Tax Reform Experience in Kenya

Stepehen Karingi

Bernadette Wanjala

Justus Nyamunga

Andrew Okello

Esther Pambah

Evans Nyakang'o

Macroeconomics Division

Kenya Institute for Public Policy Research and Analysis

KIPPRA Working Paper No. 13

December 2005

KIPPRA IN BRIEF

The Kenya Institute for Public Policy Research and Analysis (KIPPRA) is an autonomous institute whose primary mission is to conduct public policy research leading to policy advice. KIPPRA's mission is to produce consistently high quality analysis of key issues of public policy and to contribute to the achievement of national long-term development objectives by positively influencing the decision-making process. These goals are met through effective dissemination of recommendations resulting from analysis and by training policy analysts in the public sector. KIPPRA therefore produces a body of well-researched and documented information on public policy and in the process assists in formulating long-term strategic perspectives. KIPPRA serves as a centralized source from which the government and the private sector may obtain information and advice on public policy issues.

Published 2005

Bishops Garden Towers, Bishops Road
PO Box 56445, Nairobi, Kenya
tel: +254 2 2719933/4
fax: +254 2 2719951
email: admin@kippra.or.ke
website: http://www.kippra.org

ISBN 9966 949 95 X

The KIPPRA Working Paper Series disseminates results of on-going research at the Institute. The papers in this series cover specific policy issues in detail and are meant to provide policy makers and researchers with background information that can be used in developing refined discussion and policy papers. The papers are authored and reviewed by KIPPRA researchers and are disseminated to provoke debate and solicit comments. Opinions expressed in the papers are entirely those of the authors and do not necessarily reflect the views of the Institute.

KIPPRA acknowledges generous support by the European Union (EU), the African Capacity Building Foundation (ACBF), the United States Agency for International Development (USAID), the Department for International Development of the United Kingdom (DfID) and the Government of Kenya (GoK).

Abstract

Counties all over the world have reformed or are attempting to reform their tax systems, with the main impetus being the increasing complexity of tax codes, narrow tax bases, and concerns with horizontal equity. Kenya's attempts to reform the tax system were initiated under the Tax Modernization Programme in 1980's with an aim of raising more revenue, redistributing wealth and achieving a sustainable tax system. Major income tax reforms have mainly involved widening of tax brackets, lowering of top marginal rates and also increasing of tax relief in order to protect low-income earners from the inflation-induced creep. Rationalization of tax rates for easier administrative ease, lowering of top rates and widening of tax bases characterized indirect tax reforms. There was a deliberate policy shift towards indirect taxes given that they are more favourable to investment and growth. Trade taxes have declined in importance over time due to adherence to trade regulations under WTO and regional integration blocks.

Kenya's tax reform experience poses some challenges. Firstly, tax 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. Secondly, taxation of the informal sector and agriculture still remains a major challenge. Lastly, the government's objective of achieving zero deficit still remains a challenge as evidenced by the growing level of deficit, which is a two-fold issue – revenue adequacy and public expenditure management.

Several lessons can be distilled from Kenya's tax reform experience. Firstly, policy reforms need to be assessed carefully, taking into account institutional, technological, demographic and economic changes and objectives. Secondly, it should be recognized that effective tax reform cannot be accomplished without enhanced administrative capacity. Thirdly, an essential precondition for the reform of tax administration is to simplify the tax system in order to ensure that it can be applied effectively in the generally low-compliance contexts of developing and transition economies. Tax compliance levels not only reflect the effectiveness of tax administration but also the taxpayers' attitude towards both taxation and the government in general.

Contents

1. Introduction

It is important to note that countries all over the world have reformed or are attempting to reform their tax systems. For industrial countries, the impetus to reform tax systems has come from the increasing complexity of tax codes, narrow tax base, and concerns with horizontal equity. For developing countries, the motivation has been similar, but the need has been much more pressing. Further, the principles of tax reform are well known but the practice often deviates from the principles and greatly varies across countries (Thirsk, 1997).

In understanding the tax reform experience in Kenya, one of the questions that must be answered is what is the role of the tax system in Kenya? In practice, there are three common objectives of tax systems: (i) to raise revenue for funding government operations; (ii) to assist in the redistribution of wealth or income; and (iii) to encourage or discourage certain activities through the use of tax provisions. While all tax systems share these objectives, what differs is the weight placed in a given country to each of these objectives. The capacities of different countries' tax systems to achieve these objectives also differ. In Kenya, raising revenue has been the overriding objective of the tax system. Moreover, with a limited degree of success, the tax system has also been used to address issues of inequality, as can be deduced from the nominal progressivity of the income tax structure.

Kenya has witnessed significant changes in many aspects of its economy over the last four decades. One of the striking features of the country is that, unlike many other sub-Saharan African countries today, Kenya is a high tax yield country with a tax to GDP ratio of over 20 percent. Kenya is able to finance a large share of its budget, with external donor finances meeting a much lower share, when compared to other countries in the region. This striking feature, however, does not mean that the country is not faced with problems in its tax system. Like most developing countries, Kenya had to contend with the common problems that plague tax systems of developing countries. These problems inlude a tax system: with rates and structures that are difficult to administer and comply with; unresponsive, both to growth and discretionary tax measures, and therefore has low tax productivity; raises little revenue but introduces serious economic distortions; that treats individuals and businesses in similar circumstances differently; and whose administration and enforcement is selective and skewed in favour of those with ability to defeat the system.

What criteria then should one use in evaluating Kenya's tax system in general and specific tax instruments in particular given the tax reform initiatives to date?

Theory provides criteria of efficiency, fairness and administrative feasibility both for specific tax instruments and for the complete tax regime. Looking at how far Kenya's tax system goes in meeting these criteria and how the weight accorded to each of these criteria has differed over time, given the tax reform process, would be a useful way of evaluating tax reforms in the country.

This paper 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. The paper also outlines the general lessons for tax reforms in Kenya.

1.1 Kenya's Tax System

This section introduces, in brief, some of the taxes that have been administered in Kenya before and after independence. However, more emphasis is on taxes, by tax structures, that have been in place in the period after independence.

1.1.1 Income tax

Income taxes were in existence even before independence but were not structured as they are at present. Companies and individuals were meant to file returns and pay income taxes at the end of the year. At pre-independence, very few native Africans were affected by taxes.

The structure and administration of income tax has changed over time. The current income tax is charged on incomes of individuals from employment and self-employment and profits from business entities. The income tax is classified into individual, corporate, withholding and other income taxes. Income tax generally captures formal sector business profits and employment.

Personal income tax is a tax on income from individual businesses. At the end of each year, individual owners of businesses lodge income tax returns for their businesses. Income from employment is subject to Pay As You Earn (PAYE). Personal income tax and PAYE are charged at the same graduated scale. The current income tax brackets are: 10 percent on the first Ksh 121,968; 15 percent on the next Ksh 114,912; 20 percent on the next Ksh 114,912; 25 percent on the next Ksh 114,912; and 30 percent on all income over Ksh 466,704 (annually).

Corporate Income Tax (CIT), on the other hand, is charged on profits of limited liability companies at a flat rate. This is currently at 30%. Withholding Tax (WHT) is another type of income tax that is charged on interest, dividends, royalties, commission and pension. The person paying out these amounts is required to withhold a certain percentage, as prescribed in the Act, and remit the same to the Commissioner of Income Tax by the 20th day of the following month. A withholding tax certificate is issued for the amount withheld. Other income taxes include fringe benefit tax, advance tax, taxes under Widows and Pensions Act and Parliamentary Pensions Act.

1.1.2 Excise duty

An excise tax is a levy applied selectively on particular goods and services. The tax may be applied to either production or sale, to domestic output or imported, with either *ad valorem* or specific rates. Kenya's excisable commodities at the moment are alcoholic beverages, tobacco, fuel and motor vehicles. Other than motor vehicles, excise taxes on beer, cigarettes and petroleum are currently charged on a specific basis, i.e. per volume or quantity.

Excise taxes are levied for a variety of reasons, the main reason being their ability to raise substantial revenue for the government at relatively low administrative and compliance costs. The taxes are normally imposed at high rates on a few commodities produced by a few large producers. Such goods tend to have low own price elasticity of demand, implying minimum shifting of consumer purchase when prices change.

Another reason for levying excise taxes is to correct the negative externalities that arise from the consumption of the taxed products. For example, excessive smoking of cigarettes and drinking of alcohol is harmful not only to the individual consuming the products but also to the society at large. The relatively high taxes imposed on these products are therefore meant to ensure that the consumers internalize the cost to the society. Finally, excise taxes are used to improve vertical equity of the tax system. They are levied on luxurious goods that are consumed by the high-income individuals.

1.1.3 Consumption taxes

Sales tax is levied on consumption of goods. This had been levied since independence. However, in 1990, Value Added Tax (VAT) was introduced in Kenya to replace the sales tax. It is levied on consumption of both goods and services. The difference between VAT and sales tax is that sales tax never included services.

Value Added Tax is a multi-stage consumption tax based on the destination principle. The tax is applied to the sale of goods and services at all stages of the production and distribution chain. Only registered traders are required to charge VAT, and for one to qualify for registration under VAT, one must have an annual sales turnover of Ksh 3 million. VAT is currently charged at a standard rate of 16 percent, with a lower rate of 14 percent applying to hotels and restaurants.

1.1.4 Customs duties

Customs duty is currently charged on the CIF value of imported goods. The current structure of the tariff bands is: 0, 5, 15, 20, 25, 30, and 35 percent and sugar at 100 percent. Some imports from regional trading blocs like COMESA and the East African Community are subject to customs duty at the rate of zero.

1.1.5 Other taxes

Other taxes, which were applicable before independence and which have since been abolished, include the following:

- Graduated Personal Tax (GPT), which was paid by adult men (over 18 years) irrespective of employment, or not. The amount was fixed at Ksh 20 per head. This tax was abolished in the 1970s.
- Hut tax, paid by men depending on the homesteads (read wives) one had. The more homesteads one had the more wealthy one was considered to be and therefore the more tax to pay. One could sometimes pay the tax in kind; that is by use of commodities or animals.

2. History of Tax Reforms in Kenya

Before the advent of structural adjustment programmes that most developing countries initiated in the 1980s, most countries in sub-Saharan Africa had never undertaken what could pass as major tax reforms. The major tax reform in Kenya occurred under the Tax Modernization Programme (TMP) that started in the 1980s. This paper focuses on the reforms under the TMP. The changes that took place before the advent of TMP are also highlighted. Therefore, the chronology of the tax reforms is divided into two periods: 1963/64—1983/84 and 1984/85—2003/2004. Under each of these periods, the paper focuses on the major changes in terms of policy and administration. A tax-by-tax review is followed to demonstrate how these changes have influenced the composition of Kenya's tax revenues today. Again, it is by following this tax-by-tax review that the strengths and weaknesses of the evolving tax system can be explained.

2.1 Piecemeal Changes: 1963/64-1983/84

At independence, Kenya inherited a tax system whose features and characteristics were similar to the British tax system at the time in many ways. In the period under review, there were no major reform initiatives on the scale seen under the TMP. Nevertheless, there were still significant changes that continued to influence the country's tax system.

2.1.1 Indirect taxes: Consumption to sales tax

Until the early 1970s, Kenya had very little fiscal problems associated with mobilization of tax revenues. The economy was growing at a reasonably high rate, averaging over 6 percent. However, in the beginning of the 1970s, the country started to experience its first major fiscal crises, occasioned by the international energy crises that were very severe for oil-importing countries like Kenya. In an attempt to address the fiscal crises, Kenya replaced the existing consumption taxes with a sales tax in the fiscal year 1972/73. This system not only targeted to raise additional revenues from specific types of goods, but more importantly it favoured the inward-looking industrialization policy that was being pursued at the time. Sales tax was also used by the government to set the stage for the change in policy in the early 1980s of relying more on indirect taxes as a major source of development finance so that savings and investment could be increased with less reliance on direct taxes.

