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Increasing tax revenue in sub-Saharan Africa: The case of Kenya

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MAIN POINTS

Kenya has followed IMF tax recommendations and now faces grave difficulties. While initial trade liberalisation increased revenues, further change will lead to sharp falls. A new VAT-style tax and direct tax reform have not produced compensatory revenue gains, so further trade liberalisation must be resisted.

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ABOUT THE OCGG

Executive summary

The tax base in Kenya, as in most sub-Saharan African countries, is extremely narrow. So far, attempts to increase tax revenue have focused on closing the 'taxation gap' and expanding the tax base. The main policies recommended by the IMF have led to trade liberalisation, the transition from a sales tax to a system of VAT, and the creation of the Kenya Revenue Authority.

These policies have had mixed results. The reduction in tariffs has been successful, as increased imports have so far more than compensated for the reduction in tariffs and resulted in an increase in trade tax revenue. However, the impact of domestic tax reforms has been less impressive. Most importantly, revenue collected from VAT and direct taxation has not increased as hoped. Neither the switch to VAT, nor the creation of the KRA has significantly altered the proportion of government revenue made up by domestic taxation.

One reason for this is the structural weaknesses in the Kenyan economy that place limits on the possibilities of revenue expansion. In particular, low levels of formal employment, poverty wages and a high dependency ratio mean that there are strong constraints on the state's ability to increase income tax revenue.

In this context, the continued emphasis of the IMF on trade liberalisation is of great concern. The positive impact of liberalisation in 1993 was a consequence of specific circumstances that no longer pertain. As is recognised by all sides, a further reduction in tariffs would result in a fall in tax revenue. However, recent IMF reports have suggested that countries such as Kenya can compensate for this decline by increasing revenue from domestic taxation. Given the constraints on the expansion of domestic taxation this seems unlikely, and the consequence will be that the Kenyan government will remain dependent on international donors to support basic government programs.

Worryingly, there is some evidence that the pressure to both meet domestic expectations and display fiscal responsibility is leading the Kenyan government to exaggerate estimated future tax revenues. This allows the government to fulfil its expensive election promises and present balanced books to the donor community, but will ultimately lead to future budget cuts unless donors agree to cover the short fall in the near future. To support the ability of the Kenyan government to attain self-sufficiency and to allow for consistent economic planning it is imperative that further liberalisation does not occur too soon:

- Short-term

  The Kenyan government should be encouraged to operate selected tariffs to generate sufficient tax revenue to invest in expanding the tax base in the long-term. To realise this aim, funds for expensive but non-essential projects should be diverted towards projects aimed at increasing the ability of Kenyan citizens to pay tax.

- Long-term

  It is important to support the Kenyan government's attempts to increase wages, especially those of public sector workers. Selected tariffs can then be phased out as and when this revenue can be replaced by revenue raised through direct taxation.

Introduction

Poorer countries and the international financial institutions that have been propping up their economies have become preoccupied with tax systems. For international financial institutions (hereafter IFIs), expanding government revenue promises to free them from the burden of having to bail out cash-strapped governments. For the governments themselves, expanded revenue offers the promise of greater autonomy in the future and a break from restrictive aid and loan conditionalities.

There are many reasons why the focus on tax is to be supported, most importantly because there are good reasons to think that an ability to collect tax revenue is essential for state building and long-term democratisation. However, whilst it is clearly important that the principal source of a government's revenue should be taxation, in many sub-Saharan African nations this is often not the case. According to the IMF, in Guinea Bissau, aid constitutes 37.3% of GDP, whilst in Sierra Leone and Malawi, the percentage is 28.7% and 26.2% of GDP respectively.

Kenya is in a better position than these countries with aid from external donors making up only 4.9% of GDP (in 1998-2003: this figure is liable to fluctuate from year to year). The bulk of government expenditure can therefore be financed through taxation, which the government aims to keep at or above 21% of GDP. However, the Kenyan tax base is still extremely narrow. In the period 1980-1998 the proportion of total tax revenue collected through taxes on income, profits and capital gains rose from 29% to just 31%.[1] This reflects the fact that historically the vast majority of Kenyan tax revenue was raised from sales taxes and import/export duties.

Attempts to increase tax revenue in Kenya have focused on closing the 'taxation gap' and expanding the tax base. Since 1993 the main focus of tax reform has centred on trade liberalisation and moving from a sales tax was to system of value added tax (VAT). More recently the focus has expanded to address the capacity and efficiency of the tax administration, and this led to the creation of the Kenya Revenue Authority (KRA). Although many of the economic reforms attempted have been successful, the Kenyan government is no more able to depend on tax revenue than they were ten years ago. This is clear from the fact that although tax revenues have increased during the recent process of reform they have fallen in relation to GDP, whilst the share of government revenue made up through tax revenues has not increased.

The main reason that tax revenue has not increased as hoped is structural weaknesses in the economy that limit the possibilities for revenue expansion. In particular low levels of formal employment, poverty wages and a high dependency ratio impose strong constraints on the state's ability to increase income tax revenue. This is evident in the relative stagnation of revenue from direct taxation and the fact that in recent years revenue from VAT appears to have reached a plateau.

The difficulty of realizing increases in domestic taxation is concerning, because recent IMF reports have suggested that poorer countries will be able to make up for the decline in revenue resulting from further trade liberalisation by increasing revenue from domestic taxation. This suggests that the IMF is both over-estimating the ability of domestic taxation to replace taxes from trade, and planning to encourage further tariff reductions.

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[1] Unless otherwise stated, the data used throughout this report comes from the IMF's Government Financial Statistics for Kenya as accessed at 7th February 2005.

In this context if the Kenyan government follows the advice of the IMF it may significantly reduce Kenya's ability to achieve self-sufficiency. It is true that so far the reduction in tariffs has been successful, as increased imports have compensated for the reduction in tariffs and resulted in a rise in tax revenue from trade. However, the positive impact of liberalisation in 1993 was in large part a consequence of the fact that tariffs had previously been extremely high. As a result the reduction of tariff rates led to a massive increase in the quantity of imports. At the same time a weaker currency, falling costs of inputs and a reduction in export tariffs made Kenyan products more competitive and increased the quantity of exports enough to compensate for the lowering of export tariffs. These processes, combined with the increased investment in the country as a result of the optimism that greeted the transition to multi-party politics, created a situation within which trade liberalisation could be realised at the same time as increases in tax revenue.

Now that the tariff rate has been dramatically reduced, future reductions in tariff rates are unlikely to have the same effect. Trade liberalisation may have important benefits in terms of improving efficiency, restructuring the economy and promoting growth but liberalisation should not be pursued at any cost. Further liberalisation would reduce the revenue available to the Kenyan government and would consequently undermine the ability of any government to maintain development programmes.

Recent events show that even now the current National Rainbow Coalition (NARC) is dependent on international support to plug the budget deficit and to provide much needed investment. Their position as accountable to both a domestic electorate and an international donor community has placed NARC in an unenviable position. On the one hand they are under extreme pressure to implement the policies they promised to introduce during the election campaign, such as free primary education and an increase in public sector wages. On the other they must show international financial institutions and donors that they are delivering fiscal responsibility (i.e. a balanced budget) in order to access future loan and aid funds.

There is some evidence that this contradiction has resulted in a systematic exaggeration of the potential for increases in tax revenues through increases in administrative capacity. By claiming that great improvements in tax revenue are possible through more efficient administration, the Kenyan government can increase the budget to be allocated for the coming year without introducing a budget deficit. This allows them, at least in the short term, to keep both the international organisations and their domestic electorate happy. However, in the long-term if estimated tax revenues fail to materialise the inevitable consequence will be damaging u-turns on economic policy as the government introduces emergency budget cuts in order to make up the short fall.

Solutions to this vicious cycle are hard to find, but it is clear that there needs to be more targeted investment in the short-term in order for a long-term expansion of the tax base and hence tax revenue to be realised. In order to make this possible, this report argues international actors should encourage the Kenyan government to operate selected tariffs to generate sufficient tax revenue to invest in expanding the tax base in the long-term, and divert funds from expensive projects such as computerisation of the tax system to projects aimed at increasing the ability of Kenyan citizens to pay tax. In the long term, support is required for attempts to increase wages, especially those of public sector workers. The selected tariffs could be phased out as and when direct taxation is able to replace this revenue.

