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Domestic Resource Mobilization
for Poverty Reduction in East Africa:

Kenya Case Study

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List of abbreviations

AfDB	African Development Bank
ARA	Autonomous Revenue Authority
ATAF	African Tax Administration Forum
BSP	Budget Strategy Paper
CAGR	Compounded Annual Growth Rate
CAMIS	Cargo Management Information System
CDF	Constituency Development Fund
CET	Common External Tariff
CGT	Capital Gains Tax
CIT	Corporate Income Tax
CITPROD	Corporate Income Tax Revenue Productivity
COMESA	Common Market for East and Southern Africa
DRM	Domestic Resource Mobilization
EAC	East African Community
eFiling	Electronic Filing
EPZ	Export Processing Zone
E-registration	Electronic registration
ERS	Economic Recovery Strategy for Wealth and Employment Creation
ETR	Electronic Tax Register
EU	European Union
GDP	Gross Domestic Product
GNP	Gross National Product
GoK	Government of Kenya
ICT	Information and Communication Technology
IEA	Institute of Economic Affairs
IMF	International Monetary Fund
ITMS	Integrated Tax Management System
ITU	International Telecommunications Union
KAM	Kenya Association of Manufacturers
KANU	Kenya African National Union
KIPPRA	Kenya Institute of Public Policy Research and Analysis
KRA	Kenyan Revenue Authority
KRATI	Kenya Revenue Authority Training Institute
KWATOS	Kilindini Water Front Operating System
LATF	Local Authority Transfer Fund
LTO	Large Taxpayers' Office
M&E	Monitoring and Evaluation
MDG	Millennium Development Goals
MP	Member of Parliament
MPER	Ministerial Public Expenditure Review

MSE	Micro and Small Enterprise
MTEF	Medium Term Expenditure Framework
MUB	Manufacturing Under Bond
N/A	Not Applicable
NARC	National Rainbow Coalition
NGO	Non Governmental Organisation
NSE	Nairobi Stock Exchange
ODA	Official Development Assistance
OECD	Organisation for Economic Cooperation and Development
PER	Public Expenditure Review
PIN	Personal Identification Number
PIT	Presumptive Income Tax
PITPROD	Personal Income Tax Revenue Productivity
PRSP	Poverty Reduction Strategy Paper
PwC	PricewaterhouseCoopers
RADDEX	Revenue Authority Digital Data Exchange
RARMP	Revenue Administration Reform and Modernisation Programme
S2005S	Simba 2005 system
SBP	Single Business Permit
SSA	Sub-Saharan Africa
TAXSTAFF	Ratio of Tax Staff per Population
TEAMS	East African Marine Systems
TMP	Tax Modernisation Programme
TPE	Taxpayer Education
UK	United Kingdom of Great Britain and Northern Ireland
UNDP	United Nations Development Programme
USA	United States of America
USAID	United States Agency for International Development
VAT	Value Added Tax
VATGCR	VAT Gross Compliance Ratio
VMS	Vehicle Management System
WCO	World Customs Organisation
WTO	World Trade Organisation

Preface

The African Development Bank (AfDB) has partnered with the African Tax Administration Forum (ATAF) and the East African Secretariat on a project aimed at sharing lessons of experience from Domestic Resource Mobilization (DRM) through case studies for the East African Community partner states (EAC), South Africa and South Korea. For the purposes of this work, DRM is defined to include only tax policy and administration and excludes other possible components of DRM such as domestic financial markets.

The overall objective of this project is to make recommendations, for the participating countries of the EAC, on the priority reforms and ways to sequence and implement them, in order to significantly enhance DRM. As such, the primary beneficiaries of the project are both the Ministries of Finance and the Revenue Administrations of the EAC.

This paper seeks to respond to the following question: *What key factors have contributed to or inhibited DRM in Kenya?* This case study has been prepared following an extensive review of available literature, interviews with key informants in Kenya, the collection of quantitative data, and the analysis of both primary and secondary data. Its development has also been informed by a methodological framework designed by the AfDB. The core principle of the methodological framework is to analyse tax performance as a result of tax systems, reforms and the political economy. The study adopts an explanatory case study approach to match patterns from our analysis of the literature and key informant interviews.

The achievements and lessons of experience contained in this and other country case studies will provide primary inputs for a policy note. The policy note will seek to address the following questions: *What are the priority reforms for EAC partner states and the EAC? How should these reforms be sequenced and implemented?*

Chapter 1 of this case study paper begins with an examination of Kenya's political economy and fiscal legacies. Thereafter, Chapters 2 and 3 explain and analyse the trends in the tax system and their impact on domestic revenue performance respectively. The final chapters highlight the challenges and issues currently faced by government (Chapter 4), and lessons of experience for consideration by the EAC partner states (Chapter 5).

Acknowledgements

The Kenya Case Study was prepared under the overall supervision of Mrs. Diarietou Gaye (Regional Director, Department East A, OREA) and Catherine Baumont-Keita (Lead Economist, OREA). Core team members were Edward Sennoga (Macro Economist, UGFO and Task Manager, Richard Walker (Country Economist, KEFO) and Christian Lim (Private Sector Specialist, OSGE). The external consultants were led by Elizabeth Kariuki and Kithingi Kiragu (PricewaterhouseCoopers).

Mr. Aloysius Ordu (Vice President, Country and Regional Programs), Mr. Steve Kayizzi-Mugerwa (Director, Operational Resources and Policies), and Ms. Radhika Bharat (Investment Officer) initiated the project and were involved in the early design of the study.

The production of this case study was made possible by the generous financial support from the Korea-Africa Fund for Economic Cooperation. We also thank the African Tax Administration Forum, East African Community Secretariat, senior management and staff of the Kenya Revenue Authority and Ministry of Finance for the extremely productive exchanges and valuable insights provided to us during the preparation of this case study. Similar appreciation also goes to representatives of regional organizations, private sector organisations, think tanks and multilateral and bilateral development partners in Kenya

The case study also benefitted from valuable feedback provided by staff in different departments of the ADB both at headquarters and in the field offices (Kenya, Tanzania, Uganda and Rwanda). External reviewers were W. Scott Roger IMF, Snr. Res Rep, Kenya Mr. Jonah N. Ogaro, Snr. Assistant Commissioner, Kenya Revenue Authority (KRA) and John Nijiraini Commissioner Domestic Taxes, KRA, who provided very constructive comments.

There is not enough space here to name each and every one of those who have contributed immensely to the successful completion of this case study; however, Annex A lists some of the key contributors to this report. In addition, we seek the indulgence of all the contributors in accepting this blanket acknowledgement and appreciation of their efforts and contribution. We are indeed very thankful.

Executive summary

1 Political economy and fiscal legacies

The pragmatic post-independence political economy choices of the Government of Kenya (GoK) worked quite impressively for much of the first one and half decades after independence. However, a series of adverse political and economic events in the second half of the 1970s, and first half of the 1980s, served to disrupt both political and economic trends. Government promulgated wide-ranging reforms by way of “Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth” in concert with an IMF-pushed Structural Adjustment Programme. However, the macro-economic and fiscal performance continued to deteriorate throughout the late 1980s and 1990s. The average economic growth rate between 1992 and 2001 was -0.3% (IMF, 2002).

The Economic Recovery Strategy for Wealth and Employment Creation, which was implemented by the new regime from 2003 to 2007, was successful in reversing the economic decline of the past two decades. In 2007, for the first time since the 1970s, the annual rate of real GDP growth reached 7%. While the post 2007 election violence and onset of the global financial crisis resulted in a slump in real GDP growth in 2008, to 1¾% (IMF, 2010), it is projected that GDP growth will be about 5% in 2010.

In the short-to-medium term, the authors suggest that there are four key fiscal governance drivers. First, an expensive bureaucracy, as reflected in Kenya’s wage bill to GDP ratio compared to other countries in the region, needs to be sustained. In 2007/08 the wage bill to GDP ratio was estimated to be 7.4% (IMF, 2010), which was the highest amongst EAC countries. Second, there are ambitious social welfare goals that are reinforced in the Bill of Rights in Kenya’s new (2010) Constitution. Third, elite capture of fiscal governance, as depicted by two initiatives by Members of Parliament (MPs) in recent years – in terms of introduction of the Constituency Development Fund, which is under the control of individual MPs, and the arbitrarily high self-pay awarded by MPs. Fourth, the ambitious development goals for the country as aptly captured in Kenya’s Vision 2030. This underlies the recourse to using infrastructure bonds, amounting to about KShs 52 billion in 2009 and 2010 (equivalent to about US\$650 million). Nonetheless, given the comparative resilience of DRM in Kenya over the years, barring any unforeseen adverse political or socio-economic developments, Kenya’s fiscal governance trajectory is fairly solid.

2 Tax reforms: Sequencing, implementation and results

In the perspective of the authors, there are two main epochs in the reform of tax policies and administration in Kenya. The first epoch generally corresponds to the Tax Modernisation Programme (TMP) that was launched in 1986 and was under implementation until the new government in 2003. The main elements of the policy thrust under the first phase of the TMP included: raising and maintaining revenue as a ratio of GDP at 24% by 1999/2000; expanding the tax base; rationalising the tax structure to make it more equitable; reducing and rationalising tax rates and tariffs; reducing trade taxes and increasing them on consumption to support investment; and sealing leakage loopholes (Moyi and Ronge, 2006). During this epoch VAT was introduced in 1990, and the KRA was established in 1995.

It is noteworthy that during the TMP epoch, in terms of fiscal decentralisation, the Single Business Permit (SBP), which is arguably the most progressive feature of Kenya's local government system was introduced (in 1999) to replace a number of local licenses and revenues-raising permits on local businesses. The other local tax is property rates. Local governments also receive from the central government a significant block grant (local authority transfer fund) and limited earmarked funds for maintenance of rural and urban roads. Nonetheless, public services are predominantly provided through a decentralised system.

The second epoch is the on-going Revenue Administration Reform and Modernisation Programme (RARMP), which was launched in FY2004/05 by the new KRA top management that had been appointed by the NARC government (2003-2007). The goal is to transform "KRA into a modern, fully integrated and client-focused organization". The strategic thrust is to harness Information and Communication Technology (ICT) applications to drive the modernisation of the tax administration. In this regard, for example, the eFiling system and Simba 2005 online system in customs are working. Key changes to tax policy have revolved around: pursuit of equity; further widening the tax base; promoting increased investment; and reducing the tax compliance burden.

The reforms under the RARMP epoch were not specifically anticipated in the TMP. In other words, there was no specific initiative to sequence between the two programmes. Furthermore, there are aspects of certain tax policy initiatives that transverse the two programmes, and elements of which are also to be found in the pre-TMP period. In the latter context, two observations are pertinent. First, certain

policy initiatives are not particular to any reform epoch. In this regard, it is noted that some tax policies cannot be located as once-off changes in a long-term strategic trajectory. Rather, they need to be monitored, evaluated and changes effected, where appropriate, on a regular basis. Thus, the issue of sequencing does not arise with respect to, for example: (i) widening the tax base; and (ii) aligning tax policies with the national development strategies and policies.

3 Domestic revenue performance

According to the IMF (2003), Kenya's tax system has performed better than average, for Africa, in the past three decades. In 1989/90, Kenya's tax revenue collection was 23.3% of GDP. Revenue collection peaked in 1995/96 at 30.4% of GDP, as a result of economic liberalisation, and thereafter, declined to 20.5% of GDP in 2002/03, before increasing to 22.0% in 2007/08. This superior performance was attributed to a stronger tax administration system and a relatively large formal sector. The reforms of the 1970s and early 1980s, as well as the introduction of VAT in 1990, which widened the tax base, enabled GoK to mitigate for revenue losses resulting from the reduction in and removal of import and export tariffs, which were imposed both by global (WTO) conventions, as well as the structural economic adjustment measures. Empirical analysis by Muriithi and Moyi (2003) suggests that tax reforms in Kenya under the TMP have led to improved productivity of direct taxes. In particular, administrative reforms (e.g. lower tax rates, PIN etc.) aimed at eliminating "avenues for evasion and corruption". However, Kenya's performance effectiveness indicators suggest that whilst the tax effort is high, there is potential to increase tax revenue collection as a percentage of GDP by reducing the tax gap.

4 Challenges and issues

Looking forward, Kenya's tax system faces major challenges in the following aspects:

- *KRA has to cope with less than ideal policy, legal and other institutional environments:* One illustration of this challenge is that there have been significant gaps between revenue targets set by Ministry of Finance and the KRA's targets. The other is that KRA does not have a free hand to properly remunerate and motivate its staff;
- *Achieving an acceptable degree of tax compliance from a fast growing and profitable, but, increasingly complex informal sector.* The informal sector is a fast growing segment of Kenya's economy, but tax evasion by the sector remains particularly high. The structural challenges of accessing the sector

are exacerbated by populist politics, which seeks to shield some constituencies of potential taxpayers from their tax obligations;

- *Rationalising tax exemptions:* There is an array of tax exemptions given by GoK. Yet, many research studies on tax exemptions and incentives confirm the conclusion of a 2008 IMF assessment of the investment incentive regimes offered in Kenya and Tanzania, that they are not important in attracting foreign investment. Rather such incentives create distortions and result in the loss of tax revenues;
- *Achieving enhanced equity and efficiency:* Indicators of Kenya's tax revenue performance show there is considerable scope to improve in the areas of equity and efficiency;
- *Porous borders with a failed state – Somalia:* The combined effect of smuggling and insecurity in the region, arising from the failure of the Somali state, will remain obstacles to tax administration for quite some time;
- *Cultivating tax morale:* Cultivating "tax morale" is a daunting challenge. It must begin with political leaders;
- *Effectively and sustainably combating corruption:* According to a researcher, corruption is one important factor that hindered KRA from meeting its collection targets in, for example, FY 2008/09. Yet, the problem is not exactly internal to KRA because businessmen seeking to evade tax are the primary culprits;
- *Regional common markets pose challenges:* Kenya is a member of two regional blocks, the EAC and COMESA, which have not harmonised their tax regimes. An added problem is the comparability and ability of revenue authorities in member countries, and their capacity to enforce compliance. There is also the issue of exemptions granted under the EAC Customs Management Act to promote the development of infant industries, which are not effectively monitored.

