

**TAXATION AND DEVELOPMENT IN A GLOBAL ECONOMY –LAYING A
BASIS FOR TAX REFORMS IN KENYA //**

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DECLARATION

I, JOTHAM OKOME ARWA, do hereby declare that this dissertation is my original work and has not been submitted for a degree in any other University



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This Dissertation has been submitted for examination with my approval as
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ABSTRACT

This dissertation focuses on the relationship between taxation and development on the one hand, and the challenges posed to both taxation and development, by globalization, on the other hand. It starts by rejecting the narrow economic conceptions of development - which equate development with such things as GDP growth, modernization etc - and re-conceptualises development in terms that identifies it with the realization of substantive freedoms and the achievement of social justice, before concluding that the conception of development which is relevant to Africa in general and Kenya in particular is a communitarian conception. It then considers the capacity of the free market paradigm to facilitate the realization of development in its communitarian sense and concludes that since free market paradigm has a tendency to exacerbate rather than eradicate poverty and inequalities, there is need to shift from free market paradigm to a human rights paradigm. The success of human rights paradigm, however, rests upon two fundamental pillars: taxation and an autonomous state - both of which are, however, threatened by globalization. The quest for development therefore translates into a quest for appropriate response to globalization. It concludes that since no state can avoid or reverse globalization, the only option for states to effectively manage globalization is by minimizing its negative impacts while at the same time maximizing its positive impacts, through innovative tax reforms.

These issues are then considered in the context of Kenya and a finding is made that although Kenya has the appropriate normative and institutional framework for the application of human rights paradigm, it lacks the two indispensable pillars discussed above. This is because it has succumbed to global governance and has, as a consequence, reformed its tax system to facilitate globalization - in the interests of the West while lacking the autonomy to reform the said tax system to minimize the negative impacts of globalization (or to take advantage of its positive impacts) in its best interests. This dissertation therefore recommends appropriate tax reforms that would enable Kenya to manage the global economy in the interests of its own development.

PROLEGOMENON

1. INTRODUCTION

Since independence in 1963, the government of Kenya has spent lots of resources in pursuit of development – which has been equated with *per capita* growth, industrialization, modernization, westernization etc – guided by the free market ideology which glorifies the market as the only mechanism through which development can be realized. Forty two years later, it has only succeeded in creating a bifurcated state comprising of a small group of extremely wealthy aristocrats, wallowing in affluence and splendour, surrounded by a mass of extremely indigent individuals, living in conditions of abject poverty without food, shelter, education and virtually all basic amenities. This experience is shared with virtually all developing countries and different approaches have been employed in an effort to find a solution to the problem, with varying degrees of success. This dissertation appraises the various approaches to development and considers the extent to which appropriate tax reforms can offer a panacea.

2. PROBLEM STATEMENT

Concerned that the largest bracket of the populace in the third world cannot afford virtually all basic necessities, such as food, water, shelter, education, medical facilities etc, human rights activists have, in recent years, elevated these basic needs to the status of human rights, thereby imposing on states the duty to ensure that all citizens have access to them. What this implies is that the state, rather than the market, takes over the responsibility of allocating or influencing the allocation of these basic amenities to the polity. This has been referred to as the human rights approach to development.

Apart from the fact that the human rights approach to development conflicts with the free market ideology – since it emphasizes the provision of basic goods

by the state rather than the market - it is also built on two fundamental assumptions, which may not be necessarily true. First, it assumes that states are able to raise the requisite finances, through taxation, to fund the public provision of the basic needs. Available evidence suggest, on the contrary, that in the wake of deepening globalization, states have lost or are slowly losing their capacity to tax their citizens. Secondly, it assumes that states are wholly autonomous, and that they are free to make whatever decision may be in the best interests of their citizens even if such decision may not be very popular with its neighbours or trading partners. This assumption has also proved to be fallacious, especially in view of the dominant role that developed countries play in influencing virtually all decisions made by the governments of developing countries, even to the point of pushing developing countries to make decisions that are detrimental to their own interests but which serve the interests of the developed countries.