I. Recent tax history

Anne Krueger, the acting chair of the IMF, argued in early 2004 that ‘strengthening public finance and restructuring public expenditure to increase resources for social expenditure … will be critical (for Kenya) to reach its future objectives’. In doing so she was echoing the priorities of the IMF, and hence the Kenyan government, for the last two decades. The process of reforming the Kenyan tax system began in earnest in 1986 when the Kenyan government adopted the Tax Modernisation Programme, which was followed in 1987 by the Budget Rationalisation Programme. The two, in combination, were an attempt to address large, and widening, budget deficits by increasing revenue and controlling spending. From the Tax Modernisation Programme of 1986, up to the Kenyan government’s Economic Recovery Strategy for Wealth and Employment Creation of last year, not only have the objectives of tax reform remained largely the same, the policy proposals to achieve these objectives have also remained broadly similar. As corruption and political reticence to carry out unpopular actions led to the non-implementation of many of the tax reforms put forward by the IFIs, document after document released by the Kenyan government over the 1990s has been forced to reaffirm a commitment to tax reform to satisfy conditionality agreements with lenders in order to maintain a flow of funds.

Pre-reform, tax revenues came from the very heavy taxation of a very small base of people and the high taxation of imports and exports. The system was further characterised by high levels of avoidance and corruption. The modernisation programme of that year laid out the following policy goals:

- Raise the tax revenue–GDP ratio from 22% in 1986 to 24% by the mid 1990s;
- Reduce compliance and administrative costs through low and rationalised tax rates and wider tax bases;
- Improve tax administration by sealing leakage loopholes, making wider use of computers and enhancing audit surveillance;
- Enhance the institutional capacity to manage tax policy by establishing effective database management systems (Kenyan Ministry of Planning and National Development, 2003).

In 1992, these objectives were expanded to include:

- Raising the revenue–GDP ratio to 28%;
- Invigorating the growth of the fledgling capital market;
- Emphasizing self-assessment systems;
- Strengthening taxpayer education and service;
- Implementing organisational reforms that would modernise tax administration (Kenyan Ministry of Planning and National Development, 2003).

Above all, it was hoped that successful implementation of the above would succeed in increasing revenue. Another important goal was that of stability, which it was hoped would lead to greater predictability of revenue allowing for more accurate macroeconomic planning to take place for the future. It was also hoped that reform could lead to a more flexible tax system that would then act as an automatic stabiliser for the economy. This would mean that at times of economic buoyancy, with rising levels of income, tax revenues would rise by a greater proportion than income. And, conversely, at times of downturn as incomes fall, a flexible tax system exhibits tax revenues falling at a faster rate, thus cushioning incomes slightly.

In the latest document on the development of Kenya released by the government (the first of the Kibaki administration), and upon which rests the next programme of support from the Bretton Woods institutions, the current Kenyan tax system was described thus: 'it is characterised by uneven and unfair taxes, a narrow tax base with very high rates and rate dispersions with respect to trade, and low compliance' (Kenyan Ministry of Planning and National Development, 2003). Key to reform were 'measures … taken to deepen the tax reform, which are aimed at reducing the tax burden particularly on businesses and to broaden the tax base'.

Progress through the 1990s

The fundamental aim of the reforms, as stressed by the plans from 1986 right up to the present day, has been a broadening of the tax base to increase tax revenue. From 1993 this process has occurred hand-in-hand with a process of trade liberalisation. This has not all been at the bequest of the IMF. Although it is clear that the IMF has been instrumental in creating the incentive structure that has led the Kenyan government to reduce trade barriers, many African countries have also pursued this policy of their own volition through regional trade blocs. It is often difficult to see whether it is the IMF or African governments that are motivating economic reform, as African governments often implement reforms voluntarily to gain favour with powerful international donors. It seems most likely that in the case of Kenya, pressure from the IMF to liberalise came at the same time as a realisation within the Moi government that the current economic situation was untenable.

When Kenya finally embarked in 1987 on a process of trade liberalisation it was against a backdrop of deterioration in export performance over the 1980s. As well as a freeing up of trade, the Kenyan government also promoted exports through their support of domestic manufacturing through a system of tax incentives. The government then embarked on a process of phased tariff reductions (particularly in the high-rate bands) and rationalisation of the tariff bands in 1990. By 1997/8, the simple average tariff rate had been reduced to 16.2% from levels of 46% in 1989. However, the single most significant change in the trade policy regime came in May 1993 with the abolition of import licensing requirements and, more importantly, foreign exchange controls. Over 1993-94, all current account and virtually all capital account restrictions were lifted. The impact was immediately evident in the trade flows: imports jumped by some 7% of GDP after averaging 24% from 1981 to 1992 to over 30% of GDP. Exports surged by about 7% of GDP as well. The process of liberalisation continued after 1992, so that by 1998 the top tariff rate had been reduced systematically from 170% to 25%, while the rate bands were reduced from 24 to 5 (including duty free). As a result of these changes, the simple average tariff rate fell from 40% to 16% (Glenday, 2000). Discretionary exemptions were also cut down as a step towards rooting out corruption and simplifying the rules. Exemptions did remain for the import of raw materials used in the production of exported goods and for those inputs used in aid-funded projects.

Kenya's membership of two African trade blocs, the twenty-member Common Market for East and Southern Africa (COMESA) and the three-member East African Community (EAC), has further supported this process of trade liberalisation. At the start of 2005, a free trade area within the EAC commenced operation with the three member states also implementing a common external tariff on good entering the area. Plans to implement a free trade area within the much larger COMESA group have stalled as some member states continue to worry about the impact that the loss of trade revenue would have upon their state finances. The promotion of these regional trading blocs has further undermined Kenya's ability to rely upon the income from import duties as a source of revenue.

II. The impact of liberalisation

Intuitively one might not expect a reduction in tariffs in a country like Kenya to increase tax revenue, as it implies a fall in revenue from international trade that has historically been the largest source of tax revenue for poorer countries. However, in Kenya tax revenue rose from KSh 59840m in 1993 to KSh 181924m in 2001. In part this was due to increases in tax revenues from VAT, but a large part came from an increase in revenue from international trade. From KSh 7143m in 1993, the tax revenue collected from trade and international transactions rose to KSh 37444.3m in 2001. The increase in tax revenue from trade resulted from two factors. The first is that demand for imports proved to be highly elastic. As a result, the reduction in tariff barriers led to a sharp rise in the quantity of imports. This meant that although the Kenyan government was receiving less tax revenue per item imported, the quantity of imports rose so sharply that total revenue increased. This may have been reinforced by increased returns from VAT as a result of the increased number of imports being sold within Kenya. The phenomenon of trade liberalisation resulting in an increase in revenue through increased imports is not unique to Kenya. As Glenday notes 'within many customs systems there is major potential for increasing revenues that, under certain circumstances, can even lead to increases in revenue yields as import duty rates are lowered on average' (Glenday 2000).

Although the quantity of imports was a major source of the increase in overall tax revenue, it is important to note that the increase in capital inflow that followed the reforms of 1993 was an important second factor. Of particular importance to the increase in capital inflow was the abolition of import licensing requirements and foreign exchange controls. At the same time the transition from a one-party state to a multi-party system was the cause of great optimism for the future of Kenya and led to increase in international aid and investment. The capital inflows that followed the period of liberalisation in 1993 served to strengthen the value of the schilling, further encouraging imports and hence increased revenues from tariffs. In this way the one-time boom in capital inflows contributed to an increase in taxes from international trade.

That the revenue gains Kenya made from trade liberalisation resulted from a specific set of circumstances that no longer hold should make the Kenyan government think very carefully about further liberalisation. The capital inflows Kenya enjoyed post 1993 are unlikely to be repeated. This means that if total tax revenue is not to fall, all of the loss of revenue resulting from lower tariffs would need to be made up from an increase in the quantity of imports. Yet it seems likely that the high responsiveness of imports to reductions in the tariff rate in the early 1990s was a result of the exceptionally high level of the tariffs. If this is true then imports are likely to prove much less responsible to further lowering of tariff rates. Greater levels of trade liberalisation are therefore likely to result in a fall in tax revenue from trade, and consequently and fall in total tax revenue available to the government.