5 Lessons of experience

Lessons of experience that can be drawn from the Kenya case study are:

- *Stability of leadership and management enhances capacity development:* The decade of the TMP implementation was characterised by highly unstable management at both the Treasury and at the KRA. This instability is partly attributed to the failure to sustain the high domestic revenue performance, especially compared to results in the period from 2004 to 2009;
- *Tax exemptions and incentives may undermine equity and fairness:* In the past, GoK extended tax exemptions and incentives, especially on import duties to various taxpayers. Since there were no open criteria for these exemptions and incentives, they developed into favours for the well connected. This practice undermined equity and fairness of the tax system and revenue potential;
- *Enforcement with facilitation of paying taxes through modernised systems can be a win-win solution:* The introduction of Electronic Tax Registers (ETRs) in Kenya was initially controversial and strongly resisted by business people. The implementation strategy adopted by KRA undercut the resistance and, ultimately, many traders acknowledge that ETRs are also useful in sales control in their businesses. Therefore, both KRA and the business community have emerged as winners;
- *Implementation of major ICT systems can, however, seriously disrupt revenue collection:* In 2005/06, there was a decline in the tax to GDP ratio in Kenya, which has been attributed to teething technical problems when implementing the Simba 2005 system, as well as resistance from some importers and customs clearing agents;
- *Revenue authorities may be best placed to prosecute cases of tax evasion:* In 2009, KRA was allowed by the Attorney General, who is the Director of Public Prosecutions, to install six of its officers, who are legal professionals, as prosecutors in tax evasion cases. According to the authority, this arrangement has enabled more timely, effective and successful prosecutions.

1 Context – political economy and fiscal legacies

1.1 Economic legacies of the four decades following independence

After independence in 1963, Kenya chose a ‘mixed economy’ development strategy in which the government would partner with the private sector, including not-for-profit organisations in both development and future service delivery. The national political economy vision and ideology was expounded in ‘Sessional Paper No: 10 of 1965 on African Socialism and its Application to Planning in Kenya’. This Paper emphasised the “diffusion of ownership to avoid concentration of economic power...; [and] progressive taxes to ensure equitable distribution” (Grillo, 1993).

The pragmatic post-independence political economy choices of the Government of Kenya (GoK) encouraged investment by multinational corporations while at the same time actively establishing public enterprises (parastatals) in virtually every productive sector of the economy. Furthermore, in order to deliver the “fruits of independence” to the indigenous population, GoK proactively implemented policies for: on one prong, agrarian reform which entailed facilitating rapid expansion of peasants’ entry into cash crops (mainly coffee, tea, pyrethrum, sugar and cotton) farming; and redistributing large tracks of farmlands that were owned exclusively by colonial settlers (‘white highlands’) to both landless peasants and the emerging “African” elite (most of them public servants). On the other prong, Government pushed for the transfer to black race (African) Kenyans of retail businesses because “‘Africanisation’ was one of the most emotive political slogans in the tumult before [Kenya’s] independence” (Ochieng, 1992). Moreover, by the end of the decade, GoK was so impatient to realise a sizeable “African” elite that, on the basis of recommendations by a 1971 Commission (headed by a former Head of Public Service and then Central bank Governor, Duncan Ndegwa), it lifted restrictions on public servants’ involvement in private business (Mohiddin, 1981).

Those political economy policies worked quite impressively for much of the first two decades after independence. In a period of considerable socio-political and economic turmoil in most African countries, Kenya enjoyed peace, and rapid economic development, so that, for example, real Gross Domestic Product (GDP) grew “at an annual average rate of 7%, and substantial improvements in living standards were achieved” (IMF, 1995). While some fiscal imbalances, arising from excessively expanded public expenditures were evident by mid-1970s, a coffee exports boom in the period from 1976 to 78 sustained aggregate economic performance.

Nonetheless, a series of adverse political and economic events in the second half of the 1970s and first half of the 1980s, served to disrupt both political and economic trends. First, the break-up of the EAC as a regional economic block in 1977 was a big blow for Kenya's economy. At that point, Uganda and Tanzania were absorbing about 30% of total exports, and the collapse of the economic block brought down these exports to just 10%. Second, the death of the first president, Jomo Kenyatta, in August 1978 shook investor confidence for a season or two. The adverse economic impact of these two developments was exacerbated by the 1979 global oil crisis. By 1980 the real GDP growth registered only 2.4%. Yet a third adverse event, an attempted military coup in 1982 further suppressed investor confidence. Though the economy regained some growth in 1983 to reach a real GDP growth of 3.6% a severe drought in 1984 resulted in a growth rate of less than 1%, thus exacerbating the economic problems further.

By mid-1980s, the imperative for major shifts in macro-economic and fiscal policies were acknowledged by the GoK even as its major external development partners, led by the IMF, pushed for a Structural Adjustment Programme (SAP). Government promulgated wide-ranging reforms by way of "Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth". However, economic recovery never restored performance to the level of the 1960s and 1970s. Real GDP growth was an annual average of 5% between 1986 and 1990, and there was a marked deterioration in social indicators of welfare (IMF, 1995).

The government's initiatives in macro-economic and fiscal reforms of late 1980s and 1990s were not successful. In the 1991-1993 period, the economy slid further downwards, from a real GDP growth of 2.1% to 0.2%, and from there it was generally downwards all the way until a new government was elected in 2002. The average economic growth rate between 1992 and 2001 was -0.3% (IMF, 2002). Kenya's economic performance not only slipped behind neighbouring Tanzania and Uganda but it is also performed worse "than most other developing countries" (IMF, 2009a).

Measures taken to enhance macro-economic and fiscal policies did not bear fruit. These measures included: abolishing import controls (in 1993); repeal of the Exchange Control Act (in 1995); and tighter controls over public expenditure by instituting budget ceilings and cash controls (in 1994/95 and 1997/98 respectively). Several factors combined to undermine the reform measures. One, the nation suffered exogenous supply shocks such as droughts and floods. Two, discordance and intercommunity violence, following the reintroduction of multi-party elections in 1992, and again in 1997, undermined investor confidence. Three, the government's "failure to implement [governance] reforms...led to the interruption of several" IMF

programmes (IMF, 2009c). Moreover, it is in this period that grand corruption reached endemic levels. “Most upsetting to donors was the Goldenberg International scandal” (Klopp, 2001), which resulted in loss of considerable external support.

1.2 Recent economic trends (post -2002)

Economic recovery was the top priority of the National Rainbow Coalition (NARC) government that was elected into power in December 2002. The Economic Recovery Strategy for Wealth and Employment Creation (ERS), which was implemented from 2003 to 2007, targeted: maintaining a stable macroeconomic framework; reforming the financial sector and strengthening its regulation to increase savings and investment; implementing mechanisms for private sector participation in the provision of infrastructure services; and establishing a competitive environment able to attract increased private investment in productive sectors such as tourism, trade and industry. As a measure of the success of the strategy and its implementation, in 2007, for the first time since 1970s, the annual rate of real GDP growth reached 7%.

However, the post 2007 election violence, which was accompanied by fuel and food shortages, and the onset of the global financial crisis in 2008, resulted in a slump in real GDP in 2008, to 1¾% (IMF, 2010). There are good indicators of strong recovery since then. Real GDP growth rate was 2.6% in 2009, and it is projected at 5% in 2010.

1.3 Development financing mix and challenges

Figure 1.1 shows trends in the overall development financing mix for Kenya between 1996 and 2008. Gross private savings (averaging at 13.6% of GDP between 2002 and 2008) were fairly low remaining below the Africa benchmark for the post-Monterrey period of 22.1%. Still, between 2002 and 2008, gross private savings grew at an average rate of 8.9% p.a.

Foreign direct investment (FDI) in the period from 1996 to 2008 was also low, averaging at 0.5% of GDP. According to UNCTAD (2005):

“Deteriorating infrastructure and a poor track record of policies in the 1980s and 1990s discouraged inflows of FDI...FDI inflows have nevertheless had a crucial impact on the development of the country’s export oriented horticulture industry, contributed to the revival of Kenya Airways and accelerated the development of the mobile telecommunications network”.

On average from 1996 to 2008, domestic revenue (21%) and exports (24.1% %) constituted the largest share of financing as a percentage of GDP. In 2002-2008 period domestic revenue and exports grew at annual average rates of 17.4% and 15.6% respectively. Exports have over the decade benefited from easier access to the member states of the EAC and COMESA (see **Annex D**). Remittances from the diaspora have been another major source of financing. It is estimated that in 2008 alone the 1.8 million or so Kenyans living and working abroad remitted a total of about US\$1,692 million (constituting about 5% of GDP).

Figure 1.1: Trends in Kenya’s overall development financing mix (1996 to 2008)



Source: Africa Economic Outlook (AEO) 2010 data

From the early 1990s to 2008/09, Kenya’s public expenditure ranged between 23% and 36% of GDP. These expenditures were financed primarily from domestic revenues, and both local and foreign debt. Over the past twenty years, Kenya’s reliance on international development assistance by way of grants has been minimal. Grants as a percentage of GDP provided to GoK to fund its fiscal operations between 1989/90 and 2007/08, ranged from a low of 0.6% to a high of 2.9%.

Public finance deficits have been funded largely through considerable borrowing. By 2006, Kenya’s domestic and external debts were estimated to be 17.9% and 21.9% of GDP respectively. It is also noteworthy that from 2001, GoK has “pursued a deliberate policy action to restructure domestic debt, with a view to developing a vibrant bond market for generating long term finance” (Ndung’u, 2009). Although in

certain years Kenya had to reschedule its debt servicing, a joint World Bank and IMF assessment recently concluded that government's "debt sustainability does not appear to be an immediate concern provided it maintains a prudent approach to borrowing" (IMF, 2009b). This position is also upheld by the AfDB.

1.4 Political economy dynamics underpinning DRM

The synopsis of the political economy legacies that have impacted DRM, as presented in the sections below, is based on Brautigam's (2008) analytical framework¹, which consists of the following five facets: (1) level of economic development and economic structure; (2) societal factors: culture, values, trust and 'tax morale'; (3) war and taxes: bureaucratic modernisation as a response to threat; (4) political institutions and tax systems; and (5) taxation and the fiscal contract.

1.4.1 A comparatively large modern and diversified economic structure

Compared to other EAC countries, Kenya has a large modern and diversified economy. The composition of GDP in 2009 was: agriculture (21.4%); industry (16.3%); and services (62.3%)². The modernisation of the economy is on track as exemplified by the significant decline in agriculture's share of GDP, which stood at 31% in 1984 (IMF, 1995).

The country has by regional standards a well established middle class. "A Kenyan economist, estimates that... about four million are in the middle class, making between \$2,500 and \$40,000 a year" (Gettleman, 2008). Moreover, Kenya has a vibrant private sector with many formalised enterprises. However, "strong economic growth [has] done little to reduce the country's widespread poverty because distribution [is] skewed in favour of the already affluent. Between 1998 and 2002, the poorest 20% of the population received only 6% of the national income, while the richest 20% took 49%" (Sundet and Moen, 2009). This high income disparity explains the comparatively narrow tax base and possibly the difficulties in cultivating and sustaining compliance among the low income groups, including the informal sector (Moyi and Ronge, 2006). Thus, the tax base remains narrow – "830 taxpayers contribute about 75% of all domestic tax revenue" (USAID, 2009). Also, with a population of close to 40 million people, the total number of registered taxpayers at the end of 2007 was about 860,000.

¹ Brautigam's framework is adopted because compared to others that were examined; it is judged to be more comprehensive and elegant. However, like most others, its historical perspective derives too much from the emergence of the modern European state to be linearly applied to states that are legacies of colonial rule, such as Kenya.

² <https://www.cia.gov/library/publications/the-world-factbook/geos/ke.html> [Accessed 7 April 2010].

1.4.2 Building enabling social culture, values, trust and ‘tax morale’ has been elusive³

The first President of Kenya, Jomo Kenyatta, sought to cultivate a social culture of self-reliance and responsibility for development among its citizens by popularising the national motto ‘Harambee’ (‘let us pull together’)⁴. On 1 June 1963, when Kenya gained self-rule, “he gave the term currency and declared” – ‘I give you the call: Harambee!’ (Orora and Spiegel, 1981). Thereafter, a key message to Kenyans in his independence speech was:

"You and I must work together to develop our country, to get education for our children, to have doctors, to build roads, to improve or provide all day-to-day essentials"⁵.

The “Harambee” culture was to a degree a success in significant sections of Kenyan society. By 1976, Harambee projects “accounted for forty percent of capital development in rural areas and voluntary cash contributions” (Orora and Spiegel, 1981). However, Harambee initiatives fell victim of elite capture in the 1980s and 1990s, and the movements “social value... was relegated to the side” (Transparency International, 2003). Also, the culture of corruption that became pervasive in Kenya in the 1980s and 1990s chipped into whatever there was of tax morale. Moreover, the “weakening of state institutions, which were increasingly seen as serving the country’s elite rather than the people” is thought to have reduced the legitimacy of the state (Sundet and Moen, 2009). In this situation, citizens’ trust in the government was undermined and any tax morale was eroded. There was, however, a temporary respite to this trend following the election of NARC in 2002. “Kenyans’ sense of patriotism was at its peak, fuelled by the euphoria of a new regime” (Ondari, 2009). It is suggested that as a result, “a total of 33,923 taxpayers and 33,141 taxpayers were recruited in 2003/04 and 2004/05, respectively” (Moyi and Ronge, 2006). However, the subsequent much publicised grand corruption scandals of the new regime served to reverse the trend.

