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KENYA ECONOMIC AND POLITICAL TRANSITION PROJECT FOR ECONOMIC RECOVERY

Tax Reform Experience and the Reform Agenda for Kenya

Introduction

Unlike many sub-Saharan African countries, Kenya is a high tax yield country with a tax to GDP ratio of over 20 percent. A review of Kenya's tax reform experience reveals that generally, levels of tax rates have been reduced over the years to address efficiency and equity concerns, and in order to reduce the tax burden. However, achievements in tax compliance, expansion of tax base and simplification of the tax system have been minimal. Indeed, the Economic Recovery Strategy for Wealth and Employment Creation (2003-2007) observes that: ***Kenya's tax system is 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.***

This policy brief is based on a study on *Tax reform experience and the reform agenda for Kenya*. The brief also draws from other KIPPRA research papers, namely: *Tax compliance survey; Excise taxation and the informal sector; Implicit taxation of agriculture sector in Kenya; and Fiscal architecture and revenue capacity in Kenya*. These papers address the key issues in tax policy and administration, with emphasis on tax reform experience, design of tax systems and the challenges facing the current tax system.

Tax Reform Experience

One of the key goals of tax reforms in Kenya is to develop a sustainable tax system that is able to generate adequate revenue to finance public expenditure at relatively low administrative and compliance costs. Major tax reforms in Kenya started in the 1980s under the Tax Modernization Programme (TMP). The success of this reform package depended on the realization of a set of objectives, among them raising tax revenue levels from 22% to 28% of GDP, improving economic efficiency of the tax system by lowering and rationalizing tax rates, and enhancing greater reliance on self-assessment systems supported by selective audit.

Other objectives of the TMP include improving administrative efficiency through computerization and developing audit capacity, and establishing capacity for tax policy analysis in order to implement organizational reforms. In addition to raising tax yield, the TMP sought to address constraints in the existing structure that would have constrained the attainment of this objective. Some of the constraints include over-reliance on direct taxes, despite the adverse effects of such taxes on growth; and dominance of trade taxes as an instrument for protecting domestic producers.

The tax reform programme has led to, amongst others, the following notable changes:

- A shift of excise taxation from a specific regime (per unit tax) to *ad valorem* (as percentages) in fiscal year 1991/92 and back to specific in 2003/04;
- A move from protectionism towards more openness and export orientation in 1984/85 and re-emergence of industrial protectionism in 1999/2000;
- A shift from sales taxes to VAT in 1989/90;
- Lowering of corporate tax rates in a bid to compete for foreign investment; and
- Use of income tax for equity and growth purposes.

Another key component of tax reforms in Kenya was the establishment of the Kenya Revenue Authority (KRA) as an independent tax administration organization with increased autonomy.

There has been a deliberate shift in policy towards more reliance on indirect taxes as opposed to direct taxes, and increased tax administration efficiency mainly by lowering and rationalizing tax rates to reduce compliance and administrative costs.

The table below shows the composition of tax revenue before and after major reforms.

Sales tax was introduced in the fiscal year 1971/72 and was later replaced by Value Added Tax (VAT), which was introduced in 1989/90.

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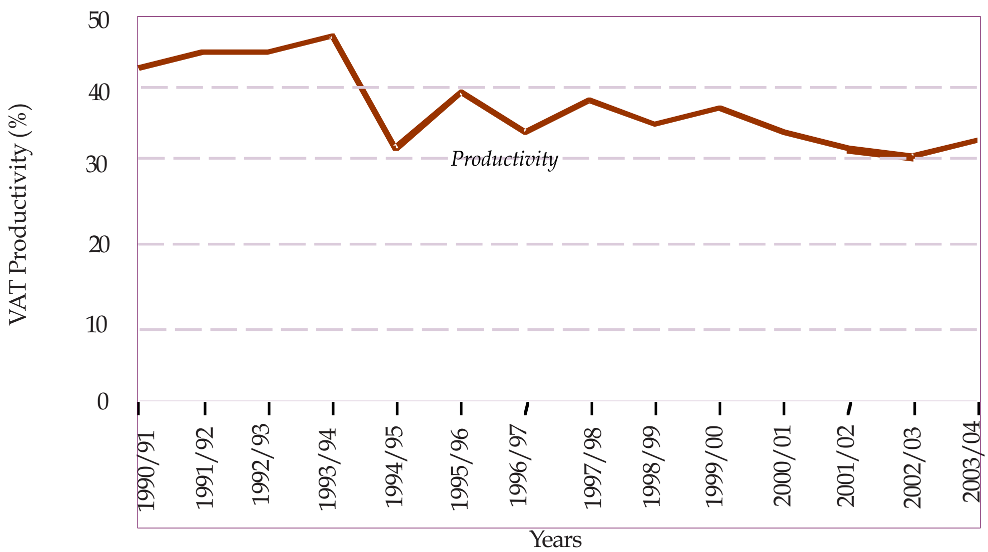
Tax revenue as a percentage of total tax revenue