There is no disagreement on this point. A United Nations Commission for Africa (UNECA) report from September 2004 stated 'negative fiscal impacts often emerge at later stages of liberalisation; the boost to revenues from higher trade volumes, as a result of tariff cuts, will be insufficient to outweigh the revenue-dampening effect of the tax reductions themselves'. Noting the potential for early liberalisation to result in a rise in tax revenue, an IMF report of 1999 pointed out that 'of course, in the later stages of tariff reform, tariff reductions are bound to be associated with revenue losses'. In a similar vein, a World Bank report written in 2004, clearly states that 'genuine trade liberalisation must eventually result in reduced trade tax revenues and, hence, will raise difficult fiscal issues if appropriate steps have not been taken to strengthen the domestic tax system' (World Bank 2004).

The best place to look for evidence of precisely what is likely to happen in Kenya if tariffs are lowered further is similar African countries that have undertaken greater liberalisation to date. The evidence from these cases suggests that the consequences of a further fall in tariffs are likely to be significant. The UNECA report found that 'most of the African countries that made the fastest progress on trade liberalisation over the last ten years heave seen a significant decrease in their revenues from international trade taxes' (African Trade Policy Centre, 2004).

Furthermore the report states clearly that a comparative analysis of those countries with low (0-10%), medium (10-15%) and high (15-20%) trade restriction shows 'revenue maximisation between 10% and 15% of the index of trade restrictions'. Countries with higher restrictions could increase revenue through the extra imports a fall in tariff level could bring. Countries with lower restrictions find that their tax revenue falls steadily as tariffs are set below 10%, with a steep decline below 5%. Over the period 1980-2002 Kenya's average rate of trade restrictions was –2.2%. The consequence of this fall is that Kenya is currently at the revenue maximizing position, with trade restrictions running at between 10% and 15%.

If the trend of a 2.2% annual fall in trade restrictions continues, Kenya will soon be in the 'low' trade restrictions bracket. Countries in this group (such as Senegal, Ghana and Tunisia) all saw their trade tax revenues fall dramatically in the period 1995-2002. The overall impact of this fall on total tax revenue is mixed. Half of the countries in this group saw total tax revenue fall or stay the same in this period, whilst half saw a rise in domestic taxation compensate for the fall in trade revenue, with the consequence that total tax revenue increased.

It is in part this evidence that inspired the belief that taxes on trade can be reduced without creating dangerous fiscal instability. The question of how damaging further liberalisation will be is therefore really a question of the extent to which taxes from international trade can be replaced.

Table 1: Sources of government revenue, KSh (thousands of million)

	1999/00	2000/01	2001/2	2002/3	2003/4
Direct					
Income tax	53.32	53.43	55.86	66.74	74.14
Total	53.32	53.43	55.86	66.74	74.14
Indirect					
VAT on domestic production	22.42	26.23	26.33	26.50	31.70
VAT on imports	18.53	23.99	24.55	28.71	28.71
Import duties	28.61	28.80	21.58	18.44	21.68
Export duties	28.49	28.32	32.08	35.68	41.94
Other	5.61	2.31	2.07	2.26	2.81
Total	103.65	109.65	106.60	112.52	126.84
Other revenue and income	28.00	37.13	26.03	31.93	36.83
Total	184.55	199.82	187.86	210.80	237.37

Source: Central Bureau of Statistics (see footnote 2).
Note: Data for 2001/2 and 2002/3 are provisional, those for 2003/4 are estimates.

III. Replacing revenue from international trade

Further liberalisation of trade could be compatible with maintaining government revenue at its current level if the loss of tax revenue from trade could be supplemented by an increase in revenue from domestic taxation. To this end the Kenyan government has attempted to expand direct taxation and the taxation of goods and services. In 1990, shortly before the main period of trade liberalisation, Kenya moved from a sales tax towards value added tax, which, it was argued, had higher revenue potential. VAT was introduced at a rate of 18%, although it has since fallen to 16%, slightly below the present African average of 16.7%. The logic behind the change from the sales tax is explained succinctly by the Kenyan Revenue Authority's website as follows; 'VAT was introduced as a measure to increase Government 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; … the tax is borne by the final consumer of goods and services' (KRA, 2004).

Since its introduction, measures have been taken to further expand the base of VAT. The tax point has been gradually moved 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 (Muriithi and Moyi, 2003). The imposition of VAT has also been 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. Efficient and effective administration is essential to the collection of a tax such as VAT, and it was largely to the achievement of this end that the Kenyan Revenue Authority (discussed later) was set up in 1995.

The result of this reform has been to increase tax revenue from VAT. In the 1988–1994 period revenues from VAT constituted 37% of total Kenyan tax revenue, the largest proportion of revenue garnered by any tax (Muriithi and Moyi, 2003). However, this fell to about 28% in the fiscal year 2000/2001 (Kenyan Ministry of Planning and National Development, 2003). Despite this the revenue gained through VAT has increased year on year since 1990. From KSh 22143m in 1993 the revenue collected from taxes VAT rose to KSh 50220.9m in 2001.

A paper by the African Economic Research Consortium (based in Nairobi) of May 2003 sounded a cautionary note about the success of the imposition of VAT. Although the authors concluded that the reform experience had been encouraging, they concluded that VAT was still the most rigid tax system still in place. Whilst the authors' own analysis indicated that tax reform had succeeded in raising the productivity of the tax system, the exception to this trend was sales tax/VAT. The authors further state that 'The low elasticity of sales tax/VAT (in the period since reform) is surprising given that the base grew faster than income. This suggests collusion between the tax collectors and the taxpayers among other things. Despite substantial reform, significant review and rationalisation of the rates under VAT, further improvements are required in the area of reduction of rates and exemptions, increasing VAT administration capacity through a higher budgetary outlay, increasing tax collectors' salaries and reviewing collusion penalties upwards, and strengthening the development of audit skills' (Muriithi and Moyi, 2003).

It has been a long-term goal of both IFIs and the Kenyan government to expand the scope of direct taxation. However, for developing countries such as Kenya it is difficult to move towards a more even balance of direct and indirect taxation for a number of reasons. The first and most significant problem is the large informal sector. Essentially, if the government does not know about the income received by farmers and farm workers, it can have no hope of taxing it. On a corporate level, the COMESA common market area allows businesses to operate from the country with the lowest tax base and move profits around through transfer pricing. A further consequence of the large informal sector is a lack of information on the part of the government making direct taxation of individuals very difficult.

In an attempt to increase the possibility of direct taxation the top rate for individual tax was reduced from 65% (in 1987) to 32.5% in 1998, making tax avoidance less rewarding. Furthermore, basic tax allowances were increased and simplified. For companies, the top rate of tax was reduced from 45% to 32.5% between 1989 and 1998, and the rate was rationalised by unifying the structure across all types of business (Muriithi and Moyi, 2003). An explicit aim of this lowering of rates was to increase disposable income for both corporate and individual capital investment. Measures to expand the income tax base also included taxation of employer provided benefits, a PAYE amnesty (in 1993), the application of presumptive income tax on selected agricultural produce and the taxation of foreign exchange gains. The imposition of a presumptive tax on agriculture was a particularly notable attempt to formalise parts of the informal agricultural sector. The tax, which was abolished in 1993 and reintroduced in 1995, requires farmers of direct agricultural exports to pay a percentage of their total earnings in tax. From the point of the tax's reintroduction in 1995, this rate was 20% although this has fallen and presently the rate of the deduction is 2% of the gross amount paid (IMF, 2003). A further policy aimed at formalizing the tax base was the introduction of the personal identification number (PIN) for purposes of tax assessment. The PIN was aimed at improving tax information management by identifying all taxable persons in the country so that any transaction made by them could be systematically identified and the appropriate tax captured.

The impact of these reforms has so far been negligible. In 1993 tax revenue from income, profits and capital gains made up 33.37% of total tax revenue. By 1998 this had risen to 37.93%, an increase of just 4.56%. Furthermore, table 1 suggests that the revenue received through income tax has stalled at around Sh 54,000m, where it has been since 1998. The provisional and estimated values for 2002/3 onwards show a notable rise, but there are strong reasons to be sceptical of these to which we return below. That a significant and consistent increase in income tax revenue has not been achieved comes as no surprise. A country's political geography 'has a profound influence on the possibilities for taxation' (Pierson, 1996). In the pre-colonial context the spare distribution of the population meant that it was difficult for governments to tax individuals and so most governments were dependent on taxing trade. Colonial governments proved unable to resolve this problem and customs duties made up roughly two thirds of the total revenue for most of the Colonial period (Hopkins, 1973). As a result, the governments of independent African countries began life heavily dependent on taxing trade, with a very narrow tax base and an inadequate infrastructure for the collection of revenue.