1.4.3 The goal of regime survival has ensured support for the tax administration bureaucracy and its modernisation

In Brautigam’s (2008) framework, historically, the threat of (conventional) war has been the common driver of bureaucratic modernisation for tax revenue mobilisation.

³ In a society where “tax morale” is high, there are low levels of tax evasion and avoidance. It is only in a social culture where citizens generally appreciate their responsibility for sustaining state services and where they have a trust in their state institutions and leaders that a “tax morale” evolves.

⁴ <http://boleswa97.tripod.com/chieni.htm> [Accessed 7 April 2010].

⁵ <http://africanhistory.about.com/od/people/a/qts-Kenyatta01.htm> [Accessed 7 April 2010].

Two complementary theoretical perspectives are proffered: firstly, a national political leadership can place a country on a non-conventional “war footing” to the same effect. Thus for example, when Kenya’s founding fathers proclaimed war against poverty, disease and ignorance on attainment of independence, the imperative to extensively mobilise domestic resources was clear. Consequently, for nearly two decades, the political leadership did not disturb the autonomy of bureaucracy that was inherited from the colonial East African Common Services Organisation and turned over to the EAC revenue administration. Secondly, in a competitive pluralistic environment, the threat of regime survival will persuade national political leadership to support bureaucratic modernisation. In this way, we may explain why Moi’s regime delayed the establishment of KRA until 1995 (three years following multiparty democracy) although it was proposed as early as 1986, when government launched the Tax Modernisation Programme (TMP).

1.4.4 Patronage politics destabilised the tax system in the 1980s and 1990s

The patronage, and ultimately corruption, that became marked features of Kenya’s political institutions in the 1980s inevitably infected the tax system in the form of undue exemptions and corruption-based tax evasion. In the late 1980s and early 1990s, for example, the ruling elite conspired to rake billions of shillings of public resources through tax exemptions as well as through a scheme, famously known as the Goldenberg scandal, by which pre-export financing and export compensation were paid for fake exports. Consequently, as fiscal deficits became a problem, the need for measures to tighten tax administration was acknowledged. Also, the establishment of KRA in 1995 was to a significant extent expected to insulate the tax system from the rampant corruption that then pervaded the public administration system. However, competition among political constituencies for control of the tax system as an instrument for patronage continued. Consequently, for example, in the first decade after its launch, KRA experienced frequent changes to its leadership. The first two Commissioner Generals did not complete their three year terms.

This problem was not confined to KRA but rather in all institutions dealing with significant public resources. Thus, for example, between 1988 and 2002, a total of eleven permanent secretaries had been appointed to the Treasury, with two of them serving for less than two months each. During the same period, the Ministry of Finance had six ministers. It is under such circumstances that one of the conditionalities for the resumption of financing placed on Kenya by the IMF, was for KRA to be allowed to operate independently (Klopp, 2001). The relative success of KRA in rapid and successful implementation of reforms of the tax system since 2003/04 could not have been feasible if the politics of patronage and corruption were still rampant. In this regard, furthermore, it is noteworthy that KRA enjoyed

relative leadership stability and autonomy in this period. The current Commissioner General, Michael G. Waweru, is in his third term of three years, and it has been observed that, unlike his predecessors, the incumbent:

“No longer waits for ...[a] phone call [through the direct line to State House] to know what the President expects of him and the Authority...[rather] the Head of State...facilitates his work by urging Kenyans to honour their dues” (Ondari, 2009).

1.4.5 Political leaders have failed to sustain a fiscal contract with the citizens⁶

It can be credibly argued that in the first decade following independence, a fiscal contract was evolving in Kenya. However, corruption, socio-economic decline, and the overall deterioration in public services and institutions in the intervening three decades, until the NARC regime of 2003, shredded that initial contract. There was an implicit fiscal contract with the new regime in 2002. However, it is doubtful what, if anything, remains of this contract.

In addition to the above, “most Kenyans seem to have lost trust in government institutions as impartial public service providers” (Miruka, 2010). Moreover, this trust is further undermined by public views that GoK is not committed to the fight against graft as “corruption cases are dragging in court with those charged continuing to hold public offices” (Kanyongo, 2010). Therefore the fiscal contract which appears to have been built in 2002 seems to have lapsed.

1.5 Fiscal governance drivers, results and trajectory

There are four key fiscal governance drivers. First, an expensive bureaucracy as reflected in Kenya’s wage bill to GDP ratio compared to other countries in the region needs to be sustained. In 2007/08 the wage bill to GDP ratio was estimated to be 7.4% (IMF, 2010), which was remained the highest among the EAC countries. While the reformist NARC government was expected by many economists to downsize the public service, it did not, as such a measure would have negated GoK’s policy objective of rapid employment creation. In fact, public sector employment has continued to grow, even, in recent years. More significantly, the sustenance of this bureaucracy may explain why even in the years of economic

⁶ Fiscal contract has its genesis in agreements between European monarchies and the propertied class and merchants that the latter would contribute to state coffers especially to fund war in return for specific benefits. In modern times a fiscal contract would be characterised by government pledges of specific socio-economic benefits to justify taxation. This is a more realistic proposition in a democratic dispensation.

decline, the tax to GDP ratio remained at relatively high levels. There is no evidence of a reversal of this trend in the near future.

Second, ambitious goals for expanded services delivery and poverty reduction are best epitomised by the unplanned launch of an expensive free primary education programme in 2003. There is a significant constituency of the nation's political class that seeks to achieve a welfare state. Such ambitions are reflected in the Bill of Rights in Kenya's proposed new Constitution.

Third, elite capture of fiscal governance is depicted by two initiatives by Members of Parliament (MPs) in recent years. Specifically: the introduction of the Constituency Development Fund (CDF) which is under the control of individual MPs ostensibly as an element of fiscal decentralisation; and the arbitrarily high self-pay awards by MPs, makes them among the best paid in the World. Inescapably, other elite constituencies continue to fight for their 'share of the cake'.

Fourth, the national elite shares ambitious goals for the country. These ambitions are aptly captured in Kenya's Vision 2030 – Working together on the Path to Prosperity. While there are sections of the community who are sceptical of the vision and goals, there is evidence that a large and strong constituency is committed to the same. The on-going high cost infrastructure initiatives express that commitment. In 2008, "President Kibaki told...[a] meeting that [GoK] will spend more than...US\$5 billion to finance infrastructure development projects in the country over the next five years" (Kapchanga, 2008). This explains the decision to float a series of infrastructure bonds. Kenya successfully floated two bonds in 2009. For the first bond issue of KShs 18.5 billion, GoK received offers worth KShs 27 billion (Irungu, 2010) . In the second bond issue, GoK "accepted 18.42 billion shillings worth of bids for the 12-year securities with a coupon of 12%, and will use proceeds to fund road, energy and water projects" (McGregor, 2009). In February 2010, the Central Bank of Kenya issued a third infrastructure bond offer worth KShs. 14.5 billion with an eight year maturity date.

The role and influence of international development organisations in terms of fiscal governance is minimal. In the 1990s, international development organisations largely disengaged from supporting GoK except for a brief two-year interlude, when the World Bank and IMF entered into an agreement for a technocrat team, popularly known as the 'dream team', to take charge of Kenya's governance. In that interval, Kenya secured a structural adjustment credit from the IMF and World Bank. But these credits lapsed before full maturity. Neither did the much anticipated engagement between the 2003 NARC government and international organisations materialise, for four reasons. First, the outbreak of the Anglo-leasing scandal stifled

dialogue. Second, a significant constituency in the echelons of government continue to harbour a distrust of the intentions of Western governments and 'their institutions'. Third, the exemplary performance of KRA in revenue collection has strengthened the voice of this latter constituency. Fourth, Kenya's access to international credit, especially from the rapidly growing Asian countries (India and China), provide an alternative source of development financing to grants from the countries of the West.

Kenya's fiscal governance trajectory is basically predicated on three variables. First, can the tempo of DRM growth experienced in recent years be sustained? Second, will fiscal discipline prevail in spite of intense pressures from different directions to stretch the fiscal space? Third, what are the prospects for GoK to mobilise more external resources to bridge the gap between DRM and ambitious public expenditure plans? There are strong indications that the answers to all three questions are positive.

The resilience of DRM in Kenya over the years is well illustrated by comparatively good performance even when poor governance and weak economic performance prevailed. With regard to fiscal discipline, since the macro-economic crisis of the early 1990s, political leaders have eschewed fiscal excesses. The imminent new Constitution will reinforce aggregate fiscal discipline. Already, the relative robustness of Kenya's economy, and sophistication of its capital market is enabling GoK to mobilise substantial debt financing to augment domestic resources. Furthermore, the performance outturns in recent times make it evident that revenue collection in Kenya is resilient (IMF, 2010). In a nutshell, barring any unforeseen adverse political or socio-economic developments, Kenya's fiscal governance trajectory is fairly solid.

2 Trends in the tax system

2.1 Changes in tax policies over the years

Kenya relied on unified tax policies and an administrative system jointly administered by the initial three members of the EAC. This was a legacy of British colonial administration that all the three countries inherited at independence. At that point, the government's three main sources of tax revenue were: income tax; customs and excise duties; and inland revenue. Changes in both policies and administration were collaboratively determined and minimal until early 1970s. Following a decision to assign responsibility for income tax to each EAC member state, Kenya adopted the community legislation and enacted the Income Tax Act of 1973. Thereafter, three distinct phases of major initiatives in tax policy reforms can be discerned for Kenya, and they are outlined below.

2.1.1 Initial efforts at widening the tax base

Following independence, the first major change to the tax system, was the introduction of a consumption tax - the sales tax in 1973. The impetus for this change derived from adverse effects on customs duty revenue receipts brought about by restrictions on imports associated with an import substitution industrialisation policy. Another measure to widen the tax base was the introduction of capital gains tax (CGT) in 1975 to cash in on high property prices arising from a coffee boom. But, in 1984, in an effort to jumpstart economic growth through the construction industry, GoK suspended the CGT and formed a commission to examine economic management, and extend advice on possible changes.

2.1.2 Tax policies introduced under the TMP (1986 to 2002)

The policy thrust under the TMP (1986 to 1996) was to: raise and maintain revenue as ratio of GDP at 24% by 1999/2000; expand the tax base; rationalise the tax structure to make it more equitable; reduce and rationalise tax rates and tariffs; reduce trade taxes and increase them on consumption to support investment; and seal leakage loopholes (Moyi and Ronge, 2006). With respect to income taxes, government reduced the top marginal rates for: personal income tax (PIT) from 65% in 1986/87 to 45% in 1993 to 35% in 1995/96 – by 1999/00 the top rate was 30%; and corporate income tax from 45% in 1987/88 to 30% in 1999/00.

Government launched the VAT in 1990 to increase “revenue through the expansion of the tax base, which hitherto was confined to sale of goods at manufacturing and

importation level under the sales tax system”⁷. Following its introduction, GoK undertook several measures to expand VAT’s coverage, gradually moving the tax point:

“From the manufacturer to the retail level, and as a result, the coverage of VAT on goods supplied at retail level expanded ‘tremendously’ from 1990 to 1995. From 1991 onwards, the coverage of the services sector was expanded to include: business services; hotel and restaurant services; entertainment; conferences; advertising; telecommunications; construction and transportation. The imposition of VAT [was] also simplified and improved with 15 bands being reduced to three, and the introduction of penalties for avoiders, those who did not maintain proper books of account and defaulters” (Cheeseman and Griffiths, 2005). Today VAT is levied at a standard rate of 16%.

When first introduced, VAT was levied at a standard rate of 17% which then rose to 18% before eventually declining to 15%, and then stabilising at 16%, and a 0% rate for the exempted items. However, there were also low and high rates for electricity and luxury goods respectively. Moreover, schedule 8 of the act provides for certain public bodies, privileged persons and institutions to be zero rated for VAT (e.g. the President of the Republic, the armed forces, diplomats, aid agencies, charitable organisations etc.).

“Prior to the TMP, excise taxes were specific. However, [from] 1991/92, excise taxes were made ad valorem. Since 1991, the scope of excise duties was expanded from domestic production to include imports, thus changing its scope from being a tax on domestic production to a tax on consumption” (Moyi and Ronge, 2006). Luxury goods also became subject to excise duties.

GoK also reduced tariffs to encourage local industries to be more efficient and competitive both in domestic and export markets and, to ensure consistency with international trade obligations such as compliance with World Trade Organisation (WTO) commitments. In particular, the: rate of import duty was reduced from 170% to 35%; rate bands reduced from 24 to 5; and simple tariff average dropped from 40% to 16% (Cheeseman and Griffiths, 2005). Furthermore, with respect to import duties, government:

- From 1991, legislated for the elimination of a wide range of import duty exemptions;

⁷ <http://www.kra.go.ke/vat/aboutvat.html> [Accessed 10 April 2010].

- From 1992, removed discretionary duty waivers, only leaving those relating to programme-based donor funding;
- From 1995, abolished NGO exemptions, which played a key role, especially in election years. Thereafter, an NGO could only get exempt when donor funded.

