institute's policy research findings. The findings are expected to stimulate discussion and also build capacity in the public policy making process in Kenya.

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