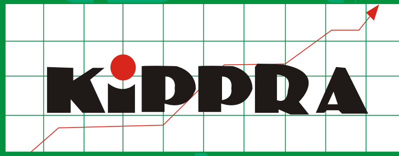

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Lessons From Kenya's Tax Reform Experience

Kenya, like many developing nations, has attempted to reform its tax system over time, with the impetus coming from the increasing complexity of the tax codes, narrow tax base and concerns with fair distribution of tax burden. There were clearly postulated objectives under the tax reform efforts, among them making the tax system more equitable, simplifying the tax system and also raising more revenue. The objective of raising revenue was met, but Kenya still faces challenges with regard to the other objectives of the tax system. Unlike many other Sub-Saharan African countries, Kenya is currently a high tax yield country with a tax revenue to GDP ratio of over 20 percent. The country is able to finance most of its expenditure from tax revenue, with international aid and grants meeting a smaller proportion of total expenditure. Despite this achievement, Kenya still faces problems with its tax system. As acknowledged in the Economic Recovery Strategy for Wealth and Employment Creation (2003-2007), the tax system is complex and cumbersome, and is 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.

Analyzing the tax reform experience therefore presents a good understanding of why the objectives of the tax system were not met and also provides lessons for future tax reform efforts. As the government continues to identify key policy actions necessary to spur economic growth, substantial emphasis is given on the need to implement tax reforms that are not only pro-poor but also pro-growth, through a tax system that encourages both household and enterprise savings and investments. A clear understanding of the tax reform process, its successes and failure is therefore important for formulation of future tax policies.

The Current Tax Structure

The current tax structure comprises of two main direct taxes: individual income tax, and corporate tax, and three main indirect taxes: Value Added Tax (VAT), excise tax, and customs duties. Individual income tax is currently charged on a graduated scale ranging from 10% to 30%. The current annual tax brackets are: 10% on the first Ksh 121,968; 15% on the next Ksh 114,912; 20% on the next Ksh 114,912; 25% on the next Ksh 114,912; and 30% on all income over Ksh 466,704. Corporate tax is charged at a flat rate, currently 30%.

Excise tax is levied selectively on particular goods and services. Current excisable commodities are alcoholic beverages, tobacco, fuel, motor vehicles and other smaller items such as carbonated drinks, safety matches, etc. Value Added Tax (VAT), on the other hand, was introduced in 1990 to replace sales tax. It is a multi-stage consumption tax based on the destination principle, which is applied to the sale of goods and services at all stages of the production and distribution chain. There are currently three VAT rates: 16, 10 and 0 percent, while some commodities are VAT exempt. For one to qualify for registration under VAT, one must have an annual sales turnover of Ksh 3 million, or Ksh 2.4 million in 9 months; 1.8 million in 6 months, or 1.2 million in 3 months. Lastly, customs duty is currently charged on the Cost, Insurance and Freight (CIF) value of imported goods. The current structure of the tariff bands is as under the East African Community Treaty, which is: 0, 10 and 25 percent and sugar at 100 percent.

Tax Reform Experience

Kenya, like many Sub-Saharan countries, did not initiate major tax reforms before the advent of the structural adjustment programmes. After independence, the country inherited a tax system whose features and characteristics were similar to the British tax system. Until early1970s, the economy was growing at an average rate of about 6 percent and there were very little problems associated with revenue mobilization. The international energy crisis of the 1970's caused the

This policy brief is based on KIPPRA Working Paper No. 13 of 2005 on Tax Reform Experience in Kenya. The study seeks to discuss Kenya's history of tax reform and the underlying pressures and motivations for the tax reforms, the process of tax reform, and the impact of the reforms on the goals of revenue adequacy, economic efficiency, equity, and the capacity to effectively administer new tax laws.

Total tax revenue to GDP averaged 10.6 percent at independence, as compared to the current level of 22 percent of GDP. Comparatively, Kenya's revenue to GDP ratio has been slightly above the Sub-Saharan average. However, there have not been major changes in the number and type of tax instruments used in Kenya's tax system before and after the reforms.

country's initial fiscal crisis, which necessitated tax reforms to increase revenue mobilization. Some of the piece-meal changes included: a shift from consumption tax to sales tax; more reliance on indirect taxes in the 80s; and a shift from import substitution to export promotion. Income tax was used to achieve an equitable distribution of the tax burden.

The major tax reforms in Kenya started in the 1980s under the Tax Modernization Programme (TMP), which had a key objective of ensuring a sustainable tax system that would generate adequate revenues to finance public expenditures. The main objectives of the TMP were to: (i) raise revenue from 22 to 28 percent of GDP; (ii) improve economic efficiency of the tax system through lowering and rationalizing of tax rates; (iii) enhance greater reliance on self-assessment systems supported by selective audit; (iv) improve administrative efficiency through computerization and audit capacity as well as establishing tax policy analysis capacity to implement organizational reforms; and (v) address constraints in the existing tax structure such as over-reliance on direct taxes.