To promote investment, GoK introduced export processing zones (EPZs) in 1990⁸. Firms operating in EPZs benefit from a ten year corporate tax holiday, exemptions on imports of inputs and capital equipment and a waiver on stamp duty on legal instruments. In return a firm must export 80% of its produce (IMF, 2008).

Meanwhile, with a view to improving future revenue streams, first in 1995, GoK extended an amnesty which covered income taxes, PAYE and penalties and interest. A second amnesty of 1998 covered: penalties and interest in respect of VAT; and tax, penalties and interest relating to income tax.

2.1.3 Tax policies introduced during the third phase: 2003/04 to 2008/09

Key changes to tax policy made by the NARC government (2003-2008), and coalition government (2008-2009) have so far evolved around: ensuring equity; further widening the tax base; promoting increased investment; and reducing the tax compliance burden. To promote equity:

- GoK widened income tax bands by 5% in 2004/05. Tax bands had remained unchanged since 2002. In the same year, GoK also increased personal relief by 10%;
- From 16 June 2006, GoK increased the threshold turnover for VAT from KShs 3 million p.a. to KShs 5 million p.a. with a view to reducing the compliance burden for three quarters of registered taxpayers who: either file nil returns, or whose turnover is not substantial. GoK also zero rated certain supplies (e.g. wheat flour, nappies, agricultural tractors, treatment and supply of water by local authorities, computer equipment and parts etc.).

In addition, as a means of widening the tax base, GoK introduced the following measures:

- An amnesty in 2004/05, covering fines, penalties and interest on: import duty (prior to 11 June 2004); excise duty on goods manufactured and sold (before

⁸ See: <http://www.epzakenya.com/>

11 June 2004); VAT (where tax was due before 11 June 2004); and income taxes (for 2003 and prior years). Taxpayers were required to disclose and pay under-paid duties and taxes by 31 December 2004;

- From 2004/05, employees of not for profit organisations became liable to pay tax on any retirement contributions made by their employers to schemes where contributions exceed the allowable limits;
- Transfer pricing guidelines with effect from 1 July 2006, which specify a wide range of transactions which may be subject to adjustment including: the sale, purchase and leasing of goods; other tangible and intangible assets; the provision of services; and interest on loans. Taxpayers who engage in cross border trade with related parties are required to document their policies and methodologies, and make them available to KRA;
- In 2006/07 in a further attempt to reach the informal sector income earners, GoK introduced an advanced tax payable for drivers and conductors of passenger service and commercial vehicles;
- A new turnover tax for small businesses with effect from 1 January 2008, intended to make it easier for them to comply with their tax obligations. The turnover tax is applicable for businesses with an annual turnover of below KShs 5 million⁹. The rate of tax is 3% of gross receipts. In 2008/09, the VAT Act was amended to exempt taxpayers who are subject to the turnover tax;
- From 1 January 2008, GoK introduced VAT on rent charged on non-residential property. When it was initially introduced in the year 2001, it drew resistance from taxpayers and thus was not passed by Parliament
- From 13 June 2008, dividends earned by financial institutions became taxable¹⁰. With this change, the withholding tax suffered by financial institutions is treated as an advance tax to be offset against its tax liability.

Some key policy measures aimed at fostering increased investment included the following:

⁹ However, from 2008/09 persons who would have been subject to the turnover tax regime were allowed to apply to KRA to be exempted.

¹⁰ Excludes dividends earned by financial institutions which hold more than 12.5% of the voting power.

- The introduction of tax incentives in 2005/06 to encourage firms to be listed on the NSE. Specifically, corporate tax for newly listed firms was reduced from 25% to 20%, on condition that they offer at least 40% of their issued share capital to the Kenyan public;
- The adjustment to tax incentives in 2006/07 to encourage private sector participation. Incentives include, for example: industrial building allowances for hostels and buildings used for educational purposes at an enhanced rate of 10%; and an income tax exemption on interest;
- “In the 2008/9 budget, the government removed the 15% withholding tax for investment in government bonds” (Irungu, 2010).

Meanwhile, following the introduction of common external tariffs (CETs) under the East African Community Customs Management Act of 2004, GoK no longer has scope to independently amend customs duties. In contrast, government has considerable room to change excise duty rates. The protocol also brought about the following changes:

- The elimination/phased elimination of customs duty originating from partner states;
- The harmonisation of customs principles and procedures;
- The removal of suspended duty (see **Annex D** for more details).

2.2 Institutional changes

The 1995 KRA Act (Chapter 469 of the Laws of Kenya) overhauled the legislative framework that had essentially remained intact since independence, and under which the revenue departments of Customs and Excise, Income Tax, and Inland Revenue, had continued to operate as distinct entities. Still, it was necessary to amend the KRA Act in 1997 in order to clarify to the Commissioners in charge of revenue departments that they were directly under the authority of the Commissioner General as the top executive a unitary organisation. It is clear the Commissioner General enjoys considerable executive authority. At the same time, the Commissioners of the respective revenue departments retain legal authority for the operational decisions.

The 1997 amendment to the KRA Act also served to spell out the non-executive but oversight role and functions of the KRA Board of Directors. However, like other parastatal organisations in Kenya, since 2006, the Commissioner General and other

members of Board of Directors are joint signatories to a performance contract with the Ministry of Finance. More significantly, this performance contract is taken seriously by the members KRA Board.

2.3 Changes in administrative systems

The rationale for forming KRA is articulated under TMP to evolve around: improving tax administration and “implementing organisational reforms that would modernise tax administration” (Cheeseman and Griffiths, 2005). GoK’s expectations were that the new authority would institute efficient and effective systems “to seal the widespread loopholes in the tax system, bring down the vice of tax evasion, and enlist as many eligible taxpayers into the tax net as possible” (Muriithi and Moyi, 2003). To this end, “in the years since its inception, the KRA, through a series of corporate strategic plans, has laid out and followed a focused course for reform and modernization”¹¹. It is significant that KRA uses the state-of-art balanced scorecard (BSC) “as a performance measurement strategy [measuring] *financial* (to surpass revenue targets), *internal processes* (increasing efficiency), *stakeholder* (high quality service) and *people* (develop a highly motivated and professional work force)” targets (Cheeseman and Griffiths, 2005). In addition, KRA prepares and disseminates quarterly progress and annual reports.

However, the focus of KRA administrative reforms in the first ten years of its existence was centred on achieving rationalisation and stabilisation of its organisational structure and general administrative systems, and coping with changes in tax policies. In this period also, KRA moved all its headquarters and Nairobi operations (other than border-related ones) to its new 30-storey headquarters, which was “donated” by the Central Bank. In addition, there was also full computerisation of basic management support services (payroll, financial management, etc), and initial attempts at computerising the tax administration.

Today, KRA employs about 4,300 staff. Out of its total establishment, 56% of KRA staff are directly involved in revenue administration (KRA, 2009), which is low. The number of staff directly involved in revenue administration in OECD countries, for example, range from 85% to 90% (OECD, 2009). KRA has invested heavily in building the capacity of its staff. It operates the Kenya Revenue Authority Training Institute (KRATI) in Mombasa, which in partnership with institutions such as the Centre for Customs and Excise Studies at the University of Canberra, delivers specialised training to the authority’s staff. KRATI is also the World Customs Organisation’s (WCO’s) Regional Training and Capacity Building Coordinator for 21

¹¹ www.bizclir.com/galleries/.../01.128.08BP12_Kenya.pdf [Accessed 11 April 2010].

countries in East and Southern Africa¹² – it “serves as a focal point for developing and implementing programmes to enhance the capability of customs”¹³. KRA also sponsors its staff to attend international training courses.

Under the Revenue Administration Reform and Modernisation Programme (RARMP), whose goal is to transform “KRA into a modern, fully integrated and client-focused organization”, and which was launched in FY 2004/05, the authority has in effect launched an ICT-driven strategy for the modernisation of the tax administration¹⁴. The salient features of this strategy are presented in some detail at **Annex E**. However, three of them deserve to be highlighted:

- First, the **Integrated Tax Management System (ITMS)** for domestic revenue. As part of the ITMS, “E-registration is fully operational and cumulatively, 60,310 new taxpayers had registered online by the end of May 2009” (KRA, 2009);
- Second, the **electronic tax registers (ETRs) for use by VAT registered taxpayers**, which KRA introduced from 1 January 2005;
- Third, the **Simba 2005 system (S2005S) for customs operations**. The S2005S “has enabled the automation of about 90 per cent of customs operations”¹⁵. S2005S is able to obtain third party information from the Kenya Ports Authority systems and it is interfaced with the electronic cargo tracking system, and the Revenue Authority Digital Data Exchange (RADDEX) that is collaboratively operated by the EAC countries.

It is noteworthy that there was serious resistance from freight forwarders and customs clearing agents to the implementation of the both ETRs and the S2005s. In the case of the ETRs, business mobilised considerable support against the new system from even MPs. In the case of the S2005S, “the Kenya International Freight and Warehousing Association initiated a court action because members felt that [modernisation] imposed unfair and costly requirements”¹⁶. However, with the support of the government, and use of experienced legal counsels, KRAs position prevailed and the systems have been implemented.

¹² www.customscentre.canberra.edu.au/.../libs/.../MOU_signing_in_Canberra.pdf [Accessed 11 April 2010].

¹³ www.revenue.go.ke/.../CG%20SPEECH%20-%20KIM%20DINNER.pdf [Accessed 11 April 2010].

¹⁴ <http://www.kra.go.ke/rarmp/rarmp.html> [Accessed 11 April 2010].

¹⁵ International Tax Dialogue Survey – 2009.

¹⁶ www.bizclir.com/galleries/.../01.128.08BP12_Kenya.pdf [Accessed 11 April 2010]

The successful implementation of the above initiatives, which is well on track, will take the KRA well on the way to its vision. In this regard, the consolidation of these gains is integral to KRA's fourth corporate plan covering the three years from 2009/10 to 2011/12. The corporate plan specifies six goals and a number of strategic objectives under them. The corporate plan details a framework for monitoring and evaluating implementation progress.

2.4 Fiscal decentralisation and taxation by local governments

Delivery of virtually all basic social public services in Kenya (including primary education, health and agricultural extension) have never been decentralised since they reverted to central government in the early 1970s. To finance the limited services under their jurisdiction, local authorities in Kenya are heavily reliant on own locally collected revenues but the Ministry of Local Government must approve most changes to local fees, taxes and other charges. Between 2003/04 and 2007/08, local government revenue as a proportion of tax and non-tax revenue collected by central government was comparatively low, at an average of 3.2% p.a. (see **Table C14 in Annex C**). The two main local own revenue sources in Kenya are property rates and the Single Business Permit (SBP) (Kelly 2000; Grava 2009; Hugounenq, Rocaboy and Vaillancourt 2010). The local governments also receive from the central government a significant block grant (local authority transfer fund) and limited earmarked funds for maintenance of rural and urban roads.

Arguably the most progressive feature of Kenya's local government system is the SBP, which was introduced in 1999 to replace a number of local licenses and revenues-raising permits on local businesses. Under the SBP local authorities are provided a range of pre-approved tariff schedules. The SBP serves the dual purpose of a regulatory instrument as well as a local tax on business activity (with the permit serving as an effective tax handle). Although the SBP has proven to be a sound revenue instrument with substantial revenue-raising power, there is considerable objection to using the issuance of a local business permit as a tax handle for local revenue raising purposes, resulting in on-going pressure to eliminate the SBP.

2.5 Reform sequencing, implementation and results

2.5.1 Overview

There is no history of long term planning for tax reforms before the TMP, which was launched in 1986. However, as discussed at **Sub-section 2.1.2** above, significant tax policy and administrative changes can be identified in the one and half decades preceding the TMP. Nevertheless, these changes were essentially reactive, and cannot qualify as reforms. In this perspective, there are two epochs in the reform of

tax policies and administration in Kenya, which generally correspond to the TMP and Revenue Administration Reform and Modernisation Programme (RARMP) periods (see **Sub-sections 2.1.2** and **2.1.3** above). Yet, reforms under the RARMP epoch were not specifically anticipated in the TMP. In other words, there was no specific initiative to sequence between the two programmes. Furthermore, there are aspects of tax policy initiatives that transverse the two programmes, and elements of which are also to be found in the pre-TMP policy changes. Considering the latter observations, what follows below is, firstly, a highlight of firstly, tax policies amenable to regular monitoring, evaluation and possible change; and secondly, a discussion of sequencing of reforms and results of implementation through the TMP and the RARMP.

2.5.2 Sequencing does not arise for tax policies

Through the three distinct phases of tax policy changes as discussed in **Section 2.1** above, it is clear that certain policy initiatives were not particular to any reform epoch. Rather they were subject to periodic changes. Such tax policies cannot therefore be located as one-off changes in a long-term strategic trajectory. Rather, they need to be monitored, evaluated and changes effected, where appropriate, on a regular basis. In this regard, the issue of sequencing does not arise, with respect to: (i) widening the tax base; and (ii) aligning the tax policies with the national development strategies and policies.

2.5.3 Sequencing and implementation of reforms under the TMP

The initial reforms under TMP (1986 to early 1990s) focussed on tax policy. On one hand, the policy reforms and strategies were driven by two main factors the need to: (i) comply with Kenya's obligations to rationalise tariffs under the WTO agreement; and (ii) introduce tax incentives to promote exports and attract foreign direct investment. These measures were to give rise to revenue losses, while the government still aimed to raise tax collections as a percentage of GDP. Therefore, the policy reforms were accompanied by the introduction of measures to raise revenue. Specifically, GoK began to levy excise duty on items formally subject to high duties and sales tax, alcoholic beverages, soft drinks, tobacco and tobacco products, luxury cars, petroleum products.