2.1.2 Trade taxes: Inward-looking policy regime

Trade taxes in Kenya have been used to achieve two main objectives. The first objective has been to support the domestic manufacturing sector through protection from imports competition. The second objective has generally been to raise revenue for the government. The weights attached to each of these objectives have varied over time. Initially, protection of domestic manufacturing sector carried more weight. As the import substitution industrialization came under criticism, trade taxes started to be used more as instruments of raising revenue rather than promoting industrialization. Therefore, as early as 1974/75, faced with a balance of payments crises that resulted from the first oil shock, there were signs of a policy shift towards promotion of export of manufactured goods in order to reduce the soaring balance of payments deficit on the current account. Import duties on imported raw materials to some of the domestic manufactures started to be reduced. In addition to the reduction of duty for imported raw materials, a subsidy was introduced at the same time of 10 percent on the value of exports of manufactured goods.

The above measures, though temporary, were the starting pointsof a radical shift in policy from import substitution to export-led industrialization.

However, it is clear that there was still a hangover of a bias towards protection of domestic manufactures since, in 1980/81, import duties were increased by 10 percent on specific commodities that were competing with domestic manufactures. These increases, while meeting the government objective of protecting domestic industries, were seen as the starting point towards a slightly more significant policy shift.

Kenya changed its policy towards relying more on indirect taxes as a major source of development finance as a deliberate policy intended to reduce the burden on income taxation so that savings and investments could be promoted. A definitive shift towards export-led industrialization was witnessed in the fiscal year 1983/84. Duty rates on intermediate inputs in local industries were reduced with the objective of granting duty relief to local manufacturers. This shift also marked the starting point of a more long-term objective of trying to make the industry more competitive. The import substitution industrialization under-performed as a result of the emergence of an inefficient local manufacturing sub-sector. By reducing duties on intermediate inputs, the domestic sector was expected to not only benefit from lower average costs resulting from the high imports intensity but also to restructure domestic manufacture of the same imported intermediates.

2.1.3 Income taxes: Search for a policy position

Income tax policies in Kenya over the entire period before the major reforms of the TMP indicate a country that was in search of a policy position. The country appears to have come face-to-face with two dilemmas. First, the savings (therefore growth)-equity dilemma, and second the efficiency-equity dilemma. In respect of the growth-equity dilemma, one observes an attempt in the early period to use income taxes for redistribution purposes. For instance, in 1973/74, corporation tax was increased from 40 to 45 percent

Table 1: Personal income tax (PIT) progressivity in Kenya

1974 - 1981		1982-85	
Annual taxable income (Ksh)	Rate (%)	Annual taxable income (Ksh)	Rate (%)
1 - 24,000	10	1 - 30,000	10
24,001 - 48,000	15	30,001 - 60,000	15
48,001 - 72,000	25	60,001 - 90,000	25
72,001 - 96,000	35	90,001 - 120,000	35
96,001 - 120,000	45	120,001 - 150,000	45
120,001 - 144,000	50	150,001 - 180,000	50
144,001 - 192,000	60	180,000 - 240,000	60
Over 192,000	65	Over 240,000	65

Source: Various Finance Acts

for local companies and from 47.5 to 52 percent for foreign companies. While it can be argued that this increase was a response to the emerging fiscal crisis occasioned by the oil crises at the time, the prevailing tax rates were quite significant. The fact that there was differentiation between local and foreign-owned companies lends support to the argument that an equity objective was in-built in the corporate taxation policy at the time. The equity objective was inherent in the sense that domestic manufacturing industries needed support, unlike foreign-owned companies.

The early attempt to use income taxation to address equity objectives is more pronounced in the personal income taxes. Kenya fell into the same trap many other countries fell into of hoping to use income taxation for redistribution purposes. Many governments considered personal income taxation as the most convenient and visible instrument that could be used to show concern with the issues of inequality. In this respect, Kenya tended to apply many rates brackets as a sign of personal income tax (PIT) rate progressivity. Between 1974 and 1986, Kenya had eight income tax brackets as indicated in Table 1. The table shows a PIT system with a very high top marginal tax rate. In 1982, the lowest and highest tax brackets were widened, indicating a move towards maintaining the real incomes of the households through protection from inflation bracket creep.

The important point to note is that the government hoped to maintain some degree of nominal PIT rate progressivity through many rates brackets. The government may have wanted to appear to be concerned with social justice, and consequently there may have been reluctance to undertake any PIT reforms that would suggest any wavering on such commitments.

The effectiveness of this nominal rate progressivity in delivering effective rate progressivity was underpinned by the lack of high personal exemption (say in multiples of per capita income, the minimum income subject to tax was as high as four) that exists today.However, it can be argued that the government failed to recognise, during this period that the effective rate progressivity could still have been improved by reducing the degree of nominal rate progressivity and the number of rates brackets. Moreover, the country failed to recognise that the effectiveness of the high marginal tax rate of 65 percent was reduced by the fact that it was being applied to high levels of income/GDP ratio such that little income was actually subject to the high rate. There was also the issue that the level of the top marginal personal income tax rate was greater that the corporate income tax rate. This must have interfered with the decision of taxpaying agents as it had the potential of encouraging taxpayers to take the corporate form of doing business. In this case, some professionals could easily have siphoned off profits through expense deductions and also be able to escape the higher PIT rate. A good tax policy would have been to have a tax system where top marginal PIT rate does not differ significantly from the corporate income tax (CIT) rate.

2.2 Tax Modernization Programme: 1984/85 to date

One major tax administration and policy reform initiative implemented in Kenya since late 1980s is the Tax Modernization Programme (TMP), which was meant to reform the tax system (Nyamunga, forthcoming). The success of this reform package depended on the realization of a set of objectives, among them raising revenue level from 22 to 28 percent 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 the TMP had set to achieve include improving administrative efficiency through computerization and audit capacity and establishing tax policy analysis capacity to implement organizational reforms[1]. The following section gives a tax type by tax type analysis of the various tax reform measures under the Tax Modernization Programme (TMP).

2.2.1 Excise taxes: Specific to *ad valorem* tax regime and to specific

Excise taxes have been an important component of total tax revenue in Kenya. In theory, there are several advantages that excise taxes have over other types of taxes. These taxes also tend to be levied on specific types of commodities. Different countries levy excise taxes for different reasons. One reason is usually to force the users of the excised commodities to internalize the externalities that excisable commodities such as tobacco, alcohol and petroleum products tend to have. Another reason for levying excise taxes may just be to raise revenue for the government. In developed countries, excise taxes are sometimes levied with particular consideration for the strategic direction an industry producing excised commodities is required to take. In the case of Kenya, one can discern that excise taxes have been

[1]For a detailed discussion on the impact of Tax Modernization Programme on Kenya's tax reform effort, see Nyamunga 2001.

levied not so much to force internalization of externalities or to direct industries towards identified strategic directions but more for meeting revenue requirements of the government. This being the overriding objective, one can then see the weakness that prevailed in the excise tax system and which the continuous discretionary excise tax measures failed to recognise. A review of the excise tax policy indicates that the country, at the time of the implementation of the Tax Modernisation Programme, used to maintain a specific excise tax regime. This is evident from the discretionary changes that used to be made in every Budget Speech since 1984/85 to 1988/89. Over this period, excise taxes on tobacco and beer were changed annually and the objective during this period was always the same. That is to ensure that prices are kept in line with domestic inflation and also to maintain the level of revenue in real terms. In fact, excise taxes on cigarettes and tobacco products were annually raised by an overall weighted average of 10 percent up to 1988/89. This clearly illustrates the challenge the country faced from pursuing a specific tax regime at a time when the economy used to experience moderate levels of inflation.

For as long as the country used excise taxes for revenue maximisation, maintaining a specific tax regime in a moderate inflation period was always going to be a challenge. Uncertainties in investment decisions and consumption decisions of excised commodities was always going to be an issue since all eyes were focused on policy pronouncements of the tax rates going up or down depending on the inflation outcome. As part of the Tax Modernisation Programme and with the objective of excise taxation remaining revenue maximisation, there was a switch in 1991/92 of the excise tax regime from specific to *ad valorem*. Therefore, a number of excise tax rates were converted from specific to *ad valorem*. The regime switch was seen to help the government achieve multiple objectives:

(a) Ensure that excise tax revenues grew with inflation, therefore removing the need for discretionary changes. This automatic inflation adjustment through *ad valorem* system was going to help offset the anticipated revenue loss from lowering of import duty rates.

(b) Allow for the rationalisation of VAT rates and to increase controls on high tax rate goods.

(c) Give equal tax treatment to all types of beer and close the gap between the malt and non-malt beer.

The regime switch from specific to *ad valorem* for excise taxes in 1991/92 did not remove discretion as would have been expected. For instance, the following year the excise tax rates for alcoholic products were raised to increase revenue collection as a result of increased beer consumption. Another issue with the excise tax policy was that multiple excise tax rates continued to persist in the country. However, there were moves to rationalize the number of rates. In 1993/94, excise duty on cigarettes, which were subject to three different price-based excise duty brackets, was changed to two-length based bands excise duty revenue. This reform measure was likely to have improved administrative ease. Eventually, in 1997/98, excise duty on cigarettes was rationalized to a uniform rate of 135 percent. The objective of this rationalisation was to simplify the collection of domestic excises and prevent mis-declaration of imported cigarettes. A similar rationalisation was not implemented for alcoholic products as multiple rates continued to be applied for malt, non-malt and other locally made alcoholic products.

Kenya, in 2003/2004, reverted to a specific tax regime from the *ad valorem* regime. Before outlining the motivation for this switch again to specific taxation in the case of tobacco and alcoholic products, it would be important to mention that the excise tax policy has recently been influenced by the regional integration initiatives that Kenya is party to. Harmonisation of policies is one of the key issues in the Treaty that created the East African Community (EAC) comprising of Kenya, Uganda and Tanzania. For example, the excise tax measures of 1990/2000, which reduced the *ad valorem* rates for malt beers from 95 to 90 percent, were occasioned by the country's desire to reduce the taxation gap with its neighbours. The duties on beer and cigarettes were reduced further in 2000/2001 with the key objective being to continue with the rationalisation of duty rates within the East African Community. This rationalisation, it was hoped, would strengthen control over undutied commodities offered for retail sales through smuggling or diversion of exports. It is noteworthy that while the excise taxes for cigarettes and alcohol had been switched from specific to *ad valorem*, the excise taxes for petroleum products all along remained under the specific tax regime.

The switch back to specific regime from *ad valorem* regime in the case of cigarettes and beer started in the fiscal year 2002/2003. During this year, 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 key objective of the hybrid system was to deal with increasing cases of smuggling, tax evasion and under-declaration that had characterised the tobacco industry and to deal with the persistent problem of under-declaration of taxable values. Eventually, in 2003/2004, excise taxation of cigarettes and beer reverted fully to a specific regime. The specific duty regime is based on four bands, equivalent to an effective rate of 110 percent replacing the *ad valorem* rates. Similarly, a specific excise regime was introduced on beers at three bands on malt beer, stout beer and non-malt beers to replace the *ad valorem* rates. The objective of this switch was to reduce tax evasion and avoidance, simplify and improve 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.