Notable Changes under the Tax Modernization Programme

Income tax

Major tax reforms under the income tax included continued rationalization through lowering of marginal tax rates from a top rate of 65 percent at independence to the current 30 percent. The objective of the reduction was mainly provision of personal incentives for savings and also stimulation of enterprises by creation of a savings pool. This, it was hoped, would improve economic performance and enhance job creation. The number of brackets was also reduced over time, from eight in the 1970s to the current five. This was meant to simplify the tax system as the many tax brackets made the system more complex. Regular adjustment of brackets and relief were done to counter the inflation creep and also to make the tax more equitable. The income tax relief has been a useful instrument in providing income tax exemption for low-income earners.

Corporate tax

The most important reforms under corporate income taxation have been towards lowering of tax rates. This was mainly motivated by the need for lower corporate tax rates, occasioned by stiff competition for investment funds globally. By having low corporate tax rates, the country has not only responded to competition from other countries for investment finance but it has also presented itself as a destination for foreign investment. The corporate tax rates were lowered from as high as 45 percent in 1989/90 to 30 percent today for local companies, and from 52.5 to 37.5 percent for foreign companies over the same period. The top corporate tax rate was equalized with the top personal income tax rate in order to avoid tax evasion. Tax incentives via corporate tax have also been used under the export industrialization strategy. Tax holidays have been extended to companies wishing to invest in the country for export. Repatriation of dividends and extension of favourable investment deduction allowances have been critical lynchpins of the corporate tax system for companies wishing to invest in Kenya.

Sales tax/VAT

As earlier indicated, there was a shift from sales tax to VAT in 1989/90. The input credit system was adopted at introduction, with a standard rate of 17 percent, which was to not only cover manufactured goods but also all goods and services. The VAT system at inception was quite complex, with 15 different rates. There has been continued rationalization from the 15 rates to four rates in 1993/94 and finally the current three rates. The major objectives of rationalization were to remove misclassification and ease administration, improve compliance, reduce smuggling and also reduce requests for exemptions. Unexpected expenditures have also been financed through increases in the VAT rate. The tax has also been used as part of the industrial strategy whereby sector-specific inputs were zero-rated in order to revamp Kenyan industries and stimulate specific economic activities, therefore encouraging local production. It is only in 2003/2004 when the VAT was seen as an important instrument that could be used to boost consumption demand in the country.

Excise taxes

Excise taxes have been levied mainly for revenue purposes, but not to internalize costs or encourage investment. The major reform was a shift of excise taxation from a specific regime to an *ad valorem*

regime in 1991/92, and reverting to a specific regime in 2003/04. The main objective of switching back to the specific regime was to reduce tax evasion and avoidance, simplify and improve the effective tax rate and subsequent revenue yield while encouraging investment in quality cigarette and beer products for export. In low inflation countries, there is empirical evidence that specific excise tax regimes are more favourable to investments in high quality products compared to outcomes of an *ad valorem* regime.

Customs duties

Unlike many developing countries, Kenya has relied in a very limited way on import duties for revenue mobilization, which can mainly be explained by the type of trade policy the country has been pursuing. Major reform changes have been in the number of tariffs and also in the rates from the time the country started implementing structural adjustment policies to date. Rationalization of rates was aimed at simplifying the system, with an adoption of the tariff bands under the East African Community in 2005. The objectives underpinning the changes in the tariffs have had a bias towards more openness. However, there have been episodes of protectionism for specific sectors or sub-sectors of the economy. There were also deliberate efforts to address the question of export competitiveness by lowering the cost of production through reduction of average tariffs and also narrowing of their dispersion. With a lot of criticism regarding the impact of liberalisation on the domestic economy, a clear policy shift towards protection of some sectors outside the agricultural sector started creeping back in 1999/2000. The objective of the reversal was to strengthen the protection to domestic businesses, to sustain and nurture their activities and to assist and promote the local industry, which was clearly similar to the import substitution industrialization policy that had been earlier discredited for encouraging an inefficient industrial sector.

Administrative reforms

Another key component of tax reforms in Kenya was the establishment of the Kenya Revenue Authority (KRA) in 1995 as an independent tax administration organization with increased autonomy, mainly to strengthen revenue collection and harmonize the separate tax collection arms. Other administrative reforms have been in terms of enhanced auditing and computerization, among others.