In 1992/93 the scope of reforms was extended and deepened to encompass structural adjustment measures that reduced protection of local industries but also lowered costs of production. The structural adjustment measures also covered policies to promote capital mobilisation, including credit for private sector investments and to improve competitiveness in a liberalised economy. The combination of these structural adjustment measures, policy adjustments under

TMP and the virtual stagnation in economic growth led to a steady decline in the tax to GDP ratio in the 1990s and early 2000s (see **Section 3.1**).

The establishment of KRA and the rationalisation of staffing that followed were the hallmark reforms under the TMP. By 2000, KRA had reduced staff numbers by 30%. It has been independently observed that the new organisational arrangements have “increased the professionalism of the tax agency’s staff and reduced, though not eliminated, the level of corruption” (Taliencio, 2004). KRA also then embarked on building capacity to enforce compliance, through: taxpayer awareness and education, and more targeted audits and detailed examinations. At the same time it introduced self–assessment, under income tax to reduce burden of tax administration and facilitate early payment.

In second half of the period when the TMP was implemented (between 1993/94-2000/01), the tax to GDP ratio was comparatively high (in the range of 20%+) but this must be qualified in three respects (see **Figure 3.1**, next chapter). One, the ratio was on a steady decline. Two, the economy (GDP) was on the decline. Three, by 2001/02, the tax to GDP ratio was at its lowest for the two decades of 1980s and 2000s. Therefore, while TMP introduced extensive policy, institutional and administrative changes, it did not in terms real growth in tax revenues; on the contrary. However, it must be emphasised, it is not necessarily the failure of either the TMP or KRA but rather that of the wider governance systems. These were the days of rampant grand corruption, political tensions and unsteady economic management (see **Chapter 1**).

Nevertheless, empirical analysis by Muriithi and Moyi (2003) suggests that tax reforms in Kenya under the TMP have led to improved productivity of direct taxes and as a result comparatively higher ratios for both Personal Income Tax Productivity (PITPROD) and Corporate Income Tax Productivity (CITPROD). In particular administrative reforms (e.g. lower tax rates, PIN etc.) aimed at eliminating “avenues for evasion and corruption” (see **Section 3.2.1**). At the same time, Muriithi and Moyi (2003) suggest that there was considerable revenue leakage in the administration of VAT.

2.5.4 Sequencing and implementation of reforms under the RARMP

As earlier indicated, the strategic thrust of the RARMP is to exploit ICT to modernise, and thereby enhance efficiency and effectiveness of KRA’s operations. However, streamlining the organisation structure and administrative systems were fast tracked. These included:

- The reorganisation and capacity building of KRA's tax assessment and collection functions to better align them with the three main segments. To this end, for example: (i) KRA amalgamated the various tax departments into the Domestic Tax Department and the LTO; and (ii) it embarked on the "continuous recruitment of management trainees, [and] up-scaling" of facilities at KRATI (KRA, 2009);
- The tax amnesty of 2004 which was to a degree a success. KRA reports that it raked in "KShs 4.41 billion from 4,483 applications in the period to 31st December 2004 when it was in force"¹⁷;
- Educating and guiding taxpayers to settle taxes through banks and not KRA counters. Now, over 90% of taxes are paid through banks, and this arrangement has contributed to reducing "revenue leakages arising from handling of cash and cheques. Tax frauds involving incidents such as the multiple usage of revenue cheques are now a thing of the past"¹⁸;
- The introduction of scanning of imported goods and goods destined for export. This process has significantly improved security of cargo and missed mis-declarations for tax purposes;
- Getting KRA to be ISO 9001 certified, as a means for improving services to taxpayers. To maintain this certification, KRA has instituted regular quality management system audits and reviews (KRA, 2009).

Implementation of the ICT-driven modernisation strategy is a long-term pursuit. Nonetheless, there has been fast tracking of some "quick wins". The initiatives and success already made in the key results areas of ICT applications have been outlined at **Section 2.3** above. In terms of specific outcomes, the following are discernible indicators:

- The e-filing system is working. Returns which are filed online are processed in 30 minutes rather than 2 weeks¹⁹. This is no mean feat given the large and increasing volume of transactions it receives: 10,000 self-assessment, 1,000 VAT and 1,500 PAYE returns per month;

¹⁷ <http://www.kra.go.ke/news/newsamnestysuccess270105.html> [Accessed 11 April 2010].

¹⁸ www.revenue.go.ke/.../CG%20SPEECH%20-%20KIM%20DINNER.pdf [Accessed 11 April 2010].

¹⁹ Ibid.

- “Simba 2005 online system which [is] interfaced with KWATOS...For the first time, KRA, through the Attorney-General's office, has began prosecuting tax evasion cases through the Anti-Corruption and Economic Crimes Act, 2003 which attracts hefty fines and harsh bail terms” (Daily Nation, 2010).

In the implementation of the RARMP, KRA management has also demonstrated that it can be proactive and creative - for example:

“KRA has put in place an elaborate plan to train cyber cafes’ in an endeavour to build their capacity to handle online services. The first training programmes brought together participants from across the country representing over 400 cyber cafes”²⁰;

Moreover, two years following the launch of the RARMP’s implementation, in 2006/07, there was the onset of a sustained reversal of the decade long decline in the tax to GDP ratio (see **Annex C – Table C6 or Figure 3.1**). It is also noteworthy that this was taking place when GDP growth was at its highest since 1970s.

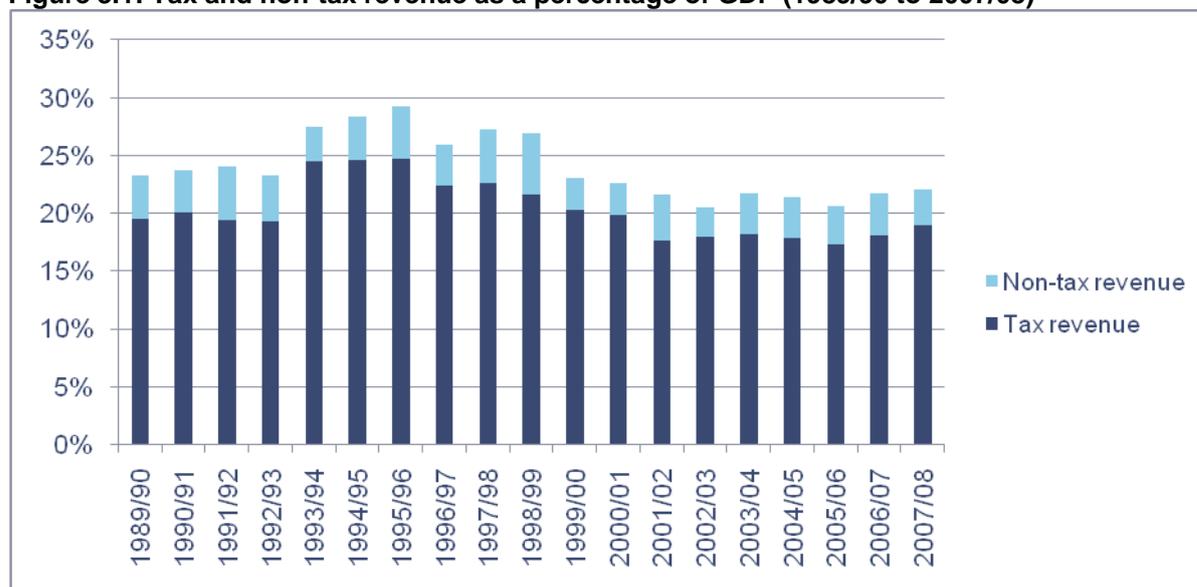
²⁰ http://www.kra.go.ke/notices/cyber_cafes.html [Accessed 6 April 2010].

3 Domestic revenue performance

3.1 Domestic revenue performance trends

Figure 3.1 presents domestic revenue collections for the period from 1989/90 to 2007/08. In 1989/90, Kenya’s domestic revenue collection was 23.3% of GDP. Revenue collection peaked in 1995/96 at 30.4% of GDP as a result of economic liberalisation, and thereafter, declined to 20.5% of GDP in 2002/03, before increasing to 22.0% in 2007/08. However, as earlier observed (see **Sub-section 2.5.4**) for many of these years, the high tax to GDP ratio did not deliver any real increase in tax revenues because this was a period of steady decline and ultimately negative growth of GDP. This stagnation or real decline in revenues may also be partly attributable to a reduction in tax rates and tariffs (see **Sub-section 2.1.2**). In addition, Ndulu et al (2007) indicate that structural weaknesses of the economy were another contributory factor – in particular, the narrow scope to expand the coverage of income taxes due to limited potential to increase the number of Kenya’s workforce in formal employment.

Figure 3.1: Tax and non-tax revenue as a percentage of GDP (1989/90 to 2007/08)



Source: Various IMF staff reports. Also see Table C6 in Annex C

It is, nonetheless, the case that on the whole, Kenya’s “tax system performed better than average for Africa. This is mainly attributable to a stronger tax administration system and a relatively large formal sector” (IMF, 2003). It is also noteworthy that,

relative to other EAC countries, non-tax revenue contributions during the same period were fairly significant – averaging at 3.7% of GDP.

In recent years, the top revenue sources in order of their contribution are: taxes on income and profits; VAT; excise duties; and import duties (see **Table C6 in Annex C**). Except in certain years, taxes on income and profits as a share of total revenue remained fairly constant throughout the eighteen year period to 2007/08, but grew at an average rate of 16.9% in nominal terms. It is worth noting that as the economy went into recession, income tax revenues declined from a high of 9.8% of GDP in 1993/94 to 1997/98, down to 7% in 1998/99, dropping further to around 6% during the period 2000/01 to 2003/04.

In the first two or three years following its introduction, VAT was the largest contributor of tax revenue – with a peak contribution of 39.4% in 1991/92. By 1994/95, revenues from VAT had declined to 22.5% of total tax revenues, but thereafter rose to 30% in 2000/01 before dropping to 25.9% in 2007/08. According to the literature, VAT's share of tax revenue initially increased as a result of the move by GoK to widen its coverage, but thereafter, reached a plateau (Cheeseman and Griffiths, 2005). In addition, the decline in collections can also be explained by VAT waivers given by GoK in years of drought, famine and other natural disasters, and revenue lost from incentives and exemptions offered to firms operating in Kenya's EPZ.

As a result of GoK's policy initiatives to reduce tariffs, there was a significant decline in the proportion of revenue generated from import duties, which fell from 16.8% in 1989/90 to 7.6% in 2007/08. According to literature sources, the benefit of this measure is that Kenya has been able to enhance its "trade openness by moving away from the restrictive import substitution strategy towards export-oriented industrialization" (Moyi and Ronge, 2006). In addition, smuggling and illicit trade at Kenya's borders contributed to revenue leakages.

3.2 Tax administration performance benchmarks

3.2.1 Performance efficiency

As one measure of performance efficiency, KRA's administrative costs for the period from 1998/99 to 2007/08 averaged at 1.5% (see **Table C3 in Annex C**), which is low when compared to figures reported by other EAC countries. However, administrative costs during the period grew at an average annual rate of 14.9% - but still remained within the 2% ceiling of operating costs as a percentage of total revenue collected, specified in law. It is also noteworthy that the number of tax staff available for every 1,000 persons in Kenya is 0.12. This 'tax staff per population

ratio' is very low compared to World and Sub-Saharan African averages which are 0.82 and 0.37 respectively²¹. However, this ratio does not take into account the narrow taxable base. The size of the labour force in 2008 was 1.94 million people (around 5% of the nation's population) (Kenya National Bureau of Statistics, 2009). In other words, there were 452 wage employees per full time revenue authority staff, which is much lower than the corresponding ratios for Korea and South Africa of 1,396 and 1,901 respectively.

As another measure, it is not impressive that the World Bank's 2010 Doing Business survey ranks Kenya 164th out of 183 countries in terms of ease of paying taxes (see **Annex C: Table C10**). On this benchmark, Kenya has the lowest score of all the five EAC member states. One contributory factor to this ranking is the number of payments that a company is required to make in a given year – in 2010, cumulative payments totalled 41 against Sub-Saharan Africa (SSA) and OECD averages of 37.7 and 12.8 a year respectively. This number of payments is particularly high in comparison to Mauritius, where a company only makes 7 payments a year (PwC, 2010). A separate survey cited "difficulties in filing and paying ...as enormous" (USAID, 2009).

Kenya tax administration system is also comparatively inefficient in administration of refunds, especially of the VAT. Informants indicate that the elapsed number of business days for VAT refunds is 60 days. The time taken to pay refunds is relatively long when compared to South Africa (21 days).

Kenya has also a low VAT gross compliance ratio (VATGCR) of 40.5 in comparison to World average of 65.48 (see **Annex C: Table C9**). But its VATGCR is higher than SSA average of 38.45²². Measures from the same source compute corporate income tax (CIT) revenue productivity (CITPROD) and personal income tax (PIT) productivity (PITPTOD) of 0.15 and 0.11 which indicate that Kenya uses the taxes fairly efficiently in generating revenue when compared to World averages of 0.13 and 0.14 for CITPROD and PITPROD respectively. It is noteworthy that Kenya fares better than other EAC countries on all three measures. Still a study by Anassi (2004) suggests that there are significant levels of tax evasion – in particular: under declarations are prevalent; and "many businesses in the informal sector that should be in the tax bracket...are not because of corruption".

²¹ http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132 [Accessed 2 February 2010].

²² http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132 [Accessed 2 February 2010].