This dissertation therefore seeks to establish the link between communitarianism on the one hand and taxation and development on the other hand. Secondly, it seeks to establish the relationship between taxation and development on the one hand and the challenges posed to both taxation and development by the phenomenon of globalization. Finally, it seeks to establish whether the development crisis in Kenya is caused by the insufficiency of tax revenues – due to the growing challenge posed by globalization – or whether it is caused by poor tax administration or both.

3. **CONCEPTUAL FRAMEWORK**

In an endeavour to provide a panacea to the poverty crisis in Kenya and to the development crisis in the third world, this dissertation conceptualises the relationship between two major variables in the study – development and taxation. It puts the conceptual model to test in an effort to establish the significance of he relationship between development and taxation, and concludes

that since taxation plays a pivotal role in development, every effort in pursuit of development should focus on tax reforms as well..

4. **THEORETICAL FRAMEWORK**

The term "development" has been defined differently by different people and in different circumstances. While some people define development as the growth in *per capita* income of a country, others view development as modernization, westernization or industrialization. Some scholars disagree with these definitions and provide different conceptualization of development in terms that equate development with the enhancement of the substantive freedoms of the individuals.

Unless an agreement is reached on the meaning of development, all efforts in pursuit of development are bound to fail. For this reason this dissertation seeks to re-conceptualise development to reveal its true meaning to the objects of development – the people themselves. Chapter one of this dissertation therefore provides the theoretical framework for this study.

5. **JUSTIFICATION FOR THE STUDY**

Poverty crisis in Kenya, as in third world countries has reached a critical point with millions of people dying annually of hunger and starvation. A large bracket of the populace succumb to death caused by treatable diseases owing to inability to afford even the most basic health care. The majority of people do not have access to clean water, education, housing or employment.

These problems have occupied the minds of policy-makers since independence and a lot of resources have been spent in an effort to address these challenges through the instrumentality of development. The situation has however not

improved. On the contrary, it has worsened. On 26th October 2004, in a report issued by the society of international Development, empirical evidence was released which disclosed that the bulk of the national wealth (which is normally used to calculate the GDP for the entire country) belongs to a mere 10% of the population. This means that 90% of the population of this country live in conditions of abject poverty. Such shocking statistics pricked the conscience of the government leading to the formation of a committee of experts to look into the problem of poverty and under development with a view to identifying workable solutions.

This dissertation therefore seeks to show that there is need to focus on the role of taxation in development and that the timely move by the government of Kenya to establish the aforesaid committee needs to be complemented by appropriate tax reforms.

6. **OBJECTIVES**

The objectives of this research can be summarized as hereunder:

- a) To demonstrate that the weakness of the free-market ideology as the dominant development paradigm stem from the vacuity of the economic conceptions of development which subordinate the pursuit of dignified life for **everybody** to the pursuit of extreme wealth and affluence for only a minority of aristocrats.
- b) To re-conceptualise development in terms that conform to the philosophical traditions of the African people which emphasize development of the community (i.e everybody) rather than the individual; (that is to say, a communitarian conception of development in contradistinction to the libertarian conception of the same) and to

illustrate that taxation is pivotal to the realization of development thus conceived.

- c) To search for an ideal paradigm that will facilitate the realization of development in its communitarian sense, in substitution of or in addition to the free market paradigm which can only facilitate the realization of development in its libertarian sense.
- d) To look into ways and means of dealing effectively with the global challenges to the new paradigm in order to ensure its efficacy.
- e) To recommend appropriate tax reform measures that Kenya can effect in pursuit of development.