2.2.2 Customs duties: Towards export-led industrialisation

The customs duties contribution to the country's total revenue has been driven mainly by the trade policy Kenya has been pursuing since 1984/85. There have been changes in the number of tariffs and also in the rates from the time the country started implementing structural adjustment policies to date. 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. We summarise below the various objectives of the trade policy and how this has influenced the tariff rates and structures and hence the contribution to total tax revenues of the customs duty. It is clear, however, that unlike many developing countries, Kenya has relied in a very limited way on import duties for revenue mobilization.

a) Economic restructuring

The country in 1984/85 adopted a trade policy that moved away from protectionism as the overriding objective. There were clear efforts towards putting in place a system of restructuring incentives and reducing the cost of production. During this period, most duties above 25 percent were lowered. The express objective was to restructure the economy away from the highly protected and inefficient pattern of industrialization that was based on import substitution towards production for exports. The zero rating of agricultural inputs was also started during this period with the objective of improving agricultural production. Import tariffs on raw materials, intermediate inputs to industry and capital goods started to be reduced in the economic restructuring efforts.

b) Enhancing efficiency

The economy had suffered significantly from an inefficient system of production resulting from a protectionist trade policy. During the era of trade liberalization, tariff rates were reduced in favour of intermediate and capital goods in order to reduce prevailing economic distortions and also encourage local production. Duties on agricultural inputs continued to be removed as the country hoped to boost agricultural productivity.

c) Tariffs simplification and rationalization

As the country continued to pursue a trade policy to boost industrialization and expand domestic manufacturing, it was realized that the tariff structure was too complex. Therefore, trade policy started on tariff rationalization towards the goal of reaching a four-rate system (including duty free) that simplified import duty administration. The country, therefore, in 1988/89 started on a path towards reducing the number of tariff categories from 25 to 17. Another five tariff categories were abolished in the following year, reducing the tariff bands to 12. This rationalization from 17 to 12 tariff bands lowered the import duty rates on raw materials and intermediate goods by an average of 5 percent. However, duties on some of the refined and finished goods were increased at this time, clearly indicating that trade policy was not completely abandoned in being used as a protectionism instrument.

d) Export competitiveness

As Kenya continued with the restructuring of the economy, there were deliberate efforts to address the question of export competitiveness by lowering the cost of production through reduction of average tariffs and also narrowing their dispersion. In 1990/91, the top duty rate of 135 percent was abolished and replaced with 100 percent. Duties on imported raw materials, intermediate goods and spare parts were reduced farther. The objective of this move was to lower the cost of manufacturing and therefore raise the competitiveness of local goods in the export market. Further rationalization of the tariff bands was undertaken and over a three-year period between 1991/92 and 1994/95 tariff bands were successfully reduced from 15 to 11 in 1991/92 with the top tariff rate at 70 percent. In 1992/93 there were only nine (9) tariff bands with top rate at 60 percent. In 1993/94, duty rationalization resulted in only seven (7) bands, underscoring the government's commitment to import liberalization policy as part of the structural adjustment programme. The programme, as already pointed out, encouraged trade liberalization to make exports more rewarding through economic competitiveness.

e) Agricultural sector protection

While there was a clear policy of zero rating inputs to the agricultural sector, by 1995/96 there were deliberate shifts again towards protection of the agricultural sector. Agricultural products were subjected to either a specific or *ad valorem* import duty. In 1996/97, several *ad valorem* rates were proposed on major agricultural products. Falling world prices were cited as justification for the need to introduce a suspended duty of 70 percent on imports of agricultural products. This policy was continued with the objective of protecting Kenyan producers who continued to face stiff competition.

f) Re-entry of industrial protection

The trade liberalization policy that had been aggressively pursued since the mid-80s started facing serious credibility questions from some of the sectors in the economy. Arguments were made that there has been blind liberalization, which hurt the domestic producers of some of the import competing goods. Therefore, in 1999/2000 clear policy shift towards protection of some sectors outside the agricultural sector started creeping back. In addition to increasing the duty rates facing imports of agricultural commodities, a suspended duty was introduced on commercial vehicles and textiles. The objective of the reversal was to strengthen the protection to domestic businesses to sustain and nurture their activities and to assist and promote local industry. This objective was clearly similar to the import substitution industrialization policy that had been earlier discredited for encouraging inefficiency in the industrial sector.

2.2.3 Consumption taxes: Sales tax to VAT

It is clear that Kenya had definitive directions on the aspect of trade taxes with the objective being more on facilitating the restructuring of the economy towards a competitive export sector rather than revenue mobilisation. However, the review of the trade taxes objectives also showed that there is still active protection of the agricultural sector and recently, policy shifts towards using tariffs to protect the manufacturing sector have re-emerged. With respect to indirect taxation through excise taxes, for most of the period 1984/85 to 2002/2003, the overriding objective of the stance of excise taxation policy has been revenue mobilization. Maximising revenue collection from the excisable commodities has been the main objective. However, the excise taxation regime was later changed with a strategic objective to help the manufacturing industry be more export-oriented through a taxation regime that is supportive of investments in high quality excisable commodities. Nevertheless, the revenue maximisation objective continues to be seen as important as can be discerned from the setting of the specific excise tax at *ad valorem* rates equivalent to what has empirically been shown to be the optimal tax rates. This is particularly so for cigarettes (Kiringai *et al.*, 2002) while in the case of beer, effective *ad valorem* taxes have been reduced towards what is considered as optimal (Karingi *et al.*, 2001). Nonetheless, to some extent, the recent reductions in effective tax rates have also been occasioned by the need for tax harmonisation within the East African Community since excise taxes tend to be lower in Uganda and Tanzania when compared to Kenya.

The other major indirect taxes are the consumption taxes. Kenya, until the 1989/90 fiscal year, had a sales tax in place, which was replaced with a

Value Added Tax (VAT) in this particular year. Before delving on the VAT, it is noteworthy that under the TMP, there were clear moves to make sales tax an easier tax to administer and comply with. For instance, in the fiscal year 1984/85, there was rationalisation of the number of sales tax rates to five. The main objective was to simplify tax administration in order to raise more revenue. However, discretionary changes of the different sales tax rates bands and for specific commodities continued. The various sales tax rates were used in such a way that some were increased (those considered as luxuries) in order to compensate for revenue lost from lowering taxes on basic commodities. At other times, the sales tax was used to stimulate local production through increased domestic demand by reducing sales tax rates on local products in order to encourage their domestic production. At other times, discretionary tax policy used the sales tax as an instrument to maximise revenues from temporary economic shocks such as in 1986/87 when the sales tax on oil products was increased and remissions on oil products revoked as part of a fiscal decision to increase the share of the windfall gains from low oil prices in 1986.

The sales tax, unlike the VAT, also presented a framework that through differentiated rates, income class specific policies could be addressed. In 1987/88, sales tax rates applied to passenger cars were lowered. The motivation for this reduction was mainly to make motor vehicles affordable to middle income earners in the country.

The entry of VAT

In 1989/90 fiscal year, VAT replaced sales tax with effect from 1st January 1990. The input credit system was adopted in the case of VAT in Kenya at its introduction. The standard VAT rate was set at 17 percent and it was to not only cover manufactured goods but also all goods and services. The initial phases of VAT introduction had a complex system, as there were 15 different rates with the highest rate at 210 percent. Several changes have

Table 2: VAT rates rationalisation process in Kenya

Year	Number 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: Budget statements

occurred in the VAT since its introduction (Table 2). In the following year after its introduction, the number of rates was reduced to 8. The top VAT rate was reduced to 100 percent. The standard VAT rate was implemented on both the inputs and outputs. The rationalisation of VAT rates and the lowering of the top VAT rate were aimed at reducing tax evasion and also making local products more competitive. Further rationalisations in the VAT rates were to follow. This rationalization took some time.

The whole idea of the rationalization was to remove misclassification and ease administration, improve compliance, reduce smuggling and also reduce requests for exemptions. The top rate continued to be brought down such that by 1994/95 when there were four (4) VAT rates, the highest rate was reduced from 40 to 30 percent and the standard rate was maintained at 18 percent.

In order to increase voluntary compliance, the standard rate was reduced to 15 percent in 1995/96 and the highest rate from 30 percent to 25 percent. At this time, the structure of VAT was moving towards a single rate, which would simplify its administration significantly. Therefore, 1996/97 saw the top rate lowered from 25 percent to the standard rate and the lower rate was increased from 6 to 8 percent and then to 10 percent in 1997/98. A clear feature of the VAT in Kenya is that it has been an instrument of choice in dealing with exceptional circumstances. Unexpected expenditures have been financed through increases in the VAT rate. The tax has also been used as part of the industrial strategy whereby in order to revamp Kenyan industries and stimulate economic activities, and also encourage local production of specific sectors, zero-rating of VAT targeted to certain sub-sectors has been used. A most surprising outcome of a look at the VAT in Kenya is that it is only in 2003/2004 when the VAT has come to be seen as an important instrument that can be used to boost consumption demand in the country.

2.2.4 Corporate income taxes: Competition for foreign investments in a globalised world

The TMP has had major changes in the income taxes in Kenya. This has been more pronounced in the personal income taxes. The most important reforms that have taken place in the corporate income taxation have mainly been in the direction of lowering the rates. The main motivation for lower Corporate Income Tax (CIT) rates has been occasioned by stiff competition for investment funds globally. By having low CIT rates, the country has not only responded to competition from other countries for investment finance but it has also presented itself as destination for investment. The CIT rates have therefore been lowered from as high as 45 percent in 1989/90 to 30 percent today. There are three important issues worth highlighting with regard to the CIT tax system in Kenya.

a) Equalisation of the CIT rate to top marginal PIT rate

The top marginal PIT rates at the time of starting the tax reforms in Kenya were in general higher than the CIT rates. This might have encouraged individuals to take the business form and in the process charge for deductions that would lower their tax liability even at the lower CIT rates. To remove this anomaly, the top marginal PIT rate and the CIT rate have been equated.

b) Differentiated CIT rates for foreign-owned versus domestic companies

The CIT rates charged for foreign incorporated companies have generally been higher than the resident companies for Kenya. This differentiation has been used as an incentive to encourage local registration and incorporation of the companies. The differentiated rates have continued even over the tax reforms period.

c) Tax incentives through the CIT system structure for export-led industrialisation strategy

As discussed under the trade taxes and excise taxes, Kenya has re-oriented its development strategy towards export-led industrialisation. In this respect, fiscal policy, particularly taxation has been a critical instrument towards realizing this goal. The trade policies that have been followed have been oriented towards making Kenya's exports competitive and as such import duties have been zero-rated or tax-exempted for raw materials. On the other hand, the excise tax regime that has been adopted presently is one of encouraging investment in the highest quality commodities so that the country can penetrate export markets with such products. In terms of the CIT, the tax system has been reformed towards using tax incentives under the income tax system to encourage investments to be located in the country. Tax holidays have been extended for companies wishing to invest in the country for export. Repatriation of dividends and extending favourable investment deduction allowances have been critical lynchpins of the income tax system for companies wishing to invest in Kenya.