3.2.2 Allocative efficiency

As earlier pointed out (**Sub-section 2.5.3**), researchers have suggested that tax reforms in Kenya under the TMP led to improved productivity of direct taxes. On the other hand, the tax exemptions and incentives were considerable, and they would have undermined the allocative efficiency of the tax regime. So for example, while EPZs have generated employment especially in the area of garment manufacturing, Omolo (2006) contends that "the importance of EPZ exports to the national economy has remained dismal". Furthermore, there are informants' claims that: produce intended for export finds its way back into the local market; and benefits are not sustained because once EPZ investors exhaust their tax incentives, they relocate from Kenya to other destinations. This is consistent with a broader literature conclusion that tax holidays and other select incentives do not deliver in terms of sustainable investments (IMF, 2008).

3.2.3 Performance equity

One is inclined to agree with Moyi and Ronge (2006) that "Kenya has relied heavily on income tax [for] ease of collection rather than on the...principles of equity". In this latter perspective, it is also significant that large corporations contribute about 75% of domestic tax revenue²³. Moreover, the literature suggests that "the tax burden in Kenya remains higher than in most comparator countries...in Kenya complaints about the tax rates top all other constraints" (Larossi, 2009). Also, the 'total tax rate' as a percentage of profit of 49.7% is higher than those of Tanzania (45.2%), Uganda (35.7%) and South Africa (30.2%). Kenya's tax rate is also higher than the OECD average of 44.5%, but significantly lower than the SSA average of 67.5%²⁴. According to the World Bank (2010), depreciation allowances offered to corporations in Kenya are lower than those available in Rwanda and Tanzania – "not surprisingly, with lower depreciation rates, the share of Kenya's corporate tax in the total tax rate (33.1%) is higher than Tanzania's (19.9%), for example".

For corporate taxpayers, Kenya's tax system has a high tax burden which negates equity. In this regard, the 2010 World Bank paying taxes survey indicates that Kenyan companies spend 417 hours a year on this task, as opposed to 432 hours in 2008²⁵. This result is significantly higher than the OCED average of 194.1 hours. Furthermore, interviews with key informants report that there are times when tax officers harass business operators, especially during post clearance customs audits.

²³ <http://www.revenue.go.ke/lto/lto.html> [Accessed 11 April 2010].

²⁴ <http://www.doingbusiness.org/ExploreEconomies/?economyid=172#PayingTaxes> [Accessed 10 March 2010].

²⁵ Ibid.

However, generally equity considerations are in-built in the Kenyan tax system. Some taxes are more progressive than others, but it is difficult to comparatively gauge equity between the different taxes. Direct taxes are definitely progressive to a degree. With respect to PIT, earnings below KShs 10,165 (US\$124) a month are tax free. Furthermore, for low income earners, GoK introduced welcome incentives such as tax free canteen staff meals (in 2007/08). The tax rates by bracket (beginning at 10%) are progressive up to a relatively low income threshold of KShs 38,893 (US\$477) per month (after which income tax it is at a flat rate of 30%) (see **Annex C – Table C2**). However, the limited progressivity of the system has been dented by the failure to change tax bands and personal relief since 2004/05; resulting in a comparatively higher tax burden over the years for the low income groups, especially as their purchasing power falls. The latter effect is compounded by the burden of consumption taxes, which have not been adjusted downwards.

Kenya's VAT system has also a degree of progressivity in terms of zero rating and exemptions of basic social goods and services. Similarly, excise and import duties are generally levied on goods and services considered to be luxurious or in demand by high income groups. On the other hand, excise duty is high on alcohol and tobacco, not only because it is readily collectable, but also to compensate for the negative public health externalities arising from their consumption. In the latter perspective, it has been argued that the scope and socio-economic merit of additional consumption tax revenue from these goods is considerable.

3.2.4 Performance effectiveness

KRA's performance effectiveness is comparatively high in terms of both tax effort and tax gap (see **Annex C: Table C13**). At 90.5%, in 2005, Kenya's tax effort was far above levels prevailing in neighbouring countries, with the closest performance by Tanzania at 54.4%. It is also noteworthy that Kenya's performance in 2005 represented a significant improvement from 2001 when its tax effort was 85.5%. Still, Kenya's performance was significantly below that of South Africa which recorded an exceptionally high tax effort of 104% in 2005. 2005 statistics report that Kenya's tax gap stood at 2%, which was well below those of Rwanda, Tanzania and Uganda of which were 8.5%, 5.9% and 7.8% respectively. But yet again, compared to South Africa, which had -0.4%, there is still scope to reduce the tax gap.

At an operational level, to enhance its performance effectiveness and in particular raise levels of compliance, KRA has adopted a three pronged approach. First, the 'National Business Agenda' constituted in 2008, is a consultative forum in which GoK interacts with the private sector on the business environment, which covers the tax system. Second, KRA commissions regular surveys. In this regard, "KRA

reports an improvement in the service satisfaction rating from 40% in 2003/04 to 69% in 2004/05 (KRA, 2006). This reflects a shift in KRA's approach towards service-orientation. Third, KRA also champions studies to establish the efficacy of key processes. It is in this context that in 2004 and 2007, KRA charged teams to undertake a time release study in the area of customs.

3.3 Summary of the overall trends

Kenya's domestic revenue collection is higher than the tax level in a representative sample of developing countries of 18% (Tanzi and Zee, 2001). Also Kenya's performance effectiveness indicators suggest that whilst the tax effort is high, there is potential to increase tax revenue collection as a percentage of GDP by reducing the tax gap.

The early reforms of the 1970s and early 1980s, as well as introduction of VAT in 1990, which widened the tax base, enabled GoK to mitigate for revenue losses resulting from the reduction in and removal of import and export tariffs, which were imposed both by global (WTO) conventions as well as the structural economic adjustment measures.

The extensive reforms in tax policies and administrative reforms under the TMP (1986-2002), including the establishment of the KRA, may not have delivered in terms of real growth in tax revenues for most of the years especially because the macro-economy was generally on the decline. Nonetheless, among other benefits, these reforms built a solid policy, institutional and administrative platform on which the RARMP reforms could yield quick and significant gains in tax revenue generation in subsequent years.

Implementation of the RARMP, which prioritised quick wins to rapidly and significantly raise tax revenues (in real terms) has demonstrated considerable results, including the reversal, in a period of real GDP growth (2004-2007), of the decade long decline in tax to GDP ratio. The programme has also already accomplished significant outputs and outcomes in such areas of ICT applications as eFiling and full computerisation of the customs operations. The programme has definitely placed KRA on a firm modernisation trajectory. However, as pointed in the assessment of performance benchmarks above, and synthesised in the next chapter, significant challenges still lie ahead for Kenya's taxation system.

4 Challenges and issues

Compared to most countries in SSA Africa, especially those whose economies are not predominantly mineral-exports dependent, Kenya's tax administration has done fairly well, in that its tax to GDP ratio has never been below 18% for the past three decades. However, on the way forward, the Kenya tax administration faces major challenges, in two perspectives. First, the need to raise its tax to GDP ratio towards the target set way back in 1992 of 28%. There is no subsequent policy decision to revise this target downwards. Second, the analysis of performance indicators in the last chapter showed a number of important areas, in terms of efficiency, effectiveness, equity, etc. on which scope for significant improvements exist. The more significant of these challenges and surrounding issues are highlighted in this chapter.

4.1 Coping with less than ideal policy, legal and other institutional environments

In Kenya, as indeed in most countries, there is a disconnect between fiscal policy making and development of realistic targets and strategies for revenue collection. So, for example, it is common that there has been a significant gap between revenue targets set by Ministry of Finance and the KRA's targets. For example, according to the Commissioner General, in 2006/07 the Ministry of Finance set a revenue growth target of 19.6%, which KRA considered to be ambitious given its own target of 17% (Waweru, 2007). In the same presentation, the Commissioner General pointed out such other disabling institutional constraints to include:

- The ministry still determines the level of VAT refunds yet the demand for refunds will change with economic circumstances;
- The ministry may provide incentives, waivers, etc. without factoring these into the revenue targets undermining the ability of the authority to meet these targets;
- Varying policy objectives - the need to facilitate trade for example - may run counter to the need to meet Customs revenue targets;
- The ministry fails to take into account the role of other parties whose actions and efficiency impacts on KRA performance results - e.g. the Kenya Bureau of Standards;

- KRA does not have a free hand to properly remunerate and motivate its staff. At the time of compiling this paper, there are salary arrears for some years due to KRA staff, following adjustments to pay made by the KRA's Board of Directors, but for which the necessary additional resources have not been released by the Treasury.

4.2 Achieving an acceptable degree of tax compliance from a fast growing and profitable, but, increasingly complex informal sector

The informal sector is a fast growing segment of Kenya's economy, but tax evasion remains particularly high. "According to the 2006 Kenya economic survey, the informal sector constitutes 72% of the working population. The sector has grown by 32.7% during the past four years to 6.5 million workers" (Iarossi, 2009). The informal segment of the agricultural sector constitutes the largest portion of the economy, and employs the largest segment of people. However, it presents unique challenges to tax administration for several reasons. First, it is a high risk and uneven source of income for its operators. As a consequence, for example, past efforts to tax it through presumptive income tax failed due to: many unrecorded open air markets; delays and a failure to make payments to producers by many government controlled marketing boards; unpredictable profit and cash flows for growers of export crops arising from global market variations; and a high reliance on rain fed agriculture, which exacerbates the unpredictability of farmers' incomes. Second, most of the labour is provided by the family and therefore it is hard to audit revenue streams and costs. Third, it attracts much politics which often blurs the real issues and results in resistance to required policy and legislative changes.

The trade segment of the informal sector has also been booming. But again, there are particular challenges around trying to bring this segment into the tax net. In one respect, informal trading businesses increasingly operate through small scale outlets, popularly called *Buzaars* (i.e. many operators trading in a big store), whereby the identity of individual operators is difficult to confirm. In another but related respect, many such outlets may be operated by an individual using different PINs. This way, for example, it is easy for the individual to avoid paying even turnover tax.

4.3 Rationalising tax exemptions

There is an array of tax exemptions given by GoK. The more prominent ones are around the EPZ, once-off capital investment deductions, the 150% capital deduction, exemptions given on withholding tax, and the zero rating of VAT payable for goods and services procured by public bodies, privileged persons and institutions etc. Many research studies on tax exemptions and incentives confirm

the conclusions of a 2008 IMF assessment of the investment incentive regimes offered in Kenya and Tanzania, that these are not important in attracting foreign investment. Rather such incentives create distortions and result in the loss of tax revenues. In addition, the socio-economic rationale for VAT zero rating is questioned in that in most instances, it does not result in lowering consumer prices for the targeted beneficiaries. In the latter perspective, it has been argued that zero rating of local products may benefit business people as windfall profits. Nonetheless, it can be expected that, at least politically and diplomatically, cases of tax exemptions and incentives will arise. Therefore, a key challenge is in rationalising them.

4.4 Achieving enhanced equity and efficiency in tax administration

As expounded in **Chapter 3** above, Kenya's indicators of performance efficiency, equity and effectiveness can be significantly improved. Examples of major flaws in equity and efficiency include: a failure to regularly review tax brackets; and an excessive number of tax payments in Kenya to what prevails in neighbouring countries. There is also, again for example, the comparatively inordinate delays in making VAT refunds. Therefore, there is considerable scope to improve performance equity and efficiency.

4.5 Porous borders with a failed state - Somalia

Kenya has an unstable porous eastern border with Somalia, where no government has been in control for over twenty years. This region poses problems with respect to smuggling of non-taxed imports such as sugar and other merchandise, as well as small arms. The combined effect of smuggling and insecurity in the region will remain obstacles to tax administration for quite some time.

4.6 Cultivating tax morale, beginning with political leaders

"Tax morale" must be presumed to be low in Kenya. Cultivating it is a daunting challenge, because a series of events have indicated MPs' tendency to take populist positions when required to support new policies to enforce tax compliance. For example, Kenya's Parliamentarians have actively resisted the following key tax policy proposals: (i) the reintroduction of CGT, in 2008; (ii) the introduction of ETRs. Some MPs joined business people in public demonstrations against the enforcement of ETRs, but the resistance was overcome; (iii) the taxation of MPs allowances; and (iv) the taxation and restriction of the use of plastic papers.

4.7 Effectively and sustainably combating corruption in tax administration

Onyango (2009) suggests that “corruption still tops the list of impediments that hindered KRA from meeting its targets during the 2008/2009 financial year”. Yet, the problem is not exactly internal to KRA. As one of its officers observes: *“You know that we have never shied away from admitting that we have a problem... We have sacked people at KRA, we have changed management but the vice is still with us. Therefore what is it that is the problem? It is those business people and they need to begin changing. These people will foster corruption as long as they are not arrested. Therefore we all need to work together to eradicate this costly vice”* (Wambui, 2009).

4.8 Regional common markets pose challenges

Kenya is a member of two regional blocks, the EAC and COMESA, but the two trading blocks, have not harmonised their tax regimes. This poses a serious challenge to the determination of origin of goods for tax purposes. With CETs between EAC member states, it will be particularly difficult to control leakage of goods which originate from non-EAC countries entering Kenya through other countries of EAC.

There is also the issue of exemptions. Kenya is eligible under the EAC Customs Management Act to grant exemptions of import duty to promote the development of infant industries. The value of goods that qualified for such exemptions increased in 2006 by 71.2% to US\$1,370.8 million, resulting in revenue foregone of US\$ 289.5 million which was about 14.20% of total trade taxes. In this regard no monitoring mechanism is in place “to ensure that goods benefiting from exemptions are not exported” or that duty is paid in full (Mugisa et al, 2009).