IV. Improving the administration and collection of taxation

With the establishment of the Kenyan Revenue Authority, the focus of international organisations and the Kenyan government shifted to improvements in tax administration as being the key to reducing taxation revenue and widening the tax base. In keeping with international best practice, and following the example of other sub-Saharan African countries, the KRA was set up to be an independent Revenue Authority to organise and monitor the collection of taxes. M.G. Waweru, Commissioner General of the KRA, states as the goal of his organisation as being to 'enforce the tax laws in a balanced manner, such that all the different taxes are collected, across all taxpayer classes and among all classes of income'.

Speaking recently, Waweru added two more aims: to make the KRA '*the leading revenue authority in the world, respected for our professionalism, integrity and fairness*' and to decrease the taxation gap (Waweru, 2004). Concerning the latter aim, Waweru cites a 1997 report by two IMF experts, Carlos Silvani and Katherine Baer, as the motivation for the KRA's current set of policies. The report estimated the following differences between the tax that ought to be paid according to the statutes and that which is actually paid:

1. For Singapore, New Zealand and Denmark, the gap was *10%;*
2. For US, Canada and Chile, the gap was *20%*;
3. For Argentina, Peru and Philippines, the gap was *40%;*
4. For Kenya, the gap was *over 40%* (Waweru, 2004).

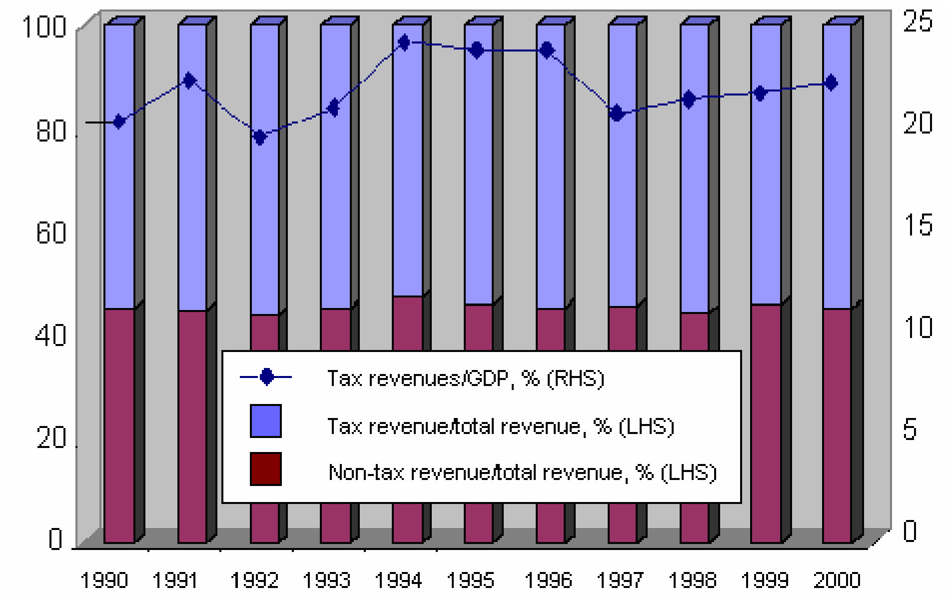
According to a recent evaluation study by the British Department for International Development (DFID) of tax reforms in a number of sub-Saharan African countries, the failure to tax the informal sector and agriculture, and the continued tendency of granting tax exemptions to powerful businesses and individuals with close political connections provide the main reasons why collection appears to have stagnated at a relatively low level. For Waweru, the implication of the report was obvious: 'our challenge is to work towards reducing the tax gap'. What this means in practice is taxation of the informal sector, reducing the high incidence of tax evasion and using information technology in support of the tax administration. To meet these three challenges the KRA has pursued a raft of measures aimed at improving the performance of the administration in line with what lenders from the developed world understand as good governance. Firstly, the KRA has adopted a corporate planning approach to revenue administration. In 2003 the 2003/2004-2005/2006 Corporate Plan was launched, in which the KRA pledged to 'not only to meet government revenue targets, but also to surpass them'.

The Plan uses the Balanced Score Card (BSC) as a performance measurement strategy along four perspectives. These are *financial* (to surpass revenue targets) *internal processes* (increasing efficiency), *stakeholders* (high quality service) and *people* (develop a highly motivated and professional work force) (Waweru, 2004). According to Waweru, monitoring the Corporate Plan by use of the BSC ensures that KRA performance is superb in all areas – that performance must exceed expectations both quantitatively in terms of revenue, and qualitatively in terms of the manner and environment in which this is done. The second strand of the KRA's strategy to close the tax base shows how heavily influenced the organisation is by notions of 'good governance'. According to Waweru 'we are continuously monitoring performance and innovatively applying global best practices in revenue administration within the provisions of the Corporate Plan. We are addressing the challenge of taxation of the informal sector by registering as many taxpayers for income tax and VAT as possible, and conducting focussed audits for optimal tax yields' (Waweru, 2004).

Evaluating the KRA

Recent changes in tax policy, and the work of the KRA, have contributed to some real improvements in the Kenyan tax system. There is a clear drive to expand tax revenue in a fair and comprehensive manner and it is agreed by most international observers that that the KRA has had a positive impact by increasing administrative efficiency, as well as lowering levels of corruption. However, despite the undoubted good intentions of the KRA, and a general increase in capacity within the organisation as a whole, tax revenue has failed to show any signs of the dramatic increase hoped for by Waweru and the international financial institutions.

Figure 1: Development of Kenyan broad tax ratios

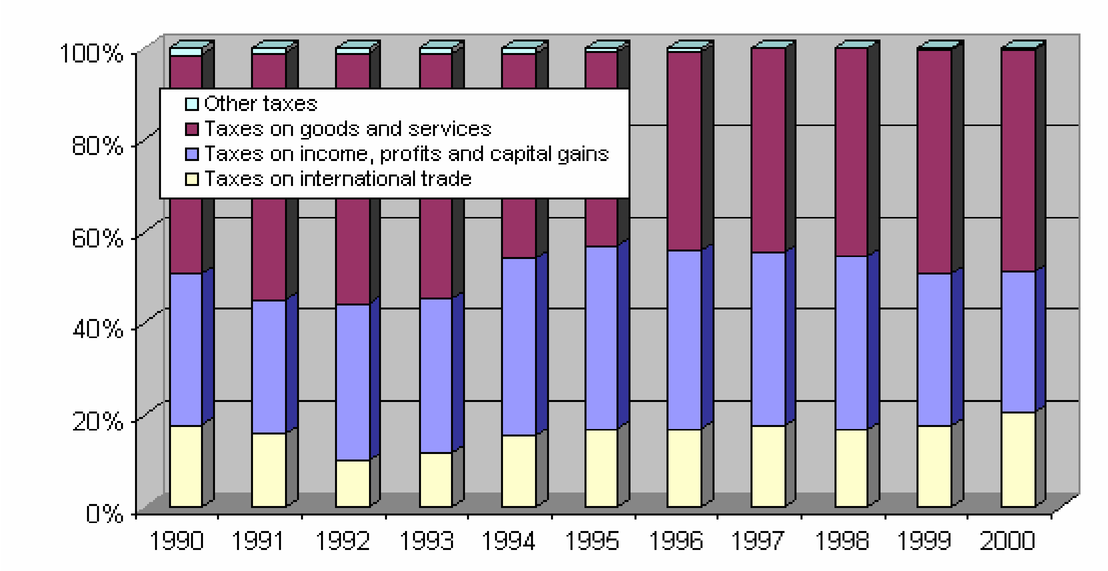


As Figure 1 shows, the proportion of revenue made up by non-tax revenue over the period 1990-2000 ranged between a low of 43% and a high of 48%. However, taking into account that the period where non-tax revenue was a smaller proportion of total revenue was the consequence of donors withholding aid due to frustration with KANU over its reticence to move towards a multi-party system and later its unwillingness to deal with corruption, a more reasonable summary would be that non-tax revenue as a proportion of total revenue has consistently hovered around 45% for the past ten years. Since the creation of the KRA and the time and money spent on tax administration, tax has not increased significantly as a proportion of total revenue. The result is that Kenya is as dependent on external sources of funding as it was twenty years ago.