2.2.5 Personal income tax: Trading progressivity for efficiency — the quest for growth over equity

Before the tax reforms, nominal progressivity and high marginal tax rates were common. Under the reforms, there was clear rationalization of tax brackets towards reducing the number of brackets. The top marginal tax rates have also been halved. Most of the criticism on the personal income taxation that prevailed in the pre-reform period has been addressed, especially the criticism about nominal progressivity when compared to effective progressivity. In addition, the high top marginal tax rates, which affect only a small proportion of the tax paying population in a country like Kenya have also been reduced. The top marginal PIT rate has been unified with the CIT rate. In this section, a discussion of the issues and reforms that have been taking place under the personal income taxes are presented.

a) Regular adjustment to counter inflation bracket creep

One of the clear observations with respect to the personal income taxation is that the PIT rates have been adjusted almost annually to keep pace with inflation. Table 3 shows how the income tax brackets have been widened over time to give relief as a result of inflation.

b) Lowering of the top marginal tax rates

Kenya, as earlier noted, attempted to use the PIT structure to achieve redistribution objectives. This has been a common practice with many countries, both developed and developing. However, as the competition for foreign direct investments increased and the level of foreign aid started to dwindle, it became necessary for countries to mobilize savings at the domestic level. High personal income taxes, especially the top marginal rates, have a negative effect on savings. Households that would have otherwise postponed consumption have their savings decisions interfered with when PIT rates are high. By lowering the top marginal tax rate, the

Table 3: Personal income tax brackets in Kenya, 1986-2003

Year	Annual taxable income (Ksh)	Rate (%)	Year	Annual taxable income (Ksh)	Rate (%)
1986-87	1 - 36,000	10	1988-89	1 - 39,600	10
	36,001 - 72,000	15		39,601 - 79,200	15
	72,001 - 180,000	25		79,201 - 118,800	25
	108,001 - 144,000	35		118,801 - 158,400	35
	144,001 - 180,000	45		158,401 - 198,000	45
	180,001 - 216,000	50		Over 198,000	65
	216,001 - 252,000	60			
	Over 252,000	65			
1990-91	1 - 42,000	10	1992	1 - 46,000	10
	42,001 - 84,000	15		46,001 - 92,000	15
	84,001 - 126,000	25		92,001 - 138,000	25
	126,001 - 168,000	35		138,001 - 184,000	35
	Over 168,000	45		Over 184,000	45
1993	1 - 52,800	10	1994	1 - 60,000	10
	52,801 - 105,600	15		60,001 - 120,000	15
	105,601 - 158,400	20		120,001 - 180,000	20
	158,401 - 211,200	25		180,001 - 240,000	25
	211,201 - 264,000	35		240,001 - 300,000	35
	Over 264,000	40		Over 300,000	40
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	2002-03	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

Source: Finance Act, various issues

PIT system can be used to remove the disincentive to save. Table 3 clearly shows that Kenya gradually reduced its top marginal tax rate from 65 percent to the current rate of 30 percent. The objective of the reduction was mainly to provide personal incentives to save and also stimulate enterprises by creating a savings pool. This, it was hoped, would better the performance of the economy and therefore enhance job creation.

c) Reduction in the number of tax brackets

The Tax Modernisation Programme, as pointed out, considered the personal income taxes as an essential instrument that could be used to achieve not only equity objectives but also growth outcomes. The reduction of the number of tax brackets helped to remove the nominal progressivity of the tax system, whose effectiveness was limited while at the same time the many tax brackets created a complex system.

d) Regular increases and unification of the family relief

Income tax credits are in practice major instruments that governments all over the world use to achieve redistribution objectives. Such credits tend to be means-tested with the level of income being the main determinant of the level of income tax credit. In Kenya, the income tax system has been such that tax relief is provided to every registered income taxpayer irrespective of the level of income. Therefore, the relief cannot be said to be playing any significant role in terms of income redistribution. However, income tax relief has been a useful instrument in providing income tax exemption for low-income earners. While the level of relief has been increased over time to its current annual level of Ksh 13,944 the most significant reform has been the unification of the single tax and the married (family) relief into one.

A differentiated relief level depending on marital status had a discriminatory element. In addition, the relief was only available to the males who claimed to be married but was not given to women. This showed gender insensitivity in addition to gender-based discrimination.

e) Differential taxation of dividend and interest income

Kenya's personal income tax is derived almost entirely from salaries and wages of those employed in the formal sector. There is limited contribution of other individual income taxes. However, a substantial proportion of Kenyan households derive part of their income from interest earnings and also from dividends. During the reform period, there have been varying changes in the treatment of these two types of income. However, they are still treated separately and attract different rates for most of the period under review. This contributes to inefficient allocation of the investments with the bias being towards the asset with lowest withholding tax and whether the tax is final or not. The taxation of interest income is in theory argued to be a disincentive to attracting foreign capital and also to encourage capital flight. This theoretical argument is apt for Kenya as the country has an open capital account, which makes it easy for investment of savings derived in Kenya in foreign capital markets where interest income attract zero tax such as in the United States.

f) Challenge of taxing agriculture and the informal sector—the presumptive income tax

Like many other developing countries, Kenya faces challenges in taxing income derived from agriculture and the informal sector. The income tax policy has at different periods attempted to introduce a presumptive income tax as a means of taxing agriculture. However, this tax has been vexing and has been introduced and then abolished in cycles. This means that a good part of income derived through the agriculture sector has been untaxed. The same applies to the informal sector, which, like agriculture has turned out to be a hard-to-tax sector. Attempts to introduce a presumptive tax system that works have been a failure even during the reform era.

3. Process of Tax Reforms

This section addresses the approach followed in implementing tax reforms. Tax reforms are mainly undertaken to restore buoyancy to revenues, reduce complexity in the tax system, address equity in the distribution of tax burden as well as composition of the tax structure, and to strengthen tax administration. The emphasis has always been towards introduction of new taxes or new rates on existing bases, introducing more stringent administrative changes to seal loopholes, including imposition of prohibitive penalties, and the need to widen tax bases and reduce exemptions. Reforms will achieve targeted goals if policy makers are actively involved in their design and implementation.

From a normative approach, governments' motives of undertaking tax reforms mainly revolve around the three classical functions of public finance, the most important being the allocative and stabilization functions (Koester, 2005). Under the allocative function, governments provide public goods, which are financed through taxation. If financing requirements are taken as exogenous, then the level of deficit is seen as an indicator of the demands under tax policy and reform. On the other hand, based on the stabilization function, the government is expected to stimulate the economy by tax burden reductions in recessions and tax burden increases during economic boom. The approach of positive finance on the other hand puts into consideration the motives of self-interested politicians and political parties. According to the Leviathan model, the government is a revenue maximizer, tapping the full potential of tax revenues. A government can also be opportunistic, by for example increasing transfers and decreasing payments just before elections so as to manipulate citizen's decisions in elections. In general, the influence of interest groups plays an important role in the discussion of the political economy of taxation.

The process of tax reforms in Kenya, as can be discerned from the foregoing sections of this paper, was more of a gradual process rather than a 'big-bang' approach. Most probably, this gradual approach was adopted because unlike some countries that have been candidates for tax reforms, Kenya's political and economic environment was not conducive for a big bang approach as has been the case in some of the transition economies in Eastern Europe or emerging post-conflict countries in Africa. The time for a tax reform appears ripest either when a new government assumes power, as in Mexico, or when political opposition is weak, as in Indonesia and Korea. Kenya only experienced a major change in government in 2002. Nevertheless, below is a brief discussion of the success and failure of tax reform implementation in Kenya.

3.1 Government Commitment to Tax Reform

The commitment of the Kenya Government to tax reforms can largely be said to have been positive. From the start of the reforms (major reforms commenced in 1986, under the Tax Modernization Programme TMP) subsequent economic policy statements such as those through the Budget Speeches read to Parliament every year contained fiscal policy options that were actually implemented as part of the tax reforms. Broadly, it can be said that the objectives that were spelt out for the tax reforms were clearly understood and were seen as part of a wider economic strategy of making the country less vulnerable to both internal and external shocks, which could easily lead to macroeconomic imbalances.

3.2 Political Opposition/Support to Reforms

Apart from the trade policy component of the tax reforms, which advocated for rationalization and reduction of import tariffs and also the liberalization of trade, there has been very limited opposition to tax reforms in Kenya.

One could even state without contradiction that there is broad consensus in the country that the tax reforms were necessary. Even the contentious taxes like VAT, whose introduction precipitated social unrest in some countries, encountered no or insignificant opposition in Kenya when it was introduced in 1990 to replace the then sales tax. One reason behind this could have been the disorganized consumers lobby constituency, but all in all the tax policy measures have broadly received very little opposition in Kenya.

At the political level, there has not been any organized political opposition. However, as the paper notes, trade liberalization reforms have met some opposition from the import competing domestic manufacturing sub-sector who have felt threatened by imports. At the political level, however, the manufacturing sector has had no organized opposition to the trade policy reforms. However, the trade policies that have recently been put in place in line with Kenya's commitments to the COMESA and EAC treaties have raised some opposition, both at industry and political level, as they have touched greatly on the agricultural sector. A good case in point is the whole question of opening up the sugar sub-sector to COMESA imports and also the liberalization of the cereals sub-sector under the Free Trade Area arrangements that would see maize flow from Kenya's neighbouring countries to the local market. In both these instances, there has been strong opposition to the reduction and removal of tariffs on sugar and maize. The political opposition has caused the government to resort to safeguard measures in-built in the regional trading arrangements such as in the COMESA treaty.

3.3 Institutional Constraints

One of the areas that this paper has not dealt with is the whole area of tax administration reforms. This paper has focused more on the tax policy reforms. One of the main objectives of TMP was to implement organizational reforms that would modernize tax collection. One of the key components of tax reforms in Kenya was the establishment of the Kenya Revenue Authority (KRA) as an independent tax administration organization with autonomy from the Treasury. The Ministry of Finance plays the role of setting tax policy while KRA ensures that the tax policy with respect to revenue mobilization is implemented. Along with this monitoring of reforms, KRA endeavors to educate the public on how tax policy will operate. KRA was created by an Act of Parliament in 1995 in order to strengthen revenue collection and harmonize the separate tax collection arms. Before then, taxes were administered by various departments of the Ministry of Finance: Customs & Excise, Sales/VAT and Income Tax departments.

The establishment of KRA was meant to address the institutional constraints that were seen as hindering the implementation of tax reforms in Kenya. However, questions can be raised on whether there was a deliberate effort to sequence implementation, especially given that the KRA became operational after implementation of the VAT. It may therefore not be easy to conclude that there have been institutional constraints that limited the success of the tax reforms. In any case, revenue adequacy as measured by the tax revenue to GDP ratio have not been much of an issue. In order to address adequately the question of institutional constraints, therefore, one has to go beyond the revenue adequacy and the tax structure question.

Research shows that compliance for VAT and income taxes are 55 and 35 percent, respectively (Karingi *et al.*, 2004). This means that it is possible to reduce the tax burden of those currently paying taxes by raising the compliance rate. In other words, it is possible to reduce the VAT rate from the current 16 percent without the government facing any revenue shortfalls by raising the level of compliance, particularly with respect to reducing corporation income tax rate from the current 30 to 25 percent. A revenue neutral position can be arrived at by raising the compliance in income taxation. It is evident that the low compliance is mainly an administrative issue related to KRA. The taxpayers face significant compliance costs and these interfere with their willingness to pay taxes. The administrative structure of KRA in itself contributes to this high cost. For instance, a taxpayer in Kenya can at times be audited three times—VAT, Income Tax and Excise tax—yet dealing with only KRA and after that be audited by the government ministries if liable to pay a levy. The tax-by-tax organization of KRA needs a revisit. The international best practice is to have revenue administration that is organized on a functional basis—like audit as one function and not by type of tax. It is, however, worthwhile to note that KRA is in the process of restructuring itself towards a functional-based organizational structure.

There are other problems related to the performance of Kenya Revenue Authority. A critical one is the failure to exploit the Personal Identification Number (PIN) facility that every taxpayer is supposed to have. The failure to exploit the PIN is mainly associated with lack of computerization at the KRA. With computerization, it is possible to interact with taxpayers through an integrated computer interface. This would not only save time but it would also help in raising compliance, as the PIN would become the most important number. It would also become easier to consolidate the payments of all taxes and levies.