Tax reforms have mainly been aimed at achieving greater simplicity and ensuring uniform tax burden across individuals with equal income, but did not consider distribution of tax burdens across the income categories. Low compliance rates remain a major challenge of the tax system. The major administrative reforms that have been carried out are yet to result into higher compliance levels. Taxation of the informal and agriculture sectors poses major challenges. The informal sector in Kenya has been growing faster than the formal sector, yet it has proved to be a hard-to-tax sector. Efforts to tax agriculture, mainly through presumptive tax, have also not been successful. The government's objective of achieving zero deficits still remains a challenge as evidenced by the growing level of deficits.

Outcomes of the Tax Reform Experience

Looking at the evolution of the tax system over time, the economy moved from a low-tax yield to a high-tax yield economy. Total tax revenue to GDP averaged 10.6 percent at independence, as compared to the current level of 22 percent of GDP. Comparatively, Kenya's revenue to GDP ratio has been slightly above the Sub-Saharan average. However, there have not been major changes in the number and type of tax instruments used in Kenya's tax system before and after the reforms.

Several facts can also be distilled as outcomes of Kenya's tax reform experience. First, the role of trade taxes has diminished considerably since the early 1960s, an indication of the country's change of trade policy paradigm to embracing free trade and challenges of globalisation. Second, the trend in excise tax revenues reveals an increase in revenues under the *ad valorem* regime, even though there was a reversal to a specific regime with the justification that the system is more favourable to investment. The implication is that it might be necessary to have an automatic up-rating of the effective excise tax rates for the given levels of revenues to be maintained unless inflation is maintained at very low rates. Third, the objective of relying more on indirect taxes resulted into a significant shift towards consumption taxes even though income taxes still play an important role despite their declining share in total revenue . Lastly, in line with the objectives of relying more on indirect taxes, VAT has been seen as a tax for the future. Despite this fact, there are still challenges with regard to its low tax yield. The low yield seems to indicate possible structural problems, which tax reforms may have failed to address.

Challenges of the Existing Tax System

Kenya's tax reform experience also poses some challenges. First, tax reforms have mainly been aimed at achieving greater simplicity and ensuring uniform tax burden across individuals with equal

income, but did not consider distribution of tax burdens across the income categories. Second, low compliance rates remain a major challenge of the tax system. The major administrative reforms that have been carried out are yet to result into higher compliance levels. Third, taxation of the informal and agriculture sectors poses major challenges. The informal sector in Kenya has been growing faster than the formal sector, yet it has proved to be a hard-to-tax sector. Efforts to tax agriculture, mainly through presumptive tax, have also not been successful. While some people argue that the agriculture sector needs to be taxed to play its role in development, others feel that agriculture is implicitly taxed heavily. Fourth, the government's objective of achieving zero deficits still remains a challenge as evidenced by the growing level of deficits. The issue is two-fold: revenue adequacy and public expenditure management. Lastly, tax harmonization in the region is a big challenge for the Kenyan economy. Given the integration of the Kenyan economy in the region, taxes need to be harmonized to make the economy more competitive.

Lessons

Several lessons emerge from Kenya's tax reform experience. First, policy reforms need to be assessed carefully, taking into account institutional, technological, demographic and economic changes and objectives. This can partially address the issue of *ad hoc* tax policy measures that have had to be reversed in the past (even though political considerations could have also played a role). Second, it should be recognized that effective tax reform cannot be accomplished without enhanced administrative capacity. One of the mistakes made during the country's reform programme was to place less emphasis on the administrative capacity of institutions. Major administrative reforms were carried out after 1995, while the Tax Modernization Programme (TMP) was initiated in 1986. Third, it is necessary to simplify the tax system in order to promote effective and wider compliance. Tax compliance levels not only reflect the effectiveness of tax administration but also the taxpayers' attitude towards both taxation and the government in general.

Conclusion

It can be concluded that the key elements of a tax reform strategy are:

- The tax reforms should aim to simplify the tax system with fewer rates and a well-defined tax base. This requires adoption of a global tax with few exemptions, credits, rebates, or deductions given that the more the exemptions, the more complicated the tax system.
- The tax system should not be used to achieve too many social and economic goals. It is difficult to trace impacts of tax reform efforts if multiple objectives are pursued, for instance using excise tax revenues to raise revenue and at the same time curb consumption of some items.
- A tax system should be continually monitored so as to identify and rectify, if need be, the negative consequences of a reform effort. This also ensures consistency of reform measures, and can therefore lessen the need for policy reversals.
- For administrative ease, tax systems should concentrate on basic tasks such as collection of tax at source and an identification number system and therefore avoid collection of more information than can be processed. In addition, good record keeping should be encouraged. This can greatly improve compliance.
- As a long-term goal, tax systems should aim for self-assessment. This is also an important way of improving compliance, which is the tax system's biggest challenge.

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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