Not only has there been no real change in tax as a proportion of government revenue, but there has been little change in tax as a proportion of GDP. Figure 1 also shows that tax revenue as a proportion of GDP has remained fairly consistent over the past decade at around 22%. From a high of 23.80% in 1994, before the KRA was established, the proportion dropped to 21.21% in 1998. Of course it may be that none of this is directly due to the performance of the KRA. As was mentioned earlier, the Kenyan government has lost significant revenue over the past decade as the result of economic liberalisation that has denied the country revenue from tariffs.

The impact of economic liberalisation is shown in Figure 2. In 1982 tax from international trade made up 31.98% of the total tax revenue collected in Kenya. This was more than the revenue collected from income tax and almost as much as that collected through the taxation of goods & services. From this highpoint onwards the contribution of taxes on international trade dropped almost year on year to a low point of 15.99% in 1992, before stabilizing around 18% from 1995 onwards. Were the KRA increasing revenue in most areas of taxation, the falling revenues from tax on international trade, caused by trade liberalisation, would provide a good explanation for the inability of the KRA to increase revenues. The organisation has, however, failed to increase revenue in the other areas: table 1 shows that between 1999 and 2001 there was no great increase in VAT collected on domestic manufacture or in income tax.

Figure 2: Shares of total tax revenue (%)



VAT on domestic production did increase slightly from KSh 22,416.62b to KSh 26,325.46b over the period whilst income tax collected did make an even smaller increase from KSh 53,316.99b to KSh 55,861.95b. But neither increase made any real impact on the total tax revenue collected by the KRA, which rose marginally from KSh 184,550.77b to KSh 187,862.79b. For all their increased capacity then, the KRA has not been able to increase the tax revenue in the key areas of income tax and domestic VAT. As a result the tax revenue available to the Kenyan government has not increased and, once again, we must conclude that Kenya is as dependent as ever on international financial institutions and foreign donors.

The KRA has, however, added a gloss of legitimacy to Kenya's tax administration. International donors no longer feel like they are pouring water into a sieve as the KRA is seen, from outside, to be taking measures to close the tax gap and securing more revenue from the domestic tax base. It is perhaps the change in approach and attitude it represents, rather than any increase in revenue collected, which is most encouraging. As an independent organisation aiming to be 'the leading revenue authority in the world', according to its Commissioner General, the KRA can be seen as an important step in Kenya's fight against corruption and in the country's hope to restore international confidence in its principles of governance.

V. Tax administration as tax policy

The fact that attempts to increase tax revenue through increasing the capacity of the KRA have failed is not seen as critical by either the international financial institutions or the Kenyan government. In fact, the international financial institutions seem more than pleased with the performance of the KRA to date. Perhaps the relaxed attitude towards the KRA's failings results from the policy/administration distinction that often lurks at the base of the justification for exporting good governance and good practice ideas. Recently, the structural reforms attached to aid packages have come under great scrutiny and have been criticised for increasing poverty levels and being anti-democratic. As a result international financial institutions have softened such demands, with donors now looking to ensure 'ownership' and 'sustainability' where once compliance and efficiency were the aims. However, the pursuit of good governance has largely been resistant to this policy sea-change, because international organisations can argue that good governance reforms do not interfere with a government's policies, they merely suggest the best way that those policies can be enacted. As they are merely devices for helping the domestic government to implement its own policy choices in a more effective manner, the argument goes, there can surely be nothing undemocratic or questionable about such good governance reforms.

This distinction between policy and administration has been internalised into the administration of the countries themselves. In describing the role of the KRA Waweru argues that 'We need to distinguish *tax policy* from *tax administration*. At the risk of repeating the obvious, let us bear in mind that promulgation of *tax policy* is the domain of the Ministry of Finance (Treasury), while tax administration in Kenya is vested in the Kenya Revenue Authority (KRA). The operational metaphor for the relationship between KRA and the Ministry is *Principal* (Tax Policy: MoF) and *Agent* (Tax Administration: KRA)'.

But the drawing of a clear line in-between policy and administration should be resisted. The emphasis that has been placed on increasing tax revenue through improvements in tax administration is itself a tax policy and to dress it up as anything else will distort the options available to the Kenyan government. This is because in an economy as strapped for cash as the Kenyan economy the financial resources, time and energy that have been spent on the KRA represent a significant and real opportunity cost to the Kenyan government. These are resources that could have been spent elsewhere but have not been as a direct result of the focus on tax administration.

What is more, the KRA and the Kenyan government are being tempted into considering the expenditure of vast sums on further improvements to the KRA's capacity. Speaking this year, Waweru noted that use of information technology in support of tax administration had boosted the tax administration in countries as diverse as Spain, Mexico, Canada, Singapore and New Zealand. Lamenting the analysis of the John F. Kennedy School of Government in 2000 that 'Kenya failed to computerise Income tax administration in the 1970s and Customs administration in 1989', Waweru continued 'We realise that we must use technology to support tax administration, even if this is an expensive venture. How else shall we be able to address the problems of transfer pricing, taxation of e-commerce and tax evasion? We look forward to the time all the KRA departments, both revenue and support, will be networked, and taxpayers and other stakeholders will be able to transact business with KRA online' (Waweru, 2004).

To fully computerise the entire Kenyan tax collection procedure in the way Waweru outlines would cost the Kenyan government hundreds of millions of dollars. Yet this is a government that is currently struggling to raise one hundred million dollars to stave off the threat of starvation for hundreds of thousands of its population following a poor year of rains. To spend vast amounts on computerising the tax system when there are strong claims that this money could be better spent elsewhere cannot be defended on the basis that this is a purely 'administrative' decision. Whether a country needs a better administrative capacity more than better schools and hospitals is itself a decision that needs to be made transparently and defended publicly. The evidence from recent attempts also suggests that such a computerisation policy is unlikely to make much of a difference. This is for two reasons. Firstly computerisation programs have a history of failure in Kenya. Either the contract goes to an unsuitable company, or the program is left incomplete and leaves an organisation with two incompatible administrative systems in which case it is inevitably the newer system that is abandoned. The fate of the computerised passport system which was the brainchild of the US government following the Embassy Bombings in 1998, and which is currently at the centre of one of Kenya's biggest ever corruption scandals is a classic example of the former. The attempt to computerise Kenya's customs administration in 1989 is a pertinent example of the latter.

Secondly, it is unclear that a more efficient KRA would lead to greater tax revenue. The resources that have so far been spent on increasing capacity have not resulted in significant increases in tax revenue, and what needs to be proved before more is spent is that such increases exist to be realised. Unfortunately, in the very latest Economic Recovery Strategy for Wealth and Employment Creation, the first such strategy paper of the Kibaki government, further such modernisation of the KRA is recommended. The remarkable similarity between the aims spelt out in the very latest strategy paper, and those put forward in 1986, serves only to emphasise the shortcomings of the present policy towards tax administration in dealing with the root causes of Kenya's structural problems.

VI. The informal economy and the dependency ratio

There is nothing wrong with having closing the taxation gap as a long term plan but what is dubious is the idea that there is scope for realizing serious gains in revenue from income tax by closing the taxation gap in the short-term. What seems more likely is that there is little scope for gains in this area for a number of reasons, most importantly the widespread levels of poverty which are increasing year on year and the elusive nature of the informal economy. In other words the supposed taxation gap which the KRA is hell bent on closing may in reality be a mirage that, as the KRA perceives itself to be getting closer to closing it, will simply slip further away.

For real gains to be made through decreasing the taxation gap the KRA would have to address two main areas; the informal economy where income and goods transactions are not disclosed, and in the disclosure of personal individual income. In order for Kenyan tax revenue to have the possibility of dramatic increase then, it must be possible for significant increases in the revenues collected from these areas to be realised. However it is unclear that this is the case. Currently, 56% of Kenya's population lives in poverty (IMF, 2003). As with many developing countries, Kenya's distribution of income is highly unequal: the richest 20% are responsible for well over half of Kenyan consumption. In addition to the 56% of the Kenyan population already below the poverty line, a further 7% of the population is forced to live on under $2.15 a day (DFID, 2004). In a country with so many poor people and a minority of very rich people, there is little in between. Many of those just above the poverty line, the 7% mentioned here and the low paid public sector workers detailed below, are likely to be pushed into poverty by the imposition of income tax on their small earnings.