4. Structure of Kenya's Tax System

One of the key pressures to undertake tax reforms in Kenya was to have a sustainable tax system that is able to generate adequate revenues to finance public expenditures. In this respect, one of the key objectives of the Tax Modernization Programme was to have a tax system that is sustainable in the face of changing conditions domestically and internationally. There was also a deliberate shift in policy towards more reliance on indirect taxes as opposed to direct taxes. Consumption taxes were seen to be more favourable to investments and hence growth. Trade taxes were also seen from the point of view of them being used not for protection or revenue-maximization purposes but more in light of being instruments that can be used to foster export-led industrialization. The trade taxes were therefore to be used in creating a competitive exports sector rather than protecting an import-competing manufacturing sector. In this section, the question of how the structure of Kenya's tax system has changed from the pre-reform to post-reform period is addressed. This involves evaluation of what has happened to tax revenues and their composition over the time before and after the tax reform. The measures used for this explanation are the tax/GDP ratios and also the share of given taxes in total tax revenues. In explaining the resulting structure, reference is made to the tax reforms that have already been discussed, with a view to mapping the outcome to the actual reform initiatives and objectives.

a) Factors to consider in determining aggregate level of tax

Economic theory provides little guidance on choosing the aggregate tax levels given a certain level of economic development. The focus therefore tends to be on the structure of a tax system given a particular tax revenue requirement. However, it is not possible to separate the question of the appropriate aggregate level of taxes from the appropriate level of government expenditure. Kenya has moved from a low tax yield country to a high tax yield. Forty years ago, the total tax revenue to GDP averaged 10.6 percent (Table 4). This tax yield rose successfully even before the major tax reform programme to peak at 19.7 percent of GDP on average by the early 1980s. Nevertheless, this level of tax yield compared to the expenditure to GDP ratio was not sufficient. Consequently, one of the main objectives of the TMP was to raise this level to 28 percent of GDP on a zero deficit strategy as the expenditures were on average 28 percent of GDP. This objective was never achieved and the best performance in terms of tax yield was 24.4 percent of GDP (1993/94–1997/98). But where does Kenya lie internationally? The often cited Tanzi and Zee (2000) study found that for the period 1985-87, taxes constituted 36.6 percent of GDP in developed countries and 19.6 percent in Africa. Kenya at this time had aggregate tax revenue of 19.3 percent of GDP meaning that its tax yield was consistent with Africa's average. In the same study, for the period 1995-97, the aggregate tax revenues for developed countries was about 38 percent of GDP. In contrast, the average level of tax revenue for developing countries for the same period was only about 18 percent and 19.8 percent in the case of Africa. Kenya at this time had managed to enhance its tax yield to revenue to GDP ratio of about 24 percent. Therefore, while other African countries' aggregate revenues had stagnated, Kenya was able to raise its ratio by more than five percentage points. During the process of tax reforms, Kenya's fiscal strategy changed and the revenue target is currently set at 22 percent of GDP. The TMP was on a path towards being successful in terms of revenue adequacy as there is a clear successful improvement in the tax yield before the revision of the fiscal strategy.

b) Relative use of different tax instruments in Kenya

Optimal tax theories provide some guidance on choice and design of tax instruments in a given tax system. The theory of optimal taxation attempts to achieve Pareto optimality, by achieving Pareto efficiency in the design of a tax structure. In practice, however, there is a gap between optimal tax

Table 4: Tax structure in Kenya as a percentage of GDP

Type of tax	Period							
	Pre-tax modernisation programme				Post-tax modernisation 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 - 03/04
Total revenue	10.6	13.6	16.9	19.7	19.3	21.4	24.4	22.8
Import duty	4.2	4.2	4.0	4.8	3.9	3.2	4.1	3.8
Excise duty	1.8	2.3	1.9	2.1	1.7	2.4	4.1	3.8
Income tax	4.1	6.1	6.6	6.5	6.3	7.3	9.3	7.4
Sales tax/VAT*	0.0	0.4	4.1	5.6	6.2	7.4	5.9	5.7
Others	0.5	0.5	0.5	0.6	1.1	1.0	0.9	2.0

Source: Economic Survey, various issues

*Sales tax was introduced in the fiscal year 1971/72 and was later replaced by VAT, which was introduced in 1989/90

theory and practical guidance on designing tax systems due to restrictive assumptions of the optimal tax theory. Given these restrictive assumptions underlying optimal tax theory, this study focuses on the relative use of the different tax instruments without too much focus on whether they are optimal or not.

Table 5 provides a clear picture of how Kenya's tax structure has changed over time. In addition to seeking to raise the tax yield of the economy to a level that allowed the country to pursue a sustainable deficit policy, the TMP sought to address constraints in the existing tax structure that would have constrained the attainment of this objective. Some of the constraints included the reliance on direct taxes in the face of the negative effects such taxes have on sustainability of economic growth. Another constraint was the significance of the trade taxes in the total tax revenue in the face of emerging evidence that the import substitution industrialisation policy was not so much a success and therefore the need to use trade policy for creating a vibrant export-oriented economy. Tied to this objective was the reality that free trade and globalisation were becoming more and more entrenched

Table 5: Tax structure in Kenya as a percentage of total tax revenue

Type of tax	Period							
	Pre-tax modernisation programme				Post-tax modernisation 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 - 03/04
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

Source: Economic Survey, various issues

*Sales tax was introduced in the fiscal year 1971/72 and was later replaced by VAT, which was introduced in 1989/90

in the global economic arena and countries had to choose whether to open-up or remain closed from the rest of the world.

With the above background in mind and looking at Table 5, it is evident that there has not been major changes in the number and type of tax instruments used in Kenya's tax system before and after the reforms. The only major change was the introduction of the VAT in place of the sales tax. The other tax instruments have remained personal income tax, corporate income tax, excise tax, and trade taxes.

c) How relevant and practical is Kenya's relative use of different tax instruments? Should the country have different tax instruments?

Theoretically, there are several advantages to using many different types of tax instruments. First, the use of many taxes provides insulation against economic or cyclical changes. Changing economic conditions may affect a particular tax base but are very unlikely to affect every different tax base at the same time. This has been very useful for Kenya, even looking at the aggregate level of tax revenues. Second, the use of multiple taxes allows lower rates on any one-tax base. This reduces the distorting effect of a tax, especially given the fact that distortion increase substantially as the tax rate increases. Third, it may be more politically palatable to have a larger group of taxes with low tax rates than a few taxes with high tax rates. Finally, multiple tax bases may reduce evasion or avoidance because taxpayers are unlikely to be able to avoid all taxes. In spite of these advantages, several disadvantages exist for using many different types of taxes. First, multiple taxes likely mean higher administration costs to both taxpayers and taxing authorities. Administrative costs for adopting new taxes are likely to be much higher than the increase in administrative costs from trying to extract more revenue from existing taxes. Second, depending on taxes used and design of the taxes, the cumulative distorting effect may be greater than the use of fewer tax instruments. This may be especially true where different taxes apply to the same transactions. Third, the use of multiple taxes makes it harder to determine the distribution of tax burden on individuals of the different taxes. Determining the incidence of multiple taxes upon an individual or group of individuals is difficult.

Given the advantages and the disadvantages of the multiple tax instruments, there are some stylized facts that can be distilled as outcomes of Kenya's tax reform efforts based on the evidence in Tables 4 and 5.

a) Diminishing role of trade taxes

The significance of trade taxes in Kenya's total tax revenues has diminished considerably. In the early 1960s, trade taxes constituted 40 percent of total tax revenue or 4.2 percent of GDP. This ratio then continued to fall and stood at around 25 percent of total revenue before the TMP. The TMP has led to a further reduction of the ratio of trade taxes to roughly 17 percent of total tax revenue. Internationally, Tanzi and Zee (2000) note that trade taxes are a relatively insignificant source of revenue for developed countries (less than 0.3 percent of GDP) while they constitute between 20 and 40 percent of total tax revenue for developing countries. Tanzi and Zee (2000) also note that in general, the percentage of trade taxes of total tax revenue for developing countries is higher for low tax yield countries (tax revenue as a percentage of GDP in the range of 5-10 percent) than for medium tax yield (tax revenue of 10-20 percent of GDP) or high tax yield countries (tax yield greater than 20 percent of GDP). As Kenya moved from a low to a high tax yield country, so did trade taxes become less important. What could be hidden in this inverse relationship is that in terms of GDP proportion, trade taxes still constitute roughly 4 percent[2]. Another possible explanation that is not explicit is that Kenya has changed its trade policy paradigm to embracing free trade and challenges of globalisation in as far as export competitiveness is concerned, as opposed to reliance on protection of import competing sectors.

b) Importance of excise taxes

Initially, as indicated in Table 5, excise taxes were important, as they constituted 17 percent of total revenue. Their contribution then declined to 11 percent of total taxes by 1982/83 fiscal year. During most of this period, Kenya's economy used to experience some moderate level of inflation. However, at the same time, a specific excise tax regime used to prevail. One of the reforms implemented under the TMP was the change in the excise tax regime to *ad valorem* at least in the case of tobacco and alcohol products. This reform seems to have been quite successful as the excise taxes contribution improved from 9-10 percent at the start of the tax reforms to about 17 percent of total tax revenue. However, as indicated earlier, the country has reverted back to a specific tax regime based on the theoretical and empirical justification that specific taxes are more favourable in terms of investments in high quality products that can compete in export markets.

[2] The trade taxes to GDP ratio constancy at roughly 4 percent might be misleading given that Kenya's economic growth has been declining and for the last decade has transited to an average growth path of 2 percent per annum (Njuguna, Karingi and Kimenyi, 2003).

An important implication of the observations related to excise taxes is that automatic up rating of the effective excise tax rates may be necessary unless the rate of inflation is contained at a very low level.

c) Income taxes have reduced their role but are still the most significant

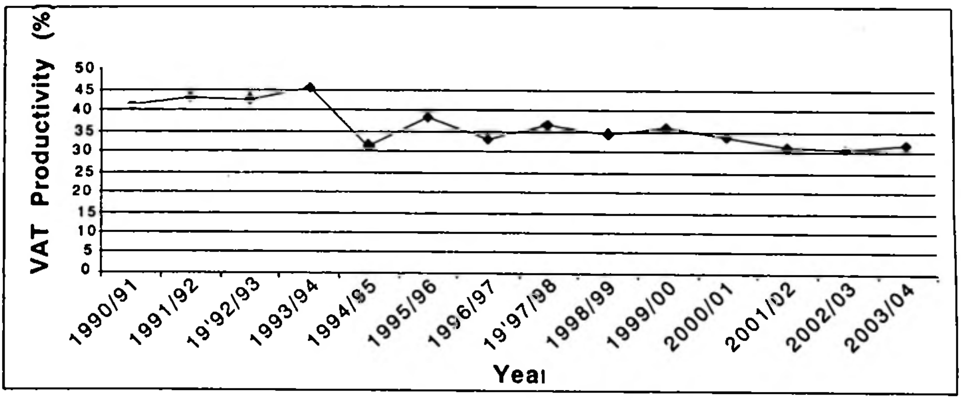
One of the objectives of Kenya's tax reform was to reduce the reliance on direct taxes. A shift towards more reliance on indirect taxes and specifically on consumption taxes was therefore expected. Theoretical justification exists in a pro-growth environment for using consumption rather than income taxes to raise government revenue. Nevertheless, to understand clearly the outcome of the tax reforms, it is necessary to consider the international context. Tanzi and Zee (2000) study indicate that developing countries rely much more on consumption taxes than income taxes. For developed countries, revenue from income taxes generally exceeds revenue from consumption taxes by a substantial margin (14.2 percent of GDP for income taxes compared to 11.4 percent of GDP for consumption taxes). In contrast, developing countries receive twice as much tax receipts from consumption taxes than income taxes (10.5 percent of GDP from consumption taxes as compared to 5.2 percent of GDP from income taxes). Kenya is not an exception from the developing countries as can be seen from Table 4. Just before the tax reforms, income taxes averaged 6 percent of GDP and consumption taxes (excise plus sales tax) stood at 7.7 percent of GDP. After the tax reforms, consumption taxes have become more significant as they constitute approximately 10 percent of GDP and income taxes slightly over 7 percent. One can therefore say that there was some significant success in shifting towards consumption taxes although not to the ratio of developed countries but at least higher than that of developing countries.