Type of tax	Period							
	Pre-Tax Modernization Programme				Post-Tax Modernization Programme			
	63/64 - 67/68	68/69 - 72/73	73/74 - 77/78	78/79 - 82/83	83/84 - 87/88	88/89 - 92/93	93/94 – 97/98	98/99 - 00/01
Total revenue	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*	*100.0*
Import duty	*39.8*	*31.5*	*23.2*	*24.6*	*20.3*	*15.7*	*16.7*	*16.9*
Excise duty	*17.0*	*17.2*	*11.0*	*10.7*	*9.0*	*10.5*	*16.9*	*16.6*
Income tax	*38.3*	*44.6*	*38.8*	*33.2*	*32.7*	*32.6*	*38.3*	*32.3*
Sales tax/VAT	*0.0*	*2.9*	*24.2*	*28.3*	*32.2*	*36.1*	*24.3*	*25.2*
Others	*5.0*	*3.8*	*2.8*	*3.2*	*5.8*	*5.0*	*3.8*	*9.0*
Total tax revenue (% of GDP)	***10.6***	***13.6***	***16.9***	***19.7***	***19.3***	***21.4***	***24.4***	***22.8***

VAT productivity/yield (1990-2004)



Note: VAT productivity is obtained as the ratio of VAT revenue to GDP divided over VAT standard rate

mainly by lowering and rationalizing tax rates to reduce compliance and administrative costs.

Despite VAT being perceived as a tax for the future, there are still challenges with regard to the low tax productivity/yield (see Chart above).

Lessons and Challenges

The following key lessons and challenges emerge from Kenya's tax policy reform process:

- Tax policy reforms have mainly been aimed at achieving greater simplicity and ensuring uniform tax burden across individuals with equal income, but do not consider distribution of tax burdens across the income categories;
- Effective tax reforms cannot be accomplished without enhanced administrative capacity;
- Tax reforms need to be assessed carefully, taking into account institutional, technological, demographic and economic changes and objectives in order to avoid *ad hoc* tax policy measures that have had to be reversed in the past;
- Taxation of the informal sector and the agricultural sector poses major challenges. The informal sector in Kenya has been growing faster than the formal sector, yet it has been difficult to tax this sector. Efforts to tax the agricultural sector, mainly through presumptive tax, have not been successful;
- Tax compliance is still low, and the productivity of the tax system has remained weak, especially productivity of VAT.

Agenda for Reform

Based on the foregoing, the following reform options should be considered:

- Enhancing tax administration and compliance in order to reduce the tax burden particularly on businesses and individuals. Critical to the tax administration reforms will be institutional re-organisation of Kenya Revenue Authority along functional responsibilities, optimal utilization of the Personal Identification Number, and computerization of KRA systems;
- Adopting integrated information technology to enhance efficiency,

effectiveness, compliance and create capacity for data matching, taxpayer profiling and tax intelligence gathering. The system should integrate all taxpayer services, processing, and accounting, and provide a detailed transaction trail of every taxpayer besides providing full disclosure for business transaction by those falling within the tax bracket;

- Enhancing capacity for tax policy analysis, especially the analytical evaluation of various tax policy options, revenue forecasting, econometric modeling and detailed evaluation of such aspects as: distributional impact of taxes, elasticities, equity, and incidence in order to give a better guide to decision making and effective fiscal management; and

- Reducing the tax burden by broadening the tax base through integrated taxpayer recruitment policy and developing the necessary administrative and legislative infrastructure to tax small businesses and informal sector individuals. In addition, there will be need to institute effective measures to ensure improved voluntary compliance, enhanced and integrated tax assessment, improved management of debts and rationalized exemption regime.

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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