The widespread poverty and lack of potentially taxable individuals is not the only thing that constrains Kenyan tax collection. Of those individuals who earn enough to be taxable by the state, the vast majority are likely to be directly financially responsible for the upkeep of numerous family members. The number of individuals dependent on each wage earner, the dependency ratio, has a direct impact on a countries ability to increase the tax base and tax revenue. Pretty much all less developed countries have notably high dependency ratios. Whilst in the developed world the figure is around 2 dependents to a working person, in the developing world the figure is closer to 6 (Schnitzer 2000). Such a dependency ratio effectively leaves an economy 'destitute in domestic revenue generation' (Yao Akligoh, 2004).

Griffiths & Wall have argued that 'all things being equal, there is an inverse relationship between the tax base (broadening or rate increment) and dependency ratio in these economies'. What they might add to that analysis is that the higher the dependency ratio, the less tax there is that can be collected from the pre-existing tax base without forcing those individuals into poverty. In part this situation arises because of the nature of the jobs that Kenya's taxpayers are doing. In general they are not jobs in the industrial sector where wages tend to be higher, but in the agricultural sector where subsistence living is the norm and wages are minimal. The practice of having children to provide additional labour for the farm does nothing to increase the position of the farmer as production rarely rises above subsistence and no significant economic gains are made.

Yao Akligoh has estimated that whilst an average American farmer produces enough to feed himself and about twenty others, farmers in Africa often only produce enough to feed themselves and three others. 'With many dependants to look after, it is clear that any attempt by government to tax their already starvation incomes will be chronic to their welfare and thus rejected'. The situation is not much better for the urban population because the close links between urban and rural Kenyans, with many workers drifting between the urban and rural areas depending on the job market, mean that those Kenyans in stable employment in the urban areas are likely to be supporting rural family members out of their pay packet.

The high dependency ratio in lesser-developed countries means that when calculating how much tax can be collected from the population, the additional cost faced by wage earners of supporting an average of 6 other individuals must be taken into consideration. Attempting to close the taxation gap by collecting more tax from these individuals will only serve to push them and those who are dependent upon them below the poverty line. It is currently the case that a significant number of government employees do not earn enough to live on, despite the fact that their income levels mean that that they are subject to taxation. Recently, the income tax allowance was increased slightly from KSh 9,400 to KSh 10,000 per month (Agina, 2004). This means, however, that public sector employees, who are paid on average KSh 20,397 per month, and more notably all civil servants who are paid, on average, a gross amount of KSh 12,279 per month, face income tax (Agina, 2004). This means that, after tax and at present exchange rates, public sector employees are paid around $8 a day, with civil servants on only $5 a day.

In an economy where women are not proportionally economically active, and which continues to experience a high birth rate, such low net wages are forced to support many dependents and large families are not uncommon – the average number of children per mother is currently 4.5 (DFID, 2004). Where this is the case, members of a public employee's family may well be forced to live on less than a dollar a day. The government, through its income tax system, is only contributing to this poverty, and to the corruption perpetuated by need. It is widely accepted that public employees will take 'gifts' on the side to make up their income. Such gifts can range from police officers who routinely offer to reduce your fine if you don't ask for a receipt, to hospital officials working at 'free' hospitals taking small payments for health services. While government officials do not earn enough to live and support their dependents, such 'graft' will remain endemic and public perceptions concerning the legitimacy of graft will continue to be ambiguous.

Unfortunately, it is partly pressure from international financial institutions that has kept wages for government employees low. Where there is pressure to balance the budget and decrease government expenditure, the Kenyan government will attempt to keep service provision consistent, while forcing funding down. As a result, many of the government funded and supported services do remain in place, but those responsible for carrying them out see their wages freeze or fall. For the poorly paid workers in the public sector, of whom there are many (the average civil service wage is half that received in the Kenyan private sector), there is simply no 'slack' waiting to be taxed. Attempting to close the taxation gap by collecting from individuals who are currently outside of the tax system may have the same results. Many of those operating outside the system are unlikely to be earning enough to support themselves and their dependents as it is. The additional burden of taxation is likely to push them below the poverty line. Instead of looking simply at the taxation gap, we need to look at what the consequences of closing the taxation gap will be on poverty levels.

To a certain extent the same can be said of the informal economy. Although it is true that there are areas of the Kenyan economy that are currently evading taxation and undoubtedly could contribute, it is also true that much of the informal economy exists as the informal economy because, were it formalised, it would fail to achieve profitability. As a result, attempts to formalise certain areas of the informal economy may lead to a loss of 'informal jobs'. What is needed if the informal sector is to be effectively formalised is to provide the support and infrastructure to that sector to enable the transition to be survived.

This is something increasingly recognised by international financial institutions and the Kenyan government. According to the latest Economic Recovery Strategy released by the Kenyan government, 'The false dichotomy between the formal and informal sectors in our economy has only been meaningful in as far as the small enterprises remain small, are denied needed services, and infrastructure, and do not pay taxes. This strategy for economic recovery progressively seeks to eliminate this dichotomy by providing infrastructure and services, particularly financial, to small and medium enterprises and by ensuring that they pay taxes' (Kenyan Ministry of Planning and National Development, 2003). In other words, for companies to fulfil their duty to pay taxes to the government, the government must fulfil their own duty to provide infrastructure and services to these companies. The government, if it wants to formalise more of Kenya's economy, must do more than simply ensure that more people and businesses pay taxes.

Whilst this approach is much more realistic, it is unlikely to see an increase in resources available to the government in the short term, because providing the infrastructure to support the formalizing of the informal sector is likely to cost as much as, if not more than, the formalizing would initially bring in by way of increased tax revenue. Furthermore, much of the taxation gap that Waweru has set his sights on closing is the result of tax breaks for the political friends of the government and institutionalised corruption by government members themselves and is consequently beyond the reach of the KRA. The international community is more than aware of this problem. On two occasions, in 1997 and 2001, loan programs instituted by the IMF were halted in response to the perceived poor performance of the Kenyan government in dealing with corruption. Although such measures are likely to have some impact, the issues of corruption is so entrenched in Kenyan politics, with so many key cabinet ministers tainted, that a full and open investigation will never be permitted by the current generation of politicians. Until this changes, a significant chunk of potential tax revenue will lie outside the scope of the KRA.

In addition to the fact that replacing taxes from trade with domestic taxes may not be feasible, if it were possible it would most likely be a highly regressive move. Given that direct taxation is unlikely to be able to make up the lost revenue, the Kenyan government is likely to turn to VAT. Although there are problems with expanding VAT as discussed above, VAT collection is far more straight forward than direct taxation. However, an increase in the rate of VAT will increase incentives for companies to stay in the informal sector and 'dodge' the tax. This may damage tax compliance and constrain attempts to expand the tax base. Furthermore, VAT hurts those who consume a higher proportion of their income (to the extent that standard consumption goods such as basic foodstuffs are in the formal sector) and is therefore damaging to the standards of living of the poorest members of society. The higher the Kenyan government is encouraged to increase VAT levels, the more damaging this is likely to be. In contrast to this outcome, a moderate imports tax and a lower VAT would be a relatively 'pro-poor' outcome, whilst representing the same level of revenue for the Kenyan government.

The issue here is not whether or not trade liberalisation is the appropriate long-term goal. In the long-term liberalisation should increase exports and render the Kenyan economy more efficient. By allowing prices to more closely reflect production costs, liberalisation will also bring a shift of resources to sectors in which the Kenyan economy has a comparative advantage (Stotsky et al, 2000). In the long-term this will promote productivity and growth. What is at issue is how 'long' the long-term needs to be. A slow process of tariff reform would allow the Kenyan government to use taxes from trade in the short-term to support attempts to expand the tax base in the long-term. In turn this would increase the ability of the Kenyan government to replaces taxes from trade, which could then be reduced at a later date.

The advantage of this approach is that it would benefit the poorest sections of society in the short-term. It would also maintain a level of revenue security for the Kenyan government, which must be seen as a priority for a country still in the early stages of democratisation. Moreover, this seems like the only viable policy. The combination of high poverty levels, a high dependency ratio and the fragile and elusive nature of the informal economy means that there are no quick and easy ways to increase tax revenue in Kenya. Long-term increases are possible but these depend on investment to enable the Kenyan government to tackle high levels of poverty, the formalizing of the informal market, and the low pay of government employees. The latter is vital as corruption will not cease to be the life-blood of the Kenyan economy whilst public employees earn wages that place them below the poverty line.