7. **HYPOTHESES**

The main hypotheses in this dissertation can be summarized as hereunder:

- i) That the conception of development which is relevant to Africa in general and Kenya in particular is a communitarian conception of development.
- ii) That the ideal paradigm for the realization of development in its communitarian sense is a human rights paradigm.
- iii) That human rights development paradigm is meaningless in the absence of a wholly "autonomous" state that is able to fully and optimally tax its people.
- iv) That the twin problems of global challenges to taxation and the loss of autonomy on the part of third world states can be solved if only those

states can effect appropriate tax reform measures that take into account their peculiar domestic circumstances.

8. **CHAPTER BREAKDOWN**

For a more spectral analysis of the research problem, this dissertation is divided into six chapters.

Chapter one focuses on the meaning of the term development. It employs jurisprudential tools in an endeavour to reveal the true meaning of development. It intends to show that the economic conceptions of development are not just narrow, but more importantly, that they are rooted in the liberal philosophy that glorifies the individual at the expense of the community and views the individual as the community's primary antagonist. This is considered to be contrary to African philosophy which glorifies the community at the expense of the individual. It therefore recommends the adoption of a communitarian conception of development which is considered more relevant for Africa in general and Kenya in particular. This chapter therefore provides the theoretical framework for this study.

Chapter two therefore analyses the free market ideology to find out whether it can facilitate the realization of development in its communitarian sense and concludes that it cannot. It therefore recommends the adoption of a human rights paradigm and considers the role of taxation in the realization of a human rights mediated development.

Chapter 3 looks at the global challenges to taxation and analyses the various approaches that developing countries have employed in response to those challenges. Chapter 4 focuses on these issues in the context of Kenya while Chapter 5 considers the appropriate reform measures that Kenya needs to effect if it intends to realize the goal of development.

Chapter 6 offers some concluding remarks.

Each chapter will focus on a specific sub-component of the research problem, with its own theme, which will be captured by a suitable quotation placed at the very beginning of the chapter.

CHAPTER ONE: THE QUEST FOR AN AFROCENTRIC CONCEPTION OF DEVELOPMENT AND A CONFORMING PARADIGM

1 INTRODUCTION

"In saying development, however, most people are now saying the opposite of what they want to convey. By using uncritically such a loaded word, and one doomed to extinction, they are transforming its agony into a chronic condition. From the unburied corpse of development every kind of pest has started to spread. The time has come to unveil the secret of development and see it in all its conceptual starkness"

Gustavo Esteva¹

The quest for development has occupied a central place in Kenya's political agenda since independence when the government identified the triune enemies of development as poverty, ignorance and disease. Despite the fact that lots of resources have been spent in pursuit of this noble goal, the available evidence on the ground suggest that there has been an increase in the level of poverty and inequality. This chapter seeks to understand why this has been the case. It argues that, as a country, we have applied a wrong conception of development which is out of touch with our culture, philosophy and way of life. This conception of development encouraged the adoption of an alien and flawed development paradigm – the liberal paradigm – which glorified the free market as the only effective vehicle for the realization of development. This chapter therefore examines the relationship between development and social justice, on the theory that social justice constitutes the end of development. It identifies three different approaches that can be employed in pursuit of development, and finds that a wrong conception of development was adopted at independence, leading to the choice of an alien development paradigm for Kenya. This circumstance has contributed to the failure of development in Kenya and raises the question as to what development paradigm is ideal for Kenya.

¹ Gustavo Esteva, "Development" in Wolfgang Sachs(ed) DEVELOPMENT DICTIONARY (Watersrand University press) at 17

1.1 **SOCIAL JUSTICE AS THE END OF DEVELOPMENT**

The term development has been given different, and sometimes conflicting meanings. As a result, everyone gets confused by these terminologies. As Gustavo Esteva^{1a} explains "most people are now saying the opposite of what they want to convey" and that "time has come to unveil the secret of development and see it in all its conceptual starkness"

Earlier attempts at defining development have identified it with the growth of gross national product², with the rise in personal incomes³, with industrialization⁴, with technological advancements⁵ and with modernisation⁶. These attributes are, however, nothing but indicators of development and should not therefore be confused with development **Stricto Sensu**. As Professor H.L.A Hart⁷ argues – with reference to the controversy regarding the meaning of "law" - it is only through the employment of a hermeneutical⁸ methodology that

^{1a} Ibid

² W. Arthur Lewis, **The Theory of Economic Growth** Homewood, 111; Richard D Irwin (1955) regarded development as growth of the gross national products. He stated: First, it should be noted that our subject matter is growth and not distribution.