Probably another important point that should be highlighted with respect to income taxes is that the relative proportion of income taxes between individual and corporate taxes differ between developed and developing countries. In the developed countries, individual income taxes exceed corporate income taxes by a margin of 3 to 1. In contrast, in developing countries revenue from corporate income taxes exceed individual income taxes by a substantial margin. In Kenya, however, corporate and individual income taxes initially contributed almost the same amount of tax revenue, though of late individual income taxes have been overtaken by corporate taxes. This may be one explanation why Kenya continues to perform better than other African countries in terms of tax yield.

d) VAT productivity

Since it was adopted by the European Union countries, the VAT has gained currency globally and has been one of the components of major tax reform initiatives in most countries. Indeed, in a country like Kenya, VAT has been

Figure 1: VAT productivity in Kenya



Source: Own computation

perceived as a tax of the future in line with the countries objective of reducing reliance on direct taxes and also the diminishing role of trade taxes. In this respect, the performance of the VAT since its introduction becomes an important issue of inquiry.

Figure 1 shows the productivity[3] of VAT since its introduction. What is clear from the figure is that during the introduction phase, the productivity improved for the first few years before peaking at around 45 percent in 1993/94 fiscal year. This was followed by a drastic fall to about 31 percent in 1994/95. This fall can be attributed to the removal of petroleum products from the VAT base, especially to reduce refund claims by the dealers and also the reduction of the top VAT rate from 40 to 30 percent. VAT productivity scaled up in the following year to around 38 percent. However, the recovery in productivity could not be sustained and it was followed by some years of decline. The low productivity does seem to indicate possible structural problems, which tax reforms may have failed to address. It also indicates that VAT is yet to find its position in Kenya's tax system as the tax of the future.

[3] VAT productivity is derived by dividing the ratio of VAT to GDP with the VAT standard rate.

5. Impact of Tax Reforms

This section assesses the impact of tax reforms on the goals of equity, revenue adequacy, economic efficiency, and the capacity to effectively administer new tax laws.

5.1 Impact on Equity

Having an equitable tax system was one of the objectives of the Tax Modernisation Programme. Therefore, an important question in assessing the outcomes of the tax reforms is how effective has been the different tax instruments in redistributing wealth or income in the country? In both theory and practice, tax instruments vary greatly in their ability to redistribute wealth or income. Individual income taxes and wealth taxes are the primary instruments to achieve redistribution. Whether and to what degree corporate income taxes aid in redistribution depends upon whether shareholders as opposed to labour or consumers bear the corporate tax burden. Taxes on consumption are generally assumed to be regressive given that lower-income groups tend to spend a higher percentage of their income than higher income groups. However, the regressivity of consumption taxes is not as severe when considered over a lifetime perspective as espoused in theories covering intergenerational equity issues. Whether taxes in Kenya, especially during and after the reforms, have aided in the redistribution of income or providing targeted relief is a difficult question. This difficulty notwithstanding, until personal income taxes play a greater role in the country, redistribution via taxation will be very difficult. Moreover, income tax competition from other countries and limitations of tax administration do limit the ability of using the tax system to redistribute income and wealth.

Addressing poverty concerns through the design of specific tax instruments sometimes looks promising but this has not been a key feature of taxation in Kenya. 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: (i) use the tax system as a part of the social welfare programme to provide cash transfers to low-income individuals; (ii) adopt a high threshold to exempt certain low-income individuals from being subject to income tax; and (iii) adopt provisions that seek to reduce the tax burden of low-income individuals. Of these three instruments, the first option has not been part of Kenya's tax reforms. The third option also has not featured in Kenya's tax system in terms of income redistribution. If anything, the provisions that have been in place such as tax deductibility of individual pension schemes, life-insurance premium payments, mortgage interest costs and education policies are all more beneficial to middle to high income households/individuals.

The equity question and support for the poor has mainly been addressed through the second option, combined with expansion of income tax brackets. Indeed, various adjustments to the income threshold, the personal relief and income tax brackets aimed at cushioning the poor have resulted in about 1.3 million taxpayers being dropped from the tax net since 1981 as indicated in Appendix 1. The income tax threshold[4] is currently four times Kenya's per capita income. This has been increased gradually over the reform period (Table 6). One can then see that during the tax reform period, there was a deliberate policy towards protecting the poor through personal income taxation as the personal income tax (PIT) threshold was consistently raised compared to the per capita income. The information in Table 6 does

[4] The multiple of the income tax threshold to per capita income has been computed by taking the countries annual tax relief and using the lowest income tax rate and asking how much an individual would have to earn in order to be in a net income tax paying position. As per 2003, an individual earning Ksh 126,720 would be liable to an income tax at 10 percent of Ksh 12,672. Given that there is an annual tax relief of Ksh 1,056 monthly, then the tax threshold is approximately Ksh 126,720 (around US$1,690 at the average exchange rate for 2003), which is four times the current per capita income of about US$ 404.

Table 6: Multiple of tax threshold to per capita income

Year	PIT threshold	Per capita income	Multiple of PIT threshold to per capita income
1995	707.4	308	2.3
1996	956.2	303	3.2
1997	1114.3	337	3.3
1998	1192.1	363	3.3
1999	1239.3	324	3.8
2000	1259.8	311	4.0
2001	1465.6	331	4.4
2002	1612.2	360	4.5
2003	1667.4	404	4.1

Source: Author's computation as explained in footnote number 4.

not tell us much about the progressivity[5] of income tax but it is quite clear that the lower income group takes longer today to be in a positive net PIT paying position compared to 1995, for instance

The other equity-related taxation question is with respect to the VAT. A single rate VAT may be regressive as related to income, as low-income individuals spend a higher percentage of their income than high-income individuals. Kenya, as part of its tax reforms, has sought to offset the regressivity of the VAT by reducing the tax burden on basic goods and services. These necessities may constitute a higher proportion of total spending of low-income individuals as compared to high-income individuals. However, it may be that individuals of different income groups are purchasing many of the same goods and services. High-income groups may just be buying more expensive varieties of products as compared to those less well off. If this is true, the use of lower VAT rates may be ineffective in achieving distributional goals. It may be more effective to address redistribution goals outside the VAT system.

The use of multiple VAT rates, which happens to have been part of Kenya's tax reforms initially, imposes significant administrative costs because of

[5] One cannot simply ascertain the level of progressivity by looking at the statutory tax schedule. As explained in this paper, in the income tax reforms in Kenya, nominal marginal rates have been reduced and tax brackets reduced and rationalized, but concurrently tax bases have been expanded by bringing untaxed income sources within the tax net.

Table 7: Kenya's tax Revenue/GDP Ratio for 1963/64 - 2002/03

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 - 2003/04
Tax revenue/GDP ratio (%)	10.6	13.5	16.9	19.7	19.3	20.3	24.1	19.6

the difficulty of defining supplies eligible for lower or zero rates. The workable alternative that was eventually adopted instead of multiple rates was to zero-rate only a limited number of basic food commodities. This approach has had two advantages. First, it avoids many of the demarcation disputes found in all tax systems with broader concessions. Second, this approach mitigates the regressivity of the exemption. A broad exemption for "food" may have benefited higher income individuals' more than lower income persons as richer people buy more expensive foods and may actually spend a higher percentage of their income on food. However, a concession only for a very limited number of defined foodstuffs may be of less benefit to high-income taxpayers as both the percentage of income spent on basic foodstuffs and the actual amount spent may decline as income rises. Although any specific proposals aimed at addressing the equity and pro-poor question need to be considered in the context of the entire tax system, reducing the number of individuals subject to income taxation through high income tax threshold and the lower rating of certain basic foodstuffs should continue to merit serious consideration.

Observing the distribution of the tax burden can also help assess the progressiveness of a tax system. Tax burden is measured as the ratio of tax revenue to GDP over the period under consideration. Table 7 indicates that on average, tax revenue to GDP ratio over the pre-reform period increased by three percentage points over the five-year interval. The gradual increment in the ratio implies that the tax burden increased gradually over the two decades.

The transition into the reform period lowered the tax burden to 19.3 percent over 1983/84-1987/88. The burden rose marginally to 20.3 percent over the next five-years. During 1993/94 – 1997/98, the Kenyan citizenry experienced the highest tax burden of 24.1 percent of GDP. This was due to the increased revenue requirements as a result of withdrawal of donor funds. The tax burden has been perceived as being high compared to other developing countries. It was in the light of this that the government changed its focus to reducing the revenue/GDP ratio to about 21 percent in as highlighted in the Economic Recovery Strategy for Wealth and Employment Creation (ERS-WEC 2003-2007).

5.2 Tax Reforms and Revenue Adequacy

Whether or not the tax reforms undertaken in Kenya have enhanced revenue adequacy remains as debatable as both theory and experiences elsewhere have demonstrated. In principle, one measure of fiscal adequacy in any country is whether sufficient revenues are generated to meet the desired level of expenditure. Both theory and experience predict that failure to generate adequate amount of revenue can be attributed to either an unrealistic level of expenditure or inadequate revenue performance. In assessing the impact of Kenya's tax reform on revenue adequacy, the paper takes notes of: (i) tax efforts in Kenya; and (ii) the level of expenditures or deficit. In order to assess the revenue adequacy of Kenya's tax reform, one question to ask is whether the tax effort is "in line" with the other countries of the same development and economic characteristics.

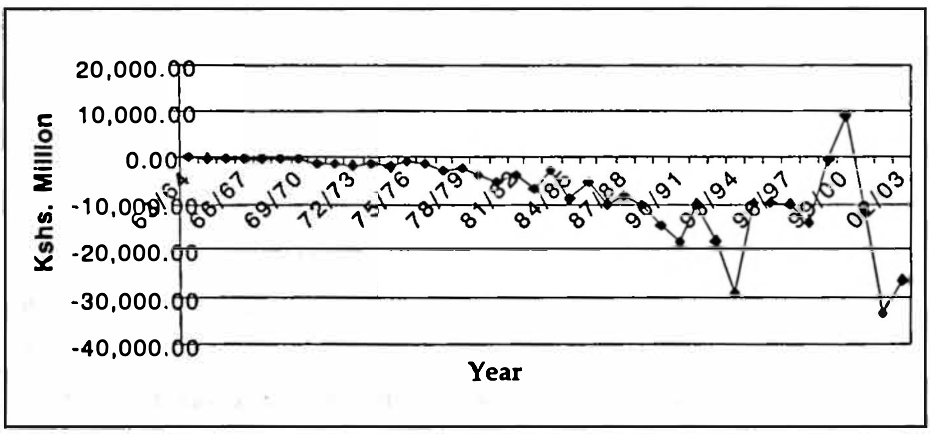
As can be seen from Table 8 below, Kenya's tax effort in 2002 was about 21 percent of GDP, above the sub-Saharan Africa's average effort of about 16 percent. This effort is also much higher than that of both Uganda and

Table 8: Tax effort for the wider East African region: 1984-2002

	Kenya	Tanzania	Uganda	Rwanda	Burundi
1984	23.81	17	10	10	14
1985	21.83	17	9	11	13
1986	22.28	14	7	13	14
1987	22.76	15	4	12	12
1988	23.62	8	5	11	14
1989	23.25	10	5	11	14
1990	22.80	10	6	9	13
1991	23.00	11	7	9	15
1992	23.03	11	6	9	14
1993	25.38	8	7	8	15
1994	27.93	10	8	4	17
1995	28.60	10	9	6	17
1996	27.20	10	10	9	13
1997	25.49	11	10	10	13
1998	25.29	10	10	10	16
1999	24.56	10	11	9	17
2000	23.91	10	10	9	18
2001	22.13	10	10	11	18
2002	20.96	10	11	11	17
Per capita income (US$)	360	290	240	230	100

Source: African Development Indicators (2004) and Economic Survey (various)

Figure 2: Kenya's fiscal deficit during 1963/64 - 2002/03



Source: Economic Survey (various)

Tanzania, which averaged about 10 percent of GDP in 2002 (African Development Indicators, 2004 and Katusiime, 2002)[6] For comparative analysis, tax burden can also be viewed as tax effort since it gives the ability for a respective government to raise revenue as a proportion of GDP. From table 8, it may be concluded that Kenya's tax reform has had positive impact on revenue yield and subsequently contributed to revenue adequacy over the years. The current effort to set revenue to GDP policy at about 20 percent is therefore aimed at not only lowering the tax burden in the economy but also making Kenya an investment competitive destination in the region. With this policy providing a constraint on revenue generation, any other assessment of revenue adequacy must be premised on the expenditure needs of deficits.