An added problem is the comparability and ability of the revenue authorities in member countries, and their capacity to enforce compliance. With a common market and the free movement of goods, there are increased risks that goods will be channelled through the country with the weaker revenue enforcement tax administration, to countries with more efficient administrations. This is especially possible when consumption taxes are different, for example, Kenya has a lower VAT rate than Burundi, Rwanda, Uganda and Tanzania and may experience increased volume of transit goods, some of which may be diverted into the domestic market.

5 Lessons of experience

The previous chapters elaborate on the wide range of policy and strategic initiatives, successes, failures, and thereby the strengths and weaknesses of the Kenya tax system over the years. This section highlights select lessons of experience.

5.1 Stability of leadership and management enhances capacity development

As discussed earlier the TMP was characterised by highly unstable management at the Treasury which was extended to KRA (see **Sub-section 1.4.4**). Consequently, although revenues as a ratio of GDP rose to exceed the target of 24% of GDP set by Sessional Paper No.1 of 1986, this could not be sustained, and ultimately in real terms tax revenues were in the decline for most of the 2000s. It is suggested that stability of leadership has enabled effective implementation of the RARMP, and the positive results achieved in terms of reform outputs and outcomes, and especially with regard to real growth in tax revenues since 2003/04.

5.2 Tax exemptions and incentives may undermine equity and fairness

In the past, GoK extended tax exemptions and incentives, especially on import duties to various taxpayers. Since there were no open criteria for these exemptions and incentives, they developed into favours for the well connected. This practice undermined equity and fairness of the tax system and revenue potential. Yet, evidence from independent studies generally shows that these exemptions and incentives have minimal economic benefits.

The EAC Customs Management Act of 2004 has restricted the range and quantum of tax exemptions and incentives by member states. However, GoK has gone around this restriction by paying duties on behalf of select institutions such as faith groups and other charities that provide public services. Furthermore, exemptions from domestic taxes remain, but are subject to, an internal criterion which guides processing and approval of such requests. Still, there is no guarantee of equity and fairness in the distribution of these exemptions.

5.3 Enforcement with facilitation of taxpayers to modernise systems can be a win-win solution

The introduction of ETRs in Kenya was initially controversial and strongly resisted by business people. Traders had argued that: (1) ETRs are an extra burden to the taxpayer – especially for those taxpayers with other systems to account for sales and VAT; (2) others argue that implementation costs are high and not recoverable

for tax purposes; and (3) some ETRs malfunction and suppliers are not responsive. KRA responded with determination, but also with an aggressive information, education and communication programme to promote the use of ETRs, and a facilitation scheme under which taxpayers acquired ETRs, and then obtained refunds through the VAT system. Many traders acknowledge today that ETRs are useful in sales control in their businesses. Therefore, both KRA and the business community have emerged as winners.

5.4 Implementation of major ICT systems can seriously disrupt revenue collection

In 2005/06, there was a decline in the tax to GDP ratio in Kenya, which has been attributed to teething problems with S2005S. In addition, “when the S2005S system was introduced... and did not immediately ease the backlog and hasten clearance procedures at the port, it encountered opposition from some stakeholders”²⁶. Therefore, possible resistance should be anticipated in the implementation of major changes in tax administration systems, and consequent disruptions in revenue collection.

5.5 Revenue authorities may be best placed to prosecute cases of tax evasion

Over the past year, KRA has been allowed by the Attorney General, who is the defacto Director of Public Prosecutions, to install six of his officers, who are legal professionals as prosecutors in tax evasion cases. According to the authority, this arrangement has enabled more timely, effective and successful prosecutions. Furthermore, KRA’s prosecutors are in a position to apply the legislative framework, knowledge and other capacities for combating corruption and other crimes, to “register substantial wins in court cases”²⁷.

²⁶ www.bizclir.com/galleries/.../01.128.08BP12_Kenya.pdf [Accessed 11 April 2010].

²⁷ http://www.kra.go.ke/notices/court_cases.html [Accessed 11 April 2010].

Annex A: Key informants

Betty Maina (Ms) Chief Executive Officer, Kenya Association of Manufacturers (KAM)

J. S. Ogai (Mr) Senior Deputy Commissioner, Research and Corporate Planning, Kenya Revenue Authority

Justus Nyamunga (Mr) Director, Department of Economic Affairs, Treasury

Karen Nginda (Ms) Deputy Commissioner, Research and Corporate Planning, Kenya Revenue Authority

Kubai Khasiani (Mr) Director, Public Financial Management Reform Secretariat

Phyllis N. Makau (Ms) Principal Budget Officer, Parliament (Kenya National Assembly) Budget Office

Stephen Wainaina (Mr) Economic Planning Secretary, Ministry of State For Planning, National Development And Vision 2030

Wa Nyambura Mwambia (Mr) Deputy Director, Economics Affairs, Treasury

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Annex C: Select indicators

Table C1: Tax policy – Maximum marginal tax rates (1994/95 to 2007/08)

Fiscal year	PIT	CIT	VAT
1994/95	37.5%	35.0%	18.0%
1995/96	35.0%	35.0%	15.0%
1996/97	35.0%	35.0%	15.0%
1997/98	32.5%	32.5%	17.0%
1998/99	32.5%	32.5%	16.0%
1999/00	30.0%	30.0%	15.0%
2000/01	30.0%	30.0%	18.0%
2001/02	30.0%	30.0%	18.0%
2002/03	30.0%	30.0%	18.0%
2003/04	30.0%	30.0%	16.0%
2004/05	30.0%	30.0%	16.0%
2005/06	30.0%	30.0%	16.0%
2006/07	30.0%	30.0%	16.0%
2007/08	30.0%	30.0%	16.0%

Source: TMP document, Institute of Economic Affairs and Kenya Legislation

Table C2: Tax brackets – PIT

Monthly taxable income	Tax on taxable income	Tax rate in each shilling
For taxable income under KShs 10,165	KShs 1,016 on taxable income of KShs 10,164	10%
For taxable income from KShs 10,165 but under KShs 19,741	KShs 1,016 plus KShs 1,436 tax on taxable income of KShs 9,576	15%
For taxable income from KShs 19,741 but under KShs 29,317	KShs 2,452 plus KShs 1,915 tax on taxable income of KShs 9,576	20%
For taxable income from KShs 29,317 but under KShs 38,893	KShs 4,367 plus KShs 2,394 tax on taxable income of KShs 9,576	25%
For taxable income from KShs 38,893 and above	KShs 6,761 plus tax calculated at 30% on taxable income over KShs 38,892	30%

Source: KRA

Table C3: Tax administration costs (1998/99 to 2007/08)

Fiscal year	Operating cost (KShs million)	Operating cost as a % of tax revenue
1998/99	2,084	1.3%
1999/00	2,208	1.3%
2000/01	2,202	1.2%
2001/02	2,927	1.6%
2002/03	3,313	1.6%
2003/04	3,546	1.5%
2004/05	4,519	1.6%
2005/06	5,697	1.9%
2006/07	6,299	1.7%
2007/08	6,989	1.6%

Source: KRA audited accounts

Table C4: Ratio of tax staff per population (TAXSTAFF)

Indicator	Kenya's measure	World's measure	SSA's measure	Upper income economies' measure
TAXSTAFF	0.12	0.82	0.37	0.88

Source: http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=132 [Accessed 2 February 2010].

Table C5: National government revenue and deficit as a percentage of GDP

Year	Revenue (tax and non-tax)	Deficit excluding grants
1989/90	23.3%	-6.9%
1990/91	23.7%	-9.1%
1991/92	25.9%	-4.8%
1992/93	24.6%	-11.0%
1993/94	28.6%	-7.5%
1994/95	29.6%	-2.3%
1995/96	30.4%	-1.5%
1996/97	25.9%	-3.9%
1997/98	27.3%	-2.5%
1998/99	26.9%	-0.7%
1999/00	22.1%	0.2%
2000/01	22.6%	-4.8%
2001/02	21.6%	-3.4%
2002/03	20.5%	-5.4%
2003/04	21.7%	-1.7%
2004/05	21.4%	-4.1%
2005/06	20.5%	-4.7%

Year	Revenue (tax and non-tax)	Deficit excluding grants
2006/07	21.6%	-2.7%
2007/08	22.0%	-5.2%

Source: Various IMF staff reports

Table C6: Total budgeted tax and non-tax revenue as a percentage of GDP (1989/90 to 2007/08)

Fiscal year	Tax revenue	Non-tax revenue
1989/90	19.5%	3.8%
1990/91	20.1%	3.6%
1991/92	19.4%	4.6%
1992/93	19.3%	4.0%
1993/94	24.5%	3.0%
1994/95	24.6%	3.8%
1995/96	24.7%	4.5%
1996/97	22.4%	3.5%
1997/98	22.6%	4.7%
1998/99	21.6%	5.3%
1999/00	20.3%	2.8%
2000/01	19.8%	2.8%
2001/02	17.6%	4.0%
2002/03	18.0%	2.5%
2003/04	18.2%	3.5%
2004/05	17.8%	3.6%
2005/06	17.3%	3.3%
2006/07	18.1%	3.6%
2007/08	19.0%	3.1%

Source: Various IMF staff reports

Table C7: Composition of national government tax revenues (1989/90 to 2007/08)

Fiscal year	Taxes on income and profits	VAT	Excise duties	Import duties	Total taxes
1989/90	33.4%	35.7%	8.3%	16.8%	100.0%
1990/91	34.0%	36.7%	8.8%	15.2%	100.0%
1991/92	36.0%	39.4%	14.0%	10.6%	100.0%
1992/93	34.6%	38.4%	13.5%	12.4%	100.0%
1993/94	40.0%	31.7%	12.3%	16.0%	100.0%
1994/95	33.6%	22.5%	17.8%	17.1%	100.0%
1995/96	39.1%	23.1%	18.4%	17.7%	100.0%
1996/97	38.1%	22.5%	20.0%	17.6%	100.0%
1997/98	37.7%	24.2%	18.8%	16.6%	100.0%
1998/99	35.7%	25.3%	18.6%	18.4%	100.0%
1999/00	34.8%	26.2%	18.2%	18.3%	100.0%
2000/01	33.3%	30.0%	16.9%	17.2%	100.0%
2001/02	29.9%	25.7%	16.2%	10.9%	100.0%
2002/03	33.4%	26.6%	16.9%	8.8%	100.0%
2003/04	32.2%	24.4%	15.9%	9.2%	100.0%
2004/05	33.3%	26.4%	15.8%	7.6%	100.0%
2005/06	36.6%	24.5%	16.2%	6.6%	100.0%
2006/07	33.8%	24.8%	14.5%	7.1%	100.0%
2007/08	38.3%	25.9%	14.3%	7.6%	100.0%

Source: Various IMF staff reports

Table C8: Analysis of tax arrears (2002/03 to 2007/08)

Item	Fiscal year					
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Debt (KShs millions)	9	31	4	416	831	880
Total tax revenue(millions)	229,276	274,252	297,699	360,191	433,915	480,569
Debt revenue (%)	8.3%	4.7%	3.4%	2.6%	5.5%	2.1%

Source: KRA

Table C9: CIT and PIT revenue productivity and VAT gross compliance ratio (2008/09)

Indicator	Kenya's measure	World's measure	SSA's measure	Upper income economies' measure
CITPROD	0.15	0.13	0.09	0.15
PITPROD	0.11	0.14	0.08	0.14
VATGCR	40.5	65.48	42.3	70.82

Source: http://www.fiscalreform.net/index.php?option=com_wrapper&Itemid=101 [Accessed 2 February 2010].

Table C10: World Bank Doing Business indicators on the tax burden (Kenya only)

Indicator	Year		
	2008	2009	2010
Kenya's global ranking	-	159	164
Number of tax payments a year	41	41	41
Time taken to comply with the major tax types	432	417	417

Source: <http://www.doingbusiness.org/ExploreEconomies/?economyid=101> [Accessed 10 March 2010]

Table C11: World Bank Doing Business indicators (2010) on the tax burden (Kenya vis-à-vis the OECD and SSA)

Indicator	Region		
	Kenya	OECD	SSA
Number of tax payments a year	41	12.8	37.7
Time taken to comply with the major tax types	417	194.1	306.0
Total tax rate as % of profit	49.7%	44.5%	67.5%

Source: <http://www.doingbusiness.org/ExploreEconomies/?economyid=101> [Accessed 10 March 2010]

Table C12: Registered tax payers based on returns for 2007

Type of taxpayer	Numbers
Civil servants	337,683
Private employees	408,477
Self-employed	72,961
Partnerships	5,543
Company	29,531
Trust	933
Club	901
Total	856,029

Source: KRA

Table C13: Tax gap and tax effort for select EAC countries and South Africa (select years)

Country	Year	Tax revenue (A)	Estimated potential tax revenue (B)	Tax gap (B) – (A)	Tax effort (A)/(B) as a %
		As a % of GDP			
Kenya	2001	17.8	20.8	3.0	85.5
	2005	18.6	20.6	2.0	90.5
South Africa	2001	24.8	26.7	1.9	92.9
	2005	27.4	27.0	-0.4	101.4
Rwanda	2001	10.7	20.9	10.2	51.2
	2005	12.2	21.4	9.9	57.0

	2008	13.5	22.0	8.5	61.4
Tanzania	2001	9.7	20.0	10.3	48.5
	2005	11.2	20.5	9.3	54.4
	2008	15.0	20.9	5.9	71.6
Uganda	2001	10.4	19.2	8.8	54.3
	2005	11.8	19.5	7.8	60.3

Source: IMF (2009e)

Table C14: Aggregate local revenues in Kenya – 2004/04 to 2007/08 (KShs millions)