Indeed, real increases in income tax revenues are only likely to be achieved if Kenya has a healthy and well-educated population, which means that a broader investment in basic public services is essential if the economy and the tax base is to expand. However these services, just like the provision of infrastructure and increases in the wages of government employees, are dependent on government spending. The government must spend in the short term to reap the benefits in the long term. Yet the budgetary constraints faced by the Kenyan government, imposed by international financial institutions, act as a direct disincentive to this sort of public spending. The benefits from such policies will only be felt in the medium to long term whereas the costs are felt immediately. It is overly optimistic to expect governments starved of cash and struggling to fulfil domestic expectations to genuinely commit to such expenditure, the benefits of which will only accrue to future governments.

It is also worth stressing that for countries in the very early stages of democratisation, fiscal stability is absolutely essential. The IFIs themselves recognise that 'trade liberalisation is a potential source of fiscal instability for African countries because of their high dependence on trade taxes for public revenue' (African Trade Policy Centre, 2004). Given this it is at best unclear as to why further trade liberalisation is a risk worth taking.

VII. Tax exaggeration

One of the most dangerous aspects of current reforms to tax policy and tax administration is that, as a result of the financial constraints placed on the Kenyan government, there is an inbuilt incentive to overestimate tax revenue. This incentive is the result of two contradictory pressures. First of all the NARC government is under great pressure to increase government spending. This pressure comes both as the result of the increased expectations of the public which have been heightened with the advent of multi-party politics, and as a direct consequence of promises made during election campaigns. At the time of writing the NARC government is attempting to deliver on its manifesto promises of free education for all, whilst also trying to head off a national civil service strike by offering pay increases across the board.

The combined effects of these two policies will be to greatly increase Kenya's public spending. This, however, conflicts sharply with the expectations of the international financial institutions and foreign donors for whom the only acceptable behaviour of the Kenyan government to act in a 'financially responsible' manner. In general this is understood to mean maintaining a balanced budget by keeping government spending to a minimum – a commitment that cannot coexist with expensive policies such as free education for all and across the board pay increases for civil servants.

Faced with this tricky dilemma there is some evidence that the Kenyan government has overestimated the tax revenue that will be collected in future years as a way of presenting international organisations with a balanced budget. By greatly inflating the estimations of revenue to be collected, the government can claim that its policy expenses are covered and so access crucial international funds. At the same time, it generates for itself the space to implement its public spending programs that are essential for its popularity domestically. The international financial institutions are only too pleased to discover that the reforms made to the KRA have been successful and have led to great increases in tax revenue. For a while, as donors are told by the Kenyan government just what they wish to hear, all parties are satisfied.

The problems arise when tax revenue inevitably falls far short of the estimate and the government is forced to either cut spending or borrow in order to make up the short fall. In 2002, despite the fact there had been no significant indications of an impending jump in revenue, the Kenyan government estimated that tax revenue for 2001/2002 would increase by 12% on the revenue collected in the previous year[2]. This was broken down as mainly comprising of a siseable rise in indirect tax revenue (KSh 112,485.96m to KSh 125,483.28m) and a massive increase in direct tax revenue (KSh 53,428.93m to 63,107.00m). This would have represented a 12% increase in tax revenues from indirect taxation and an 18% increase in revenues from direct taxation.

However, as table 2 shows this increase never materialised. Instead the estimated tax revenue for the period has been continuously scaled down. The figures

[2] The figures from 2002 and before would have been collected by the Central Bureau of Statistics under the previous KANU government. What is striking from the annual Economic Surveys produced under KANU and those produced during the tenure of the new NARC government is that there seems to be no change in the tendency to exaggerate tax revenues. In part this may well be the result of continuity in the staffing of the Ministries and Bureaus involved in the collation of the surveys. This suggests the possibility that tax exaggeration may be the consequence of administrative procedures and not solely be the consequence of political pressures.

presented in 2004 suggest that the total revenue collected in the 2001/2002 period was actually KSh 187,863.79m, some KSh 28,275.80m lower than the original estimate. The greatest shortfall occurred in import duties, which sheds further doubt on the future development of trade tax revenues.

Despite the fact that previous estimates of tax revenue have proved wildly optimistic, the statistics provided by the Kenyan government continue to predict great increases in tax revenue. As table 1 shows, the original estimate for the 2003/4 period was that total revenue would increase to KSh 237,369.70m, a 13% increase on the provisional figures for 2002/3 and a 26% increase on the last period for which reliable tax collection figures exist, 2001/2. Indeed, for the years when actual tax revenues (as opposed to provisional and estimated revenues) are known, government revenue in Kenya seems fairly stable. Revenue from direct taxation has hovered around KSh 53,000m whilst revenue from indirect taxation seems stuck at around KSh 26,000m. There are some reasons to expect a jump in taxes from international trade, as the change of power in Kenya with the NARC election victory in 2002 was viewed favourably by the international community. Most commentators seem to have anticipated a new period of political stability and economic progress, and this led to renewed foreign aid, loans and investment.

Table 2: Changes in central government estimates of own revenues in 2001/2, KSh (thousands of million)

	Original (2002) estimate	Revised (2004) estimate	Shortfall	
	KSh	KSh	KSh	%
Direct				
Income tax	63.11	55.86	7.25	11.5
Total	63.11	55.86	7.25	11.5
Indirect				
VAT on domestic production	29.66	26.33	3.33	11.2
VAT on imports	26.50	24.55	1.95	7.4
Import duties	31.65	21.58	10.07	31.8
Export duties	31.24	32.08	-0.83	-2.7
Other	6.43	2.07	4.36	67.8
Total	125.48	106.60	18.88	15.0
Other revenue and income	27.55	26.03	1.52	5.5
Total	216.14	187.86	28.28	13.1

Source: Central Bureau of Statistics (see footnote 2).

However, despite the boom in economic expectations that greeted the election of NARC, recent revised estimates of the tax revenue that will be collected in the current year are already predicting that total revenue will be far below that originally estimated. As a result, Kenya is facing a small financial crisis. Recently IMF funds were released after the Kibaki government managed to persuade the IMF that it was doing enough to tackle corruption. However, a number of key donors have failed to follow the IMF's lead and in the absence of this support NARC is struggling to implement its biggest election promise of free primary school education for all. Without the resumption of the loan program, the Kibaki government will be forced to either sharply reduce government expenditure or increase taxes in a bid to tame the budget deficit.

The result is that Kenya has once again to choose between either a series of tax increases and cut backs in government services or taking its begging bowl to the international financial institutions. Anyone wanting an insight into the likely impact of international funds not being released only need cast their eyes back as far as 1998. Attempting to introduce a popular budget, the then governing Kenya African National Union (KANU) ignored limited tax revenue in order to pursue policies aimed at winning the hearts and minds of the Kenyan electorate. At a time of severe drought and power-cuts in Kenya, KANU introduced a budget aimed at reducing poverty and encouraging economic growth. Among the measures announced were the raising of the lowest wages and the removal of two hundred thousand low earners from the tax roll. Just as the economy slowed down and the IMF aid program lapsed, it became evident that government expenditure had exceeded budget estimates, while at the same time, tax revenue had fallen below them. Consequently, Finance Minister Mr. Nyachae was faced with a rapidly widening deficit.

The lapse forced Kenya to raise interest rates from 18% to 26% and to devalue the Kenya shilling against all major currencies. The impact on tax policy was immediate. The lower rate of value added tax (VAT) was raised immediately from 10% to 12% and the higher rate from 16% to 17%. At the same time, duties on petrol and diesel went up and tax concessions on gifts to charities and non-profit organisations were revoked. In addition, Nyachae proposed to increase the tax levied on subsidised loans to bank employees. The moves caused uproar domestically and KANU quickly lost any good will the 'anti poverty' budget had generated. Moreover, some of the reforms proved impossible to implement. In response to the tax increase on their loans, around 12,000 bank employees began a nationwide strike. As the strike entered its sixth day, paralyzing businesses and further damaging Kenya's economy, their employers announced that the striking workers were to be sacked. In response, Kenya's trade union federation threatened to call a national strike and, recognizing the impossibility of his situation, Nyachae was forced to climb down and reverse the decision.