An alternative approach to assessing the impact of tax reform on revenue adequacy is to examine the level of expenditure and persistence of budget deficits. The basic premise in this approach is that a budget deficit that is high and persistent could be taken as valid evidence that tax effort is too low for expenditure needs of the country.

As can be seen from figure 2, Kenya's fiscal deficit regime exhibited varied profile between 1964 and 2003 (Appendix 2). During the pre-tax reform period (1963/64 - 1983/84), growth in fiscal deficit was gradual, peaking at Ksh 6.896 billion in the fiscal year 1982/83. The deficit increased to Ksh 10 billion by 1988/89, which was indicative of tax revenue increasing at a slower pace than government expenditure. The growth in expenditure was as a result of funding the 8-4-4 education programme in 1985, double university intake in 1986, and the general elections of March 1988, among other expenditures.

[6] For detailed discussions on the tax efforts of the EAC partner states, see Katusiime (2002) paper presented to East African Revenue Authority Technical Committee (EARATC).

With the increasing level of deficit, the government became more focused on increasing revenue collections. This was to be achieved through new tax measures and improved tax collection, which was further reinforced by the introduction of cost sharing in public hospitals and universities during the period.

The above measures reversed the trend and by 1994/95, the deficit declined to Ksh 9 billion. However, the honeymoon was short-lived as observed in figure 2. A sharp increase was experienced in 1997/98 with a deficit of Ksh 14.251 billion, up from Ksh 9 billion in 1995/96. A sharp increase in the deficit was again experienced thereafter, with 2001/02 registering a peak of Ksh 33.8 billion. This was fuelled by the December 2002 general elections, expenditure on the constitutional review process and bailing out of Kenya Airways for war risk insurance cover as a result of terrorist attacks on the United States on 11th September 2001.

The trend in fiscal deficit could be an indicator of the inability of tax reforms to achieve the revenue adequacy goal, which can mainly be attributed to ever-increasing government expenditure in the face of slowly increasing revenue. The problem is more pronounced from early 1990s to date. This fiscal deficit problem calls for both revenue enhancement measures and expenditure management strategies. The Budget Rationalization Programme was initiated in 1987 just after the TMP, which involved regulating expenditure through strict controls. Under the Budget Rationalization Programme, projects with potentially high productivity (high cost-benefit ratio) were to be identified and their completion accelerated by an infusion of funds. Projects with low potential benefits were to be identified and postponed or cancelled to free funds for projects with higher rates of return. The recurrent expenditure implications of completed or almost completed development projects were to be assessed and sufficient resources set aside to fund these projects in subsequent years, therefore ensuring full utilization of completed facilities. New development projects were to be funded only where they promised to be productive investments of high priority. This shows that revenue and expenditure policies have been jointly implemented, even though expenditure policies did not yield much success as expenditures have continued to rise faster than revenue over time.

The current fiscal strategy aims at achieving zero deficit mainly through: increasing revenue collection primarily through modernization of tax collection institutions; setting of optimal tax rates to realize improved compliance and expanding the tax base; and rationalizing the allocations of recurrent expenditure and allowing development expenditure to grow at a sustainable pace (Development Plan, 2002-2008; Medium-Term Expenditure Framework, 2000/01-2002/03); and Budget Speech, 2000/01). At the moment, tax effort[7] for most tax heads is low. Research shows that in 2001/02, excise tax on beer registered the highest effort of 85 percent while corporate income tax had the least effort of 35 percent (Karingi *et al.*, forthcoming). Other tax heads registered modest efforts: PAYE 66.9 percent; VAT 56 percent; import duty 51 percent; Excise tax on cigarettes and petroleum products 52.1 percent and 69.5 percent, respectively. The low levels of tax compliance in Kenya are attributed to tax evasion and avoidance, emanating from the rapidly growing informal sector. This is due to the fact that majority of the informal sector players are below the VAT threshold of Ksh 3 million per year. Therefore, in addition to compliance enhancement measures, the government should focus on tapping the potential revenue from the informal sector by developing a simplified taxation system for the sector. There is also need to inculcate a tax-paying culture in the Kenyan citizenry.

[7] Tax effort is defined as actual revenue collected over the potential revenue

5.3 Other Performance Indicators of TMP

a) Size of the tax base: The number of taxpayers has considerably increased over time. The number of those registered under PAYE increased from about 274,344 in 1992/93 to about 1.8 million in 1999/2000 (Nyamunga, forthcoming). VAT registrations on the other hand increased from about 5,000 to about 30,000 over the same period. Despite the increase in taxpayer registration, an analysis of compliance level shows that there has not been much improvement (Nyamunga, forthcoming; Karingi *et al.*, 2004). Nyamunga (forthcoming) shows that compliance levels (taken as the proportion of those who file returns as a proportion of the potential return filers) dropped markedly by about 50 percent over the period 1990-1999. The two studies clearly reveal that there is potential for increasing tax revenue and expanding the tax base without necessarily increasing the tax burden on individuals.

b) Revenue Performance: Revenue collection has significantly grown over the last decade. The objective of TMP of raising revenue to GDP to 28 percent was realized in 1994/95 and 1995/96, where revenue to GDP reached 28.35 percent and 28.86 percent, respectively. The concerns on tax burden have since made the government to refocus on lowering the tax to GDP ratio in an attempt to reduce the burden. The ability of TMP to enhance revenue collection over time could have been undermined by various factors. Muriithi and Moyi (2003) found out that the buoyancy of Kenya's overall tax system is 0.645, which implies that the growth in GDP has spurred a less than proportionate automatic increase in tax revenue. This shows that a decreasing proportion of incremental income is transferred to the government in the form of tax revenues, which implies that Kenya's tax structure is inelastic. There were low tax-to-income elasticity of direct taxes, import duties, excise duties and sales tax/VAT, which affected the overall elasticity of the total tax. The overall tax system was inelastic with respect to GDP for the pre-reform period, with excise duties and sales tax/VAT being the main sources of inelasticity due to their low tax-to-base elasticity, but elastic for post-reform period. For post-reform period, the most elastic taxes were direct taxes (2.165), excise duties (1.699) and import duties (1.661). Similarly, direct taxes, import duties and excise taxes had a high tax-to-base elasticity. Therefore, tax reforms had a positive impact on the overall tax structure and on individual tax handles, and they had a bigger impact on direct taxes than on indirect taxes. This shows that revenue leakage is a problem as regards indirect taxes since the tax structure is elastic.

c) Revenue structure: There was a shift in emphasis to indirect taxation in the 1990's. Trends in revenue, however, show that there is still more reliance on direct taxation, more probably due to their ease of administration. There still exists an untaxed potential under both the direct and indirect taxation, which should be exploited before actively shifting towards consumption taxes (Nyamunga, forthcoming).

d) Revenue administrative efficiency: Over the reform period, compliance was greatly increased (even though still low) through use of field audits introduced in 1996 and further adoption of investigation audits. However, there is lack of a national audit plan and audit monitoring and control measures capable of evolving efficient audit management structures for revenue administration. There is still need for Kenya Revenue Authority (KRA) to address training needs and automation of some service deliveries, even though the human resource base for revenue administration has significantly changed especially in terms of staff compliment, training, skills up-grading, salary review, staff discipline and staff rationalization and right-sizing (Nyamunga, forthcoming).

e) Economic efficiency: This goal was to be achieved through lowering and rationalization of tax rates to reduce compliance and administrative costs, while expanding the tax bases. Lowering and rationalization of duties was successfully carried out as evidenced by the specific reforms under TMP. For instance, VAT rates decreased from 15 at inception to the current three, with the top rate being lowered from 210 percent to the standard rate of 16 percent. CIT rates were lowered from the top rate of 47.5 percent to the current 30 percent (also initially differentiated between foreign and locally-owned companies) while PIT rate was lowered from a top rate of 65 percent to the current rate of 30 percent. Excise tax rates have on the contrary been increasing, which is mainly due to the rationale of taxing these commodities (as a sin tax).

It should be noted that there exists various methodologies of rigorously analyzing the impact of reforms on the aforementioned goals. This study briefly gives the likely impact but does not carry out the rigorous analysis mainly because of data limitations and also because the subjects under review are quite broad. A rigorous analysis of the impact of tax reforms on equity, revenue adequacy and efficiency are left as an area of further research.

6. Lessons From Kenya's Tax Reform Experience

The study has evaluated Kenya's tax reform process based on the principles of equity, revenue adequacy, economic efficiency and administrative capacity. In light of the above analysis, several lessons emerge from the country's tax reform experience.

First, it was noted that one of the key pressures of tax reform was to have a sustainable tax system that is able to generate adequate revenue to finance public expenditure. This has not been achieved, as seen by the increasingly growing budget deficit. Revenue has been growing at a much slower pace as compared to expenditure, giving rise to a fiscal deficit that had to be financed domestically through the 1990s. With the current revenue set at 22 percent of GDP, the goal of revenue adequacy cannot be achieved, since fiscal discipline is yet to be achieved. The implication of the envisaged zero deficit is that government expenditure to GDP ratio is also reduced to 22 percent of GDP, which might not be achievable with the introduction of free primary education and also the proposed social health plan. Whereas tradeoffs among the equity, revenue adequacy, economic efficiency and administrative capacity goals have been inevitable, these goals have more often tended to complement each other. The tax reforms have mainly been aimed at achieving greater simplicity, neutrality and horizontal equity at the expense of vertical equity.

Secondly, effective tax reform cannot be accomplished in isolation from 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, when TMP was initiated in 1986. As noted earlier, the success of the reform programme has been to a large extent undermined by the ability of the government to effectively implement the policies. This not only resulted in increased compliance costs and greater tax evasion but also resulted in lagged collections. This is evidenced by large tax arrears presently at KRA (estimated at Ksh 61,764 million for income tax and Ksh 27,733 million for VAT (Income Tax and VAT Departments, Kenya Revenue Authority). This shows that tax administration still needs to be enhanced to reduce tax arrears and therefore increase tax collections. Experience suggests that there are three essential ingredients, which are important for effective tax administration. These include: the political will to implement the tax system; a clear strategy to achieve the goal; and adequate resources to carry out the reforms. The most important ingredient is a clear recognition at the highest political level of the importance of the task and the willingness to support good administrative practices. The key to success in tax administration reform lies in evolving a strategy that best utilizes the available resources to minimize the scope for non-compliance and to maximize the likelihood of detection and punishment of non-compliance, while simultaneously providing facilities and incentives for compliance at each stage of the compliance process.

Thirdly, an important lesson that emerges from tax reform experience is that an essential precondition for the reform of tax administration is to simplify the tax system in order to ensure that it can be applied effectively in the generally low-compliance contexts of developing and transition economies (Bird, 2004). Tax compliance levels not only reflect the effectiveness of tax administration but also the taxpayers' attitude towards both taxation and the government in general. Attitudes are formed by factors such as the perceived level of evasion, the perceived fairness of the tax structure, its complexity and stability, how it is administered, the value attached to government activities, and the legitimacy of government. Tax administration problem can be approached from three different dimensions: the general legal framework; the specific organizational structure and operating rules for tax administration; and the institutional infrastructure. This implies that one cannot assess the functioning of a tax system without taking into account the environment in which it is supposed to function, the laws being administered and the institutional infrastructure. An example is the impossibility of appraising the efficiency or effectiveness of tax administration without taking into account both the degree of complexity of the tax structure and also the extent to which that structure remains stable over time.