³ Ibid

⁴ Walter W. Rostow, **The stages of Economic Growth: A Non-Communist Manifesto**. Cambridge University press (1960)

⁵ H.W Arndt, **Economic Development: The History of an Idea** (University of Chicago press) (1987)

⁶ Adelman S Paliwala A "Law and Development in crisis" In Adelman and Paliwala (ed) **Law and Crisis in the Third World**" 5 (Hans Zell publishers) (1993).

⁷ H.L.A. Hart "Definition and Theory in jurisprudence (1954) 70 LAW QUARTERLY REVIEW 37. See also H.L.A Hart, The concept of Law (1994) 258.

⁸ Hermeneutic approach is concerned with understanding the significance of social phenomena by those who experience them. It is based on the theory that social life has an internal logic which can only be appreciated by those who participate in it. Strangers disposed to study social phenomena will therefore never fully understand the subjective meaning of the phenomena to who experience the same. Hermeneutic methodology therefore seeks to study social phenomena from the perspective of those who experience them.

philosophically illuminating definitions of social phenomena can be arrived at. Accordingly, a philosophically illuminating definition of development must focus on its subjective meaning to the very objects of development – the people themselves.

One such definition has been offered by Amartya Sen⁹ who conceives of development as freedom. Sen sees development as the process of expanding the real freedoms that people enjoy. According to him therefore, development requires the removal of the major sources of unfreedom: Poverty as well as tyranny, poor economic opportunities as well as systematic social deprivation, neglect of public facilities as well as intolerance or over activity of repressive states.

This broader conception of development therefore narrows the gap between development and social justice. This is because social justice^{9a} also concerns itself with the removal of the major sources of unfreedom as outlined above as well as with the enhancement of the substantive freedoms through the provision of access to and distribution of income and wealth in accordance with principles of fairness. As Marshall^{9a} Explains, social justice involve a situation in which all people enjoy the rights, freedoms and duties of full citizenships, be they civil political, economic, social, cultural or environmental. Clearly therefore, the sphere of development is co-extensive with that of social justice, which ought, to be seen as the end of development. This is confirmed by Article 8 of the Declaration of the Right to Development which provides that states should take all necessary measures for the realization of the right to development by instituting appropriate economic and social reforms with a view to eradicating all social injustices. But if social justice is the end of development, then it follows

⁹ Amartya Sen, **Development as Freedom** (Anchor Books) (1999) 3

^{9a} Marshall T.H, **Citizenship, Social Class And Other Essays**, Cambridge University Press (1950); see also Dee Cook "**Social Justice and Taxation** University, of Wolverhampton

that different approaches may be followed by different societies depending on the society's conception of social justice.

Three different approaches have been identified; utilitarianism, communitarianism, and libertarianism. These three main approaches to development conform to the three main conceptions of social justice.

Utilitarian Conception of Development

A society that subscribes to utilitarian ethics, conceive of development as the process of putting in place social, economic and political structures which enhance the pleasures or happiness of its members. Such a society considers itself developed as long as its members are satisfied and happy with the prevailing economic, social and political structures irrespective of whether some other person might regard them as under developed in accordance with some other conception of development. The late president of Tanzania, Julius Nyerere subscribed to this conception of development. Convinced that it is madness to pursue goals that others have set, he proposed that development should be seen as the political mobilization of the people for attaining their own objectives¹⁰.

Two major strengths of the utilitarian approach to development have been identified as follows: First, it takes into account the results of social arrangements in judging them, that is to say, it is consequentialist rather than deontological in approach that is to say, it focuses on the consequences of an act rather than on **a priori** legal determination of its status. Secondly, it pays attention to the well being of the people involved in judging social arrangements

¹⁰ Gustavo Esteva note 1 at 7

and their results. This has obvious attractions even to those who detest the utility-centred and mental-centric way of judging well-being¹¹.

The utilitarian approach to development however suffers from three main limitations: First, it tends to ignore inequalities in the distribution of happiness, secondly, it attaches no intrinsic significance to claims of rights and freedom¹². Finally, there is no method of calculating the effect of a decision or policy on the total happiness of a relevant population¹³.

These, however, are not the only weaknesses of utilitarianism. John Rawls¹⁴ attacks utilitarianism on the basis that it is incompatible with the conception of social co-operation among equals for mutual advantage. He argues that people who view themselves as equals are unlikely to agree to a principle which require lesser life prospects for some simply for the sake of greater advantages to be enjoyed by others. Accordingly, he concludes that the principle of utility is incompatible with the idea of reciprocity implicit in the notion of a well-ordered society.

Communitarian Conception of Development

Rawls therefore puts forward a conception of social justice that emphasizes social co-operation. He argues that "The intuitive idea is that everyone's well-being depends upon a scheme of co-operation without which no one could have

¹¹ Amartya Sen note 10 to 60

¹² Id at 62

¹³ Freeman M.D.A., **Llodys introduction to Jurisprudence**, 7th edition (sweets and Maxwell) (2001) at 557

¹⁴ John Rawls, **A Theory of Justice** (Revised edition) (199)

a satisfactory life, the division of advantages should be such as to draw the willing co-operation of everyone taking part in it including those less fortunate¹⁵”.

The idea that “everyone’s well-being depends on co-operation is premised on the theory that all natural resources including natural talents, belong to the community as a whole and must be enjoyed equally by everyone in accordance with a scheme of co-operation fashioned politically by the state in accordance with the difference principle which provides that the social and economic inequalities are to be arranged so that they are both (a) to the greatest advantage of the least advantaged.... and (b) attached to offices and positions open to all under conditions of fair equality and opportunity¹⁶”.

Freeman makes the following comment regarding the Rawlsian principle of difference. He argues that “To Rawls, the principle represents “an agreement to regard the distribution of natural talents as a common asset and to share in the benefits of this distribution whatever it turns out to be. He sees the distribution of natural talents as a “collective asset with the result that the more fortunate are to benefit only in ways that help those who have lost out¹⁷”.

Michael Sandel¹⁸ adds a strictly communitarian tinge to the Rawlsian philosophy. He argues that a proper conception of social justice must place the community at the centre. The distribution of benefits to individuals must be based on membership of a political community, which alone has the duty to distribute the community’s wealth in accordance with the principles of fairness.

¹⁵ Id

¹⁶ Brian Bix, **Jurisprudence: Theory and Context** (3rd edition) Sweet and Maxwell (2003) at 108

¹⁷ Freeman M.D.A (Supra) note 14 at 529

¹⁸ See Michael Sandel, “**Morality and the Liberal Ideal**”, The New Republic, May 7 1984 at 15-17

A communitarian society therefore sees development as the process of "generating" as well as "distributing" national wealth and of ensuring its enjoyment by "everybody" in a manner that assures social cohesion, restores social peace and maintains the happiness of everybody. To such a society, development is not merely an economic phenomenon but also and more importantly, a sociological phenomenon. Accordingly, the essence of development does not lie in its capacity to generate, and or even, distribute wealth, but rather in the capacity of the thus generated and/or distributed wealth to contribute to the overall maintenance of social equilibrium.

The treatment of wealth created by private individuals in their personal capacities as "common asset" to be enjoyed by everybody, however, contradicts the central tenets of libertarian philosophy such as the emphasis on the inviolability of the individual, the institution of private property and the freedom of contract doctrine. For this reason the greatest challenge to the primacy of communitarianism comes from the libertarians.