Although the situation in 1998 was caused by many more factors than simple over-estimation of tax revenue and was made more extreme by the dire state of the economic and political landscape in Kenya at the time, the consequences of such a budget short fall in the future are to be similar. A survey of the estimates and final total of tax revenues over the past decade suggests the exaggeration of tax revenues has become an ad-hoc policy response by the Kenyan government to placate domestic and international pressures. If this continues then any hope of a coherent and longer-term economic development plan are likely to be asphyxiated by the short-term survival instincts of elected governments. Clearly any economy in which government spending and taxation plans are based on a routinely false picture of future revenue will find itself locked into a cycle of responding in an ad-hoc fashion to short-falls instead of planning how to invest its surpluses. Unfortunately it is hard to find another explanation for the overestimation of Kenya's tax revenue than a strategic overestimation on behalf of the government. Such estimates could not be as a result of a prediction in the growth of the economy as the Economic Survey for 1999 showed that economic growth decelerated from 4.6% in 1996 to 2.3% in 1997 and has been falling ever since, with no major developments which would suggest a reverse in this trend. Given the fall in growth and the stagnant nature of GDP, as was discussed earlier, such increases in tax revenue can only come from a narrowing of the taxation gap, something which the KRA has so far shown no signs of being able to achieve.

VIII. Policy Recommendations and Conclusions

The self-sufficiency of Kenya depends on the ability of the Kenyan government to increase tax revenue. Given that the tax revenue from VAT seems to have reached a plateau at around KSh 50000m, it seems likely that if significant increases in tax revenue are to be realised in the future that they must come from direct taxation. A crucial problem with the current situation is that the Kenyan government does not receive enough revenue to be able to invest in measures that would expand the tax base in the future. For example in the long run formalizing the informal sector is an essential component in the development of any lesser-developed country. However, undertaking such a task is likely to be a difficult and expensive business. Many of the small industries that operate within the informal economy will be eradicated if they are formalised without the provision of government services and infrastructure to support them. Some areas of the informal sector may only be able to survive the transition with the help of limited period tax breaks, and overall the informal economy may require more support from the government than it is able to contribute in terms of tax revenue. To this extent formalizing the informal sector should be seen as an investment that will reap benefits in the future and not as a short-term way of increasing the tax revenue of the Kenyan government.

Similarly, if tax revenue is to be increased then there is a need to seriously address wage levels in the long-term. The question which should be asked is not ‘how much tax can this individual afford to pay’ but ‘how much tax can this unit of people afford to pay’, where the unit is understood to include the individual and their dependents. Such an approach will lay bare the fact that Kenya will not be able to increase income tax to a level where it is the primary source of taxation and this needs to be accepted by the Kenyan government and incorporated into their spending plans. One obvious way the government can affect wage levels is by paying all government employees a wage on which they can live. This will benefit a significant proportion of the population in wage labour and would support them to not rely on corruption to make up their salaries. In time it would also increase the proportion of the population regularly paying income tax. A further benefit of increasing the wages of government employees is that remaining in government employment will become more attractive. This would encourage skilled workers to seek government employment and may induce the bigger companies to increase the salaries they offer to their own workers.

It is crucial for the long-term expansion of the tax base that these policies are not passed over in favour of investing in the KRA. Increasing administrative capacity is, on its own, a good thing. But such a policy does not attempt to solve the more fundamental problems, many of which have been discussed in this report, that underlie the shortfall in Kenyan tax revenue, such as the small tax base and punitive rates of taxation. What must also be highlighted is the opportunity cost of increasing the administrative capacity of the KRA: as was discussed above, the best administrative practice held up by the IMF presents, in a Kenyan context, a very expensive and frequently unsuccessful template upon which to build. The potentially small gains in tax revenue that would be realised by a computerised tax system suggest that such expenditure may not represent a good investment for the Kenyan government. If the choice is between investing hundreds of millions of dollars in new computer equipment, or in increasing the wages of government workers and improving the health and education services available to those workers, it is the latter policy which is more likely to realise long term expansion in the Kenyan tax base and hence increases in tax revenue.

One of the most worrying consequences of the pressure on the Kenyan government to meet the demands of its domestic electorate and foreign donors is the systematic over-estimation of tax revenue. It is important to note that the average annual change in the tax revenue to GDP in Kenya in the period 1995-2002 was around –3%. This was one of the biggest average falls in the ratio of tax revenue to GDP in sub-Saharan Africa. What this suggests is that although tax revenue has increased it may not have kept pace with the spending commitments of the Kenyan government. This is backed up by the fact that although total tax revenues have increased, the average annual change in the fiscal balance to GDP ratio over the same period was –300% (Africa Trade Policy Center, 2004). Such a decline (the biggest in sub-Saharan Africa) undermines the notion that the Kenyan economy could accommodate a significant reduction in government revenue.

At present the pressures on the Kenyan government provide incentives for the exaggeration of future tax revenues. This is dangerous because it reduces the likelihood of the government making long-term economic development plans. It may also be dangerous, in that it may be taken by the IMF as evidence that real gains in domestic tax revenue exist to be realised. This could lead to the IMF encouraging further inappropriate trade liberalisation. There are two fairly straightforward ways to reduce the incentive to exaggerate future tax returns. Firstly, IFIs could remove some of the pressure by diluting the link between balancing the budget and the release of future aid. Secondly, IFIs could be more critical when presented with estimates that predict a significant increase in taxation revenue that lies contrary to all current economic trends in the country.

The most damaging aspect of the incentive to exaggerate tax revenue is that it undermines long-term investment in a set of consistent and compatible policies. However, even if this were not the case it is unclear that the Kenyan government would have sufficient revenue to both successfully meet public expectations and make significant changes in the working of the economy. If the goal of a self-sufficient and developing Kenya is to be attained, the Kenyan government must be supported in its bid to increase revenue streams. In the short-term this will most likely mean that Kenya should not seek to liberalise trade further. Given the constraints on expanding direct taxation, investment in the economy can only be funded by maintaining taxes on trade. This has the beneficial side-effect of being a reasonably ‘pro poor’ policy, at least compared to the alternatives.

In summary, international actors should:

Short-term

- Accept that formalizing the informal sector requires the provision of government services and infrastructure and therefore is likely to result in a net outflow of government funds in the short term;
- Alleviate the pressure on the Kenyan government to further liberalise trade;
- Encourage the Kenyan government to operate further selected tariffs to generate sufficient tax revenue to invest in expanding the tax base in the long-term;
- Divert funds from expensive projects designed to make the tax administration system more efficient to projects to increase the ability of Kenyan citizens to pay tax.

Long-term

- Support attempts to increase wages, especially those of public sector workers.
- Look to phase out the selected tariffs as and when this revenue can be replaced by revenue raised through direct taxation.

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This OCGG Economy Analysis is part of a series of publications stemming from the OCGG Economy Section's Development and Fiscal Policy project, by early career-stage researchers currently studying and working at leading universities around the world. The central theme is the reassessment of fiscal policy priorities in development.

The project seeks to assess the prospects for poorer countries moving towards stable and sustainable long-term paths on which governments are able to pursue poverty reduction and broader human development goals through the exercise of fiscal policy. Advice for bilateral and multilateral donors will focus on the nature of development assistance provided and on the policy priorities pursued.

The project combines different approaches, leading to research that:

- assesses the experience of specific countries (from Mexican social policy to Kenyan tax administration, from Argentinean inequality to Zambia's use of aid revenues);

- considers the drivers of policy change at national and international level, including a careful case-study assessment of IFI recommendations for fiscal policy made to countries at different levels of income;

- offers new theoretical perspectives (e.g. on political inequality and inflation as a tax, and the decomposition of poverty changes into their growth and inequality components); and

- carries out analysis on newly assembled data (e.g. on the components and nature of redistribution in rich countries).

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The OCGG Economy Section will publish an issue of the Oxford Journal on Good Governance, which will be devoted to the themes of this project. It will include contributions from high-profile external contributors from academia and policy, as well as showcasing OCGG policy advice. Since all of the OCGG's operations – including research, advice and publications – are funded by donation, project sponsors are sought. To get involved with the project, visit the website or contact the section director Alex Cobham at alex.cobham@oxfordgovernance.org.

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