Policy reforms also need to be assessed carefully, putting into consideration the different options against the economic objectives, and to be swiftly enacted and left unchanged for some time. Kenya's reform experience has seen a continuous *ad hoc* patching of the system, which has led to a number of policy reversals. This is evidenced by the continuous annual increase in tax rates and the shift from specific to *ad valorem*, and back to specific tax regimes.

A general lesson from tax reforms is that reformers should be risk averse. Recommended changes should be considered carefully to ensure that their full introduction does not damage revenue yields. An essential element of meaningful tax reform is a careful, detailed, and realistic study of the limits and potentials of the administrative system that is expected to implement the desired tax reforms.

As indicated at the introductory section of this paper, the issue of revenue adequacy is not much of an issue in Kenya because the stated policy is to maintain the revenue to GDP ratio at 22 percent. Consequently, the key issues with improvement of tax mobilization are seen to be more of administrative rather than policy. The appropriate recommendations on this respect have already been identified by the government and are stated in the Economic Recovery Strategy for Wealth and Employment Creation (Government of Kenya, 2003). Essentially, the key recommendation that is consistent with the Kenya government's tax reform effort is the need to reform the tax administration so that the tax burden can be reduced particularly on businesses and individuals. Critical to the tax administration reforms will be the optimal utilization of the Personal Identification Number (PIN) and the computerization of KRA systems. The authority should be given adequate budgetary allocation to support its functions.

The tax burden can also be reduced by broadening of tax base through integrated taxpayer recruitment policy. A high potential lies in the informal sector, which, once tapped, will drastically reduce the burden. Nyamunga *et al* (forthcoming) also showed that it is possible to raise more revenue by lowering the VAT rates but increasing compliance. Other measures include improving voluntary compliance, enhanced and integrated tax assessment, improved management of debts and arrears and exemptions and finally effective enforcement of tax laws. The above tax administration reforms will enable the government to reduce the tax rates of most of the taxes and therefore reduce the tax burden.

So far, there has been very little work undertaken on the distributional impact of taxes in Kenya. Even in this paper, the evidence alluded to on the progressivity of the tax system is more anecdotal rather than empirical. Therefore, it would be useful if a more thorough incidence analysis of the different taxes were to be undertaken. The main challenge towards achieving this objective is data limitation. Incidence analysis of taxes would require availability of disaggregated data and if possible at household level. A well-structured database of the labour market is also essential. Unless such data was available, it would be difficult to carry out a reasonable study of the distributional impact of taxes. Micro simulation modeling coupled with general equilibrium models are two methodologies that are amenable to distributional impact analysis and which this study would like to recommend.

Therefore, further analysis on the impact of tax reforms can be carried out using the Computable General Equilibrium Models (CGE), and marginal

Effective Tax Rates and Principal Component Analysis, which are currently beyond the scope of this paper.

In conclusion, the key elements of a tax reform strategy can be summarized as:

'Keep the tax laws as simple as possible; Aim for a global tax with few exemptions, credits, rebates, or deductions; Do not try to use the tax system to achieve too many social and economic goals; Continually monitor the tax system; Concentrate on basic tasks such as collection of tax at source and an ID number system; Do not collect more information than can be processed; Actively encourage good record keeping; and Aim, as a long term goal, for self assessment' (Wallschutzky, 1989) as quoted by Bird (2004).

References

African Development Bank (2004). *African Development Indcators.*

Bahl, R., (1990). 'The Jamaican tax reform'. Lincoln Institute of Land Policy, Cambridge, Massachusetts, 02138.

Bahl, R., J.M. Vazquez, and S. Wallace (1996). 'The Guatemalan tax reform', West View Press, USA.

Bird, R. M. (2004). 'International administrative dimensions of tax reform', *Asia-Pacific Tax Bulletin,* International Bureau of Fiscal Documentation.

Carey, D. (2003). 'Tax reform in Belgium', Economics Department Working Papers No. 319, Organization for Economic Co-operation and Development.

Government of Kenya (2003). Economic Recovery Strategy for Wealth and Employment Creation (ERS 2003-2007).

Government of Kenya (various). Budget Speeches.

Government of Kenya (various). Economic Survey.

Government of Kenya (various). Statistical Abstracts.

Koester, G.B. (2005), 'The political economy of tax reforms: Evidence from the German case, 1964-2004'. Humboldt University Berlin, Department of Economics, Berlin, Germany.

Karingi, S.N., M.S. Kimenyi, and N.S. Ndung'u, (2001). Beer taxation in Kenya: An Assessment. KIPPRA Discussion Paper No. 4, Nairobi: Kenya Institute for Public Policy Research and Analysis.

Karingi, S.N., B. Wanjala, A. Kamau, A. Mwangi, E. Nyakang'o and M. Muhoro (2004). 'Fiscal architecture and revenue capacity in Kenya', KIPPRA Discussion Paper No. 45, Nairobi: Kenya Institute for Public Policy Research and Analysis.

Karingi, S.N. (2001). 'Revenue design: The Kenyan experience'. Fiscal Policy for Poverty Reduction Case Study submitted to the World Bank Institute, World Bank.

Katusiime F. (2002). "Tax effort in the Sub-Saharan African countries". Discussion paper presented during the 20th Tax Consultative meeting in Uganda and 21st Tax Consultative meeting in Dar es Salaam.

Kiringai, J., N.S. Ndung'u, and S.N. Karingi (2002). Tobacco excise tax in Kenya: An appraisal. KIPPRA Discussion Paper No. 21, Nairobi: Kenya Institute for Public Policy Research and Analysis.

Muriithi M.K. and E.D. Moyi (2003). 'Tax reforms and revenue mobilization in Kenya', African Economic Research Consortium Research Paper 131, Nairobi.

Njuguna, A.E., S.N. Karingi, and M.S. Kimenyi (2003). Alternative methodologies for measuring Kenya's potential output and output gap, KIPPRA Discussion Paper No. 28, Nairobi: Kenya Institute for Public Policy Research and Analysis.

Nyamunga, J.B., J. Kanyi., D. Kagira, A. Mwarua, and J. Kiringai, (forthcoming). 'VAT micro-simulation model', The Tax Policy Unit.

Nyamunga, J.B. (forthcoming). 'Tax administration and reforms in Kenya: A review of tax administration reforms', mimeo.

Tanzi, Vito and H. Z. Howell (2000). Tax policy for emerging markets: Developing countries, IMF Working Papers WP/00/35, International Monetary Fund.

Thirsk, W. (1991). 'Lessons from tax reform: An overview', World Bank Working Paper No. 576, Washington DC.

Vasquez, J.M and R. McNab (1997). 'Tax reform in transition economies: Experience and lessons', International Studies Program, Andrew Young School of Policy Studies, Georgia State University Working Paper 97-6.

Wallschutzky I. (1989). 'Achieving compliance in developing countries', Bulletin for International Fiscal Documentation.

Appendix

Appendix 1: Income tax: Equity issues

	Personal relief	Approximate number of individuals out of tax net
1981/82	A uniform married relief of K£90 p.a., single relief of K£30 and a special single relief of K£42 for singles with children.	
1987/88	Single relief increased from Ksh 720 to Ksh 960, while family relief increased from Ksh 1,800 to Ksh 2,400 and special single Ksh 1,200.	140,000
1989/90	Reliefs were increased by 10%, i.e. married relief to K£99, single relief to K£33 and special single relief to K£46.	60,000
1991/92	Single relief increased from Ksh 1,320 to Ksh 1,452, while family relief increased from Ksh 2,640 to Ksh 2,904.	
1992/93	Single relief increased from Ksh 1,320 to Ksh 1,452, while family relief increased from Ksh 2,640 to Ksh 2,904.	50,000
1993/94	Single relief increased from Ksh 1,452 to Ksh 2,424, while family relief increased from Ksh 2,904 to Ksh 3,636.	150,000
1994/95	Single relief increased from Ksh 2,424 to Ksh 3,636, while family relief increased from Kshs. 3,636 to Ksh 5,460.	230,000
1995/96	Single relief increased from Ksh 3,636 to Ksh 4,368, while family relief increased from Ksh 5,460 to Ksh 6,552.	130,000
1996/97	Personal reliefs combined into uniform personal relief of Ksh 7,200 p.a.	140,000
1997/98	Reliefs were increased to Ksh 7,920 p.a.	152,000
1998/99	Reliefs were increased to Ksh 8,712 p.a.	
1999/2000	Reliefs were increased by 10% to Ksh 9,600 p.a.	
2000/2001	Relief was increased to 960 per month or 11,520 per annum	200,000
2001/2002	Relief was increased to Ksh 1,056 per month or 12,672 per annum	
2002/2003	Relief remained at Ksh 1,056 per month or 12,672 per annum	
2003/04	Relief was increased by 10%.	

Source: Budget Statements (various years)

Appendix 2: Tax structure as a percentage of GDP

Fiscal year	Total revenue	Import duty	Excise tax	Income tax	VAT	Others
63/64	9.66	3.82	1.69	3.74	0.00	0.41
64/65	9.86	4.24	1.67	3.59	0.00	0.36
65/66	10.36	4.25	1.56	3.90	0.00	0.65
66/67	11.33	4.51	1.90	4.18	0.00	0.75
67/68	11.77	4.18	2.19	4.90	0.00	0.49
68/69	11.93	4.23	2.28	4.85	0.00	0.57
69/70	12.93	4.38	2.37	5.66	0.00	0.53
70/71	14.31	4.68	2.49	6.57	0.00	0.58
71/72	14.63	4.56	2.34	6.50	0.87	0.36
72/73	13.98	3.40	2.12	6.74	1.21	0.51
73/74	16.37	4.25	2.23	6.00	3.43	0.47
74/75	17.01	3.65	1.97	6.81	4.17	0.42
75/76	16.36	3.54	1.48	6.52	4.36	0.45
76/77	15.30	3.12	1.66	6.34	3.86	0.33
77/78	19.61	5.20	1.92	7.11	4.63	0.75
78/79	18.58	4.57	2.21	6.81	4.50	0.50
79/80	20.15	4.08	2.36	6.83	6.16	0.71
80/81	20.69	5.04	2.08	6.82	6.19	0.57
81/82	20.39	5.87	1.93	6.04	5.89	0.66
82/83	18.76	4.69	1.97	6.17	5.22	0.70
83/84	18.88	4.35	1.88	5.95	6.01	0.70
84/85	18.32	3.47	1.66	6.33	5.76	1.11
85/86	19.17	3.88	1.63	6.51	5.56	1.59
86/87	19.59	3.97	1.71	6.21	6.40	1.31
87/88	20.47	3.89	1.76	6.51	7.44	0.87
88/89	20.29	3.77	1.73	6.43	7.38	0.98
89/90	19.67	3.79	1.63	6.53	6.98	0.73
90/91	20.42	3.19	1.76	6.78	7.28	1.41
91/92	20.54	2.05	2.79	6.69	7.60	1.41
92/93	20.54	3.07	2.80	6.68	7.41	0.58
93/94	25.62	4.03	3.03	10.01	7.90	0.65
94/95	24.97	4.30	4.47	10.05	5.67	0.49
95/96	24.59	4.29	4.55	9.71	5.71	0.33
96/97	23.06	3.95	4.28	8.42	4.97	1.45
97/98	22.16	3.70	4.22	8.52	5.58	0.15
98/99	21.46	3.96	4.02	7.74	5.61	0.14
99/00	20.14	3.71	3.69	7.01	5.60	0.14
00/01	19.96	3.41	3.37	6.70	6.36	0.12
01/02	18.24	2.30	3.47	6.57	5.78	0.12
02/03	18.17	1.79	3.51	6.52	5.49	0.12
03/04	16.82	1.81	3.94	5.87	4.88	0.32

Source: Economic Survey (various years)