Libertarian Conception of Development

Robert Nozick¹⁹ a firm believer in deontological liberalism, for example rejects the argument that what is, in truth, private property can be treated as "common asset" to be shared by all. He argues that to do so is tantamount to using someone as a means to others' ends which violates the principle of individual liberty. Nozick therefore extols the virtues of individualism, capitalism and the free-market engineering. He puts forward the argument that since the community comprises of individuals, who are driven in all they do by self interest (which is itself too strong to be overridden by any community-centred altruistic

¹⁹ Rober Nozick, **Anarchy, State and Utopia** (1974) at 228

motives) the only way to ensure social justice is to provide conditions in which the individuals can maximise their own wealth – the assumption being that when all the individuals maximize their wealth the wealth of the entire community will have been maximised. According to him the virtues of benevolence, altruism or humanism have no role whatsoever, as the wealth – and by extension, happiness – of the entire community can be maximized without recourse to them through the instrumentality of self-interests of the individuals. Adam Smith argues that "It is not the benevolence of the butcher, the brewer or the baker that we expect our dinner, but from their regard for their own self-interests. We address ourselves not to their humanity but to their self-love²⁰".

Nozick therefore argues that the only legitimate role for the state is to provide a mechanism for the acquisition and transfer of property rights, and to institutionalize the freedom of contract doctrine while abstaining from any interference with the operations of the market. He concludes that once the individuals have acquired property rights within the law, such property becomes, for all practical purposes, outside the reach of the state and therefore the whole idea of distribution is misconceived. He argues that both the concepts of distribution and taxation constitute violations of individuals rights maintains that "There is no such meaningful concept as goods of society but only goods of particular individuals and the society has no prima facie right to shuffle those around between individuals²¹."

Nozick therefore puts forward a strong argument for a minimalist state. What he calls the night – watchman state, which like the night-watch man, watches over the operations of the market without any interference whatsoever.

²⁰ Adam Smith "**Wealth of Nations** (1976) (Campbell and Skinner edition) pp 26 – 27

²¹ Robert Nozick (supra) note 20 at page 169.

1.3 THE SUITABILITY OF COMMUNITARIAN CONCEPTION OF DEVELOPMENT

Having looked at the three different conceptions of development, it is instructive to consider which one of them is suitable for Africa in general and Kenya in particular. The determinant of a suitable conception of development must however be the philosophy of the people concerned on the appropriate balance between the individual interests and community interests. On this issue, three main philosophic positions have been identified. These are totalitarianism, communitarianism and libertarianism. Totalitarianism argues that the collectivity in the form of the state has superior needs and objectives and that individuals exist only to serve these needs. Libertarianism on the other hand argues that the autonomous individual stands at the center of the philosophic universe and the larger community can make no legitimate demands on the individual except those necessary to maintain civil order which is ultimately necessary to enable the individual pursue his own self-interests. Communitarianism holds a centrist position that mediates between totalitarianism and libertarianism. Norton Garfinkle²² puts this point succinctly thus:

"Communitarians seek to mediate the tension between these two forces of extreme autonomy and extreme centralized authority based upon their understanding that societies remain healthy only so long as they effectively provide a balance between the centrifugal forces of autonomy and the centripetal forces of centralized authority"

Communitarian philosophy recognizes that with every right given to an individual, there is a responsibility imposed on the individual in the interest of the community. Accordingly, the grant of specific rights to individuals or groups impose specific demands on all other community members and are effectively

²² Norton Garfinkle, "Communitarian Economics" JOURNAL OF SOCIO-ECONOMICS 26(1997) 1 – 24 at page 1

upheld only as long as the basic needs of all community members are attended to.