Revenue Source	03/04	%	04/05	%	05/06	%	06/07	%	07/08	%
LATF	3,719	27%	3,930	30%	4,986	32%	7,461	36%	8,232	35%
RMLF	323	2%	524	4%	506	3%	869	4%	1,485	6%
CILOR	365	3%	270	2%	300	2%	327	2%	327	1%
Subtotal CG transfers	4,407	33%	4,724	36%	5,792	37%	8,657	42%	10,043	43%
SBP	1,572	12%	1,674	13%	1,736	11%	1,963	10%	2,232	10%
Property rates	2,028	15%	1,840	14%	2,497	16%	2,986	14%	3,067	13%
Market fees	706	5%	701	5%	832	5%	950	5%	1,092	5%
Vehicle parking	615	5%	973	8%	1,128	7%	1,300	6%	1,452	6%
House rents	386	3%	314	2%	314	2%	308	1%	160	1%
Plot rents	166	1%	163	1%	169	1%	202	1%	198	1%
Total cess Receipts	440	3%	494	4%	569	4%	569	3%	755	3%
Game park fees	458	3%	688	5%	729	5%	1,011	5%	884	4%
Water & sewerage fees	1,767	13%	535	4%	472	3%	518	3%	392	2%
Others	994	7%	843	7%	1,367	9%	2,156	10%	3,157	13%
Subtotal LA Revenues	9,132	67%	8,225	64%	9,813	63%	11,963	58%	13,390	57%
Total central and local	13,538	100%	12,948	100%	15,604	100%	20,619	100%	23,432	100%
Local as a % of tax and non-tax revenue	3.6%	-	2.8%	-	3.1%	-	3.2%	-	3.1%	-

Source : Ministry of Local Government, as cited by Hugounenq, Rocaboy et Vaillancourt (2010)

Annex D: The EAC Customs Union

The East Africa Community (EAC) was reborn on 20th November 1999 and the Treaty for the Establishment of the EAC became effective on 7th July 2000, with Kenya, Tanzania and Uganda as its founding members. Four years later, in March 2004, Kenya, Tanzania and Uganda signed a customs union protocol which became effective in January 2005. This protocol is enshrined into the East African Community Customs Management Act of 2004 that has been legislated in each of the member countries.

The protocol establishes common external tariffs (CETs), eliminating internal tariffs. It also brought about the following changes:

- The elimination/phased elimination of customs duty originating from partner states;
- The harmonisation of customs principles and procedures;
- The removal of suspended duty.

Furthermore, to harmonise Kenya's exemption regime with those of the other EAC partner states, and to reduce the abuse of exemptions by undeserving organisations, in 2004/05, GoK abolished the discretionary customs duty waiver. However, government still retained powers to grant exemptions in the national interest. The implications of the customs union are further elaborated in **Box D1 below**.

Box D1: Implications of the EAC Customs Union

The formation of the EAC Customs Union has provided major momentum to Kenya's trade reform process. Since the signing of the protocols in January 2005, the EAC Customs Union has gone into high gear to address critical areas of reform. Areas of reform include documentation rationalization and standardization, information communications technology, port services facilitation, border post cooperation, third-party insurance, transit charges harmonization, tariff reforms (common external tariff), and standards harmonization. The reforms will install the risk management procedures needed to build this expanded "domestic market" (originally signed by Kenya, Uganda, and Tanzania, the countries of Rwanda and Burundi have also now been accepted for membership). Kenya's need to comply with the requirements of the new Customs Union will continue to be a major driver for trade reform and

customs modernization.

Concern is expressed about the capacity of the EAC Customs Union to move forward successfully. A number of those interviewed remarked on the fact that participating countries remain suspicious of each other. There is also the view that the EAC needs to be restructured so that it can act more quickly and spend less time talking.

Source: www.bizclir.com/galleries/.../01.128.08BP12_Kenya.pdf [Accessed 11 April 2010]

It is also noteworthy that with the EAC Customs Union protocol in place, GoK no longer has scope to independently amend customs duties. In contrast, government has considerable room to change excise duty rates. It has therefore made many changes to excise duty rates over the years – including increases in rates levied on beer, alcoholic spirits, tobacco etc. Furthermore, in a move to curb the environmental menace caused by plastic bags and sacks, in 2007/08, the Minister of Finance proposed to levy an excise duty of 120% on these items. Also, in 2008/09, all wireless telephony services became subject to excise duty at 10%. In the same year, imports of second-hand computers were subject to excise duty of 25%.

As a result of the formation of regional trading blocks, Kenya has over the past decade been able to increase its volumes of exports to member states of the EAC and COMESA . In particular, Kenya exports food and beverages, industrial supplies, machinery and transport supplies and consumer goods to these countries (McCormick and Pedersen, 1999). However, horticulture products and tea are Kenya's highest export earners, and in 2009 contributed KShs 71.6 and KShs 69.0 billion respectively (Mugambi, 2010). The highest share of horticultural exports is from flowers, and fresh fruit and vegetables. Kenya is one of the World's largest tea producers – its largest buyers are Egypt, the United Kingdom, Afghanistan, Pakistan and Yemen²⁸.

²⁸ <http://www.abndigital.com/news/top-business-stories/454111.htm> [Accessed 7 April 2010].

Annex E: KRA's ICT-based comprehensive tax administration reform strategy

Since 2004/05, KRA has embarked on more fundamental reforms under the Revenue Administration Reform and Modernisation Programme (RARMP). RARMP seeks to transform “KRA into a modern, fully integrated and client-focused organization”²⁹. RARMP consists of seven projects as follows: (1) customs reforms and modernisation; (2) domestic taxes reform and modernisation; (3) road transport reform and modernisation; (4) investigation and enforcement reform and modernisation; (5) KRA infrastructure development; (6) KRA business automation; and (7) human resource revitalisation. RARMP is sequenced into phases, which are incorporated in KRA's successive corporate plans.

In line with the vision underlying the RARMP, KRA's current (fourth) corporate plan (2009-2013), has set the following goals:

- A professional team that is well remunerated;
- An enabling work environment;
- A fully automated authority allowing for a single view of the taxpayer and full utilisation of ICT to promote compliance;
- A transformed and fully functional organisation;
- Compliance costs are minimised and customer service is enhanced;
- Revenue targets achieved.

More significantly, through the RARMP, KRA has in effect launched an ICT-based strategy for modernisation of tax administration³⁰. According to KRA's Commissioner General, the objectives of the system include, to:

- Enhance the efficiency of the tax collection process;

²⁹ <http://www.kra.go.ke/rarmp/rarmp.html> [Accessed 11 April 2010].

³⁰ <http://www.kra.go.ke/rarmp/rarmp.html> [Accessed 11 April 2010].

- Strengthen responsiveness of systems in terms of their accuracy and timeliness;
- Minimise contact between taxpayers and tax officials as a means of reducing corruption;
- Facilitate the sharing of information with third parties;
- Enable KRA to have a single-view of the taxpayer;
- Reduce transaction and administration costs for taxpayers and KRA respectively³¹.

The strategy covers five key ICT systems. First, there is an Integrated Tax Management System (ITMS) in place for domestic revenue. As part of the ITMS, KRA automated the issue of unique personal identification numbers (PINs) from 30 March 2009. Using an electronic registration (e-Registration) module, taxpayers can register to obtain PINs online for the purposes of: pay as you earn (PAYE); VAT; land rent; income tax; and withholding tax. KRA also discontinued the manual distribution of PIN certificates. As a result, the “issuance of multiple tax registration numbers has been discontinued and replaced with a generic PIN certificate”³². “E-registration is fully operational and cumulatively, 60,310 new taxpayers had registered online by the end of May 2009” (KRA, 2009).

The ITMS initially enabled registered taxpayers to file their tax returns for VAT and PAYE online – subsequently; the system has been extended to cover the filing of corporate income tax returns. The system was first piloted in December 2008, three firms, East African Portland Company, Safaricom and Kenya Breweries were the pioneer users. KRA provides taxpayer software and a user manual, both of which can be downloaded from its website. Taxpayers can call-in to a dedicated help centre for further assistance.

Second, from 1 January 2005, KRA introduced electronic tax registers (ETRs) for use by VAT registered taxpayers. The key features of ETRs include: the ability to maintain fiscal memory – they contain “read only memory...to store tax information at the time of sale”; and in-built security features (e.g. seal memory, special technical specifications etc. (KRA, 2005). KRA finances the “purchase of ETRs and

³¹ www.kra.go.ke/.../CG_Remarks_Launch%20E-filing_E-registration_290109.pdf [Accessed 11 April 2010].

³² <http://www.revenue.go.ke/portal/index.html> [Accessed 11 April 2010].

other fiscal devices. However taxpayers are required to install the machines and claim the cost from KRA³³.

Third, in the area of customs, the Simba 2005 system (S2005S) has been implemented. The S2005S replaced a legacy “Bishops Office Freight Forwarders Integrated Network”. It is based on the GAINDE system developed in Senegal. The S2005S “has enabled the automation of about 90 per cent of customs operations”³⁴. The S2005S facilitates the clearance of shipments by enabling importers and exporters to submit declarations through direct input, provides readily accessible information on tariffs and regulations and is linked to banks, operates at most of Kenya’s border posts via a wide area network. S2005S is able to obtain third party information from the Kenya Ports Authority systems – Cargo Management Information System (CAMIS) and Kilindini Water Front Operating System (KWATOS). S2005S is also interfaced with the electronic cargo tracking system, and the Revenue Authority Digital Data Exchange (RADDEX). RADDEX is operational in Rwanda, Uganda and Tanzania, and being piloted in Burundi (see **Box E1**).

Box E1: The rationale for setting up RADDEX within the EAC

At a meeting of Commissioner Generals of the East African Revenue Authorities held on 21 April 2006 it was agreed that measures be taken for quick confirmation of goods by customs administrations in importing countries. The logical method for achieving this lies in creating a seamless and efficient customs network by providing interconnectivity among the Revenue Authorities’ computerized systems.

EAC Revenue Authorities in partnership with the East and Central Africa Global Competitiveness Hub (ECA Hub) [discussed] the interconnectivity of... ASYCUDA++ and KRA’s Simba 2005 Customs IT Systems. These discussions have given rise to the RADDEX system.

RADDEX, intends to greatly benefit trade and trade stakeholders by further reducing the time and cost of cargo clearance at East African borders through the introduction of an electronic communication channel... This channel will effectively allow Kenya’s Simba 2005 customs system to exchange data with...ASYCUDA++ system.

Data communicated through RADDEX... consist of exports, re-exports and transit declarations that have been cleared by customs in the country of departure and reconciliation data from goods accepted in the country of entry.

³³ <http://www.kra.go.ke/faq/fagetr.html> [Accessed 11 April 2010].

³⁴ International Tax Dialogue Survey – 2009.

Data security has been addressed at every level of the RADDEX system to ensure confidentiality and integrity among the trade stakeholders. RADDEX is expected to benefit all stakeholders with particular positive impact on importers/exporters, shippers and freight forwarders, transporters and Revenue Authorities.

Source: <http://www.ictcorridor.com/wp-content/uploads/2008/01/usermanualagent.pdf>
[Accessed 11 April 2010]

Fourth, KRA has automated the management of drivers' licences, and the Vehicle Management System (VMS). The VMS and S2005S are linked to allow "for payment of motor vehicle registration fees with import duty. The integration process enables vehicle importers to...[more easily] pay for registration along with other relevant customs duties online" (KRA, 2009). The VMS is also integrated with the PIN system in ITMS.

Fifth, KRA is implementing Free Open Source Software (FOSS). FOSS is an enterprise resource planning (ERP) system. FOSS merges "the support administrative functions to enable efficiency, effectiveness and transparency. It will provide an integrated application with a unified database" (KRA, 2009). Currently FOSS is used "for on-line staff leave applications, request for purchase orders which are approved on-line, stationery requests among others"³⁵.

It is noteworthy that there was serious resistance from freight forwarders and customs clearing agents to the implementation of the both ETR and the S2005s systems from tax payers or their agents. In the case of the ETRs, business mobilised considerable support against the new system from even members of Parliament. In the case of the S2005S, "The Kenya International Freight and Warehousing Association initiated a court action because members felt that [modernisation] imposed unfair and costly requirements"³⁶. However, following, "an agreement made on 21st July 2005 between KRA's advocates and advocates for Chivalo Investments and 790 others (clearing agents)"³⁷, KRA implemented the Simba system in 2005. It is with the support of the Government, and by use of experienced legal counsels that KRAs position prevailed and the systems have been implemented.

³⁵ International Tax Dialogue Survey – 2009.

³⁶ www.bizclir.com/galleries/.../01.128.08BP12_Kenya.pdf [Accessed 11 April 2010]

³⁷ http://www.communication.go.ke/kenya.asp?cat_id=37 Accessed 11 April 2010].

Annex F: Glossary of definitions of select terms

CITPROD	CITPROD indicates how well CIT does in terms of producing revenue, given the prevailing tax rate. It is calculated by dividing total corporate income tax revenues by GDP and then dividing this by the general corporate income tax rate.
PITPROD	PITPROD attempts to provide an indication of how well the personal income tax in a country does in terms of producing revenue. It is calculated by taking the actual revenue collected as a percentage of GDP, divided by the weighted average PIT rate.
Tax effort	Actual tax revenue as a percentage of estimated potential tax revenue
Tax gap	The difference between estimated potential tax revenue and actual tax revenue
VATCGR	This is a measure of how well the VAT produces revenue for the government. It is computed by dividing VAT revenues by total private consumption in the economy and then dividing this by the VAT rate.