The African philosophy on social order is basically a communitarian philosophy. This is because, as with the communitarian philosophy, it provided a value-centred guide to defining the society's common goals. In traditional African societies, individuals had specific rights, although the maintenance of social equilibrium outweighed the satisfaction of individual interests. Makau Mutua²³ emphasizes this point thus:

"The African language of duty, however, offers a different meaning for the individual-state relations: while the individual had rights, they also bore duties. The resolution of a claim was not, necessarily directed at satisfying or remedying an individual wrong....This conception that of the individual as a moral being endowed with rights but also bounded by duties proactively uniting his needs with those of others was the quintessence of the formulation of rights in pre-colonial societies. It radically differs from the liberal conception of the individual as the state's primary antagonist".

In their book entitled major legal systems, David and Brierley²⁴ reiterates the above arguments of Makau Mutua. They argue that in traditional African societies, the role of justice was to decide what is "right" and what is right in the African context is what will "assure cohesion of the group, restore social peace and maintain "social equilibrium"²⁵"

²³ Makau Mutua, "The Banjul Charter and the African Finger Print: An Evaluation of the Language of Duties. 35 **Vanderbilt journal of international Law** 339 (1995) at 344

²⁴ **David and Brierley, Major Legal Systems** (1968) 462-464

²⁵ For more information of the African conception of social justice, read the following: GULLIVER, **Social Control in an African Society** (1963) pp 243 – 272; VAN VELSEN, "Procedural informality, Reconciliation and false comparisons" In Gluckman (ed) **Ideas and Procedures in African Customary Laws** (1949) pp 137 – 149; ABEL, "Customary Laws of wrongs in Kenya: An Essay in Research Method 17 **American Journal of Comparative Law** 573; Jomo Kenyatta, **Facing Mount Kenya** (1965) at page 109.

Before a conclusion can be reached that a communitarian conception of development is still the most suitable one for Kenya, it is important to consider whether the Kenyan philosophy is still a communitarian philosophy, that is to say, whether it has resisted the influence of modernism.

The evidence on the ground suggest that despite the pervasive influence of modernism and the deepening globalization, the dominant philosophy in Kenya today – especially in the rural areas – is still communitarianism. The majority of people who live in urban areas still maintain strong ties with their rural communities and still participate in the cultural life of those communities which remains largely unaffected by the pervasive influence of cosmopolitanism as witnessed in urban centers. It is for this reason that this dissertation maintains that a communitarian conception of development is still the most suitable conception for Kenya today.

1.4 THE IMPACT OF COMMUNITARIAN ECONOMICS ON DEVELOPMENT AND TAXATION

How then would the adoption of a communitarian conception of development impact on development policies and the structure of taxation? In other words, how would it accelerate the process of development in Kenya?

In order to answer the above question, it is important to consider that at present, Kenya has not adopted a definite paradigm to guide its development agenda. While most of its development policies are informed by a firm belief in laissez-fair economy characterized by a decentralized self-interested, autonomous, and rational individual behaviour, a few of its development policies – especially its regulatory policies – are informed by the belief in a command

economy, managed by a highly structured centralized authority. This has created so much confusion and has consequently slowed our development process.

The communitarian approach to development, otherwise referred to as "communitarian economics" seeks to mediate the tension between the thrust towards a laissez-faire economy, and the thrust towards a command economy. Communitarian economics adopts the positive elements drawn from laissez-faire economics, with its emphasis on individual responsibility for wealth creation and the command economics, with its emphasis on community objectives and the government responsibility for their achievement.

There are a number of ways in which the communitarian economics differ from the contemporary market oriented approach to development, otherwise referred to as the free market paradigm. The following are some of the differences:

- While the free market paradigm focuses on questions that can be answered in a value neutral way, communitarian economics insists that clearly defined societal values provide the starting point to development policy deliberations.
- While free market paradigm assumes that the single defined goal of development is to maximize the growth of GDP, communitarian economics insists that GDP growth must be coupled with other socio-economic goals established by a democratic process.
- While free market paradigm assume that individual economic behaviour is solely motivated by rational self-interest, communitarian economics recognizes that human behaviour in the economic sphere as well as in all other areas of activity is motivated not only by rational self-interest, but

also by other considerations – including community values that are reinforced by general approbation for community-defined moral behaviour and general censure of community-defined immoral behaviour.

- Free market paradigm assumes that individuals have a natural right to engage in behaviour that maximizes their economic gain without regard for the consequences of that behaviour on others and the society while communitarian economics insists that individual also has responsibilities to others as well.
- Free market paradigm tends to emphasize the negative effects of government regulation in inhibiting economic growth while communitarian economics support appropriate government regulation to maintain free and open competition and to improve the quality of life for everybody.
- Free market paradigm tends to emphasize the negative effects of taxation in detracting from growth of the economy by diminishing funds available for investment by private individuals, while communitarian economics supports the positive role of appropriate levels of taxation to provide funds for investment to ensure the enjoyment by its citizens of their civil as well as socio-economic rights.
- Finally the free market paradigm tends to evaluate alternative tax structures with respect to their impact on GDP growth while communitarian economics evaluates the same from the point of view of fairness as well as growth.

The adoption of a communitarian conception of development would also have far-reaching impacts on tax structure. The application of the above

communitarian philosophies to taxation would no doubt lead to the formulation of a tax structure that incorporates the following essential elements:

- i) Tax laws should impose tax rates which are low enough for everyone so as to encourage people to engage in maximum economic effort to fulfil their own economic goals and indirectly the society's goal of a growing GDP.
- ii) There should be an adequate tax structure to provide sufficient funds for legitimate and agreed national goals.
- iii) The tax structure should be progressive to sustain the general belief that fairness is achieved when people with higher incomes provide the larger share of tax revenue.

1.5 CONCLUSION

Thus far, I have attempted to illustrate that the appropriate conception of development for Africa in general and Kenya in particular is a communitarian conception. I have also shown that the adoption of a communitarian conception of development would have positive impacts on both development and taxation.

In the next chapter, I will examine the suitability of human rights and the role of taxation in the realization of development in its communitarian sense.

CHAPTER TWO: TOWARDS A HUMAN RIGHTS-MEDIATED DEVELOPMENT: WHAT ROLE FOR TAXATION?

2 INTRODUCTION

"Basically it seems human rights is not an independent category of norms and principles that govern the way development should take place. Rather human rights is assimilated into development, achieved through development"

Antony Angie¹

The conclusion reached at the end of the last chapter is that the relevant conception of development for Kenya is a communitarian conception, meaning that development must aim at promoting social justice for the entire community and not just to a few individuals. In other words, development must balance the interests of individuals with that of the community. This chapter will therefore consider whether this change in the conception of development necessitate a paradigmatic shift from the free-market development paradigm to a human rights paradigm.

2.1 IN DISPRAISE OF THE FREE MARKET PARADIGM

The narrow conceptions of development which identified development with GDP growth modernization, westernisation etc also posited the free market paradigm as the ideal paradigm for the realization of development. This unquestioned belief in the unrivalled capacity of the free market paradigm to promote development obviated the need to conceive of an alternative development paradigm. However with the rejection of the narrow economic conceptions of development and the acceptance of a communitarian conception of development as being the most ideal for Kenya, it is instructive to consider whether the free market paradigm can facilitate the realization of development in its communitarian sense.

¹ Antony Angie, "Time present and time past: Globalization, International Financial Institutions and the Third World" **32 New York University Journal of International Law and Politics**, 243.

Given the experience of the countries that glorified the free market paradigm as the ideal development paradigm, such as America² and Britain³, it is doubtful whether the free market paradigm can facilitate the realization of development in its communitarian sense given its tendency to exacerbate poverty and inequalities.

Why does the free market paradigm exacerbate rather than eradicate poverty and inequalities? To what extent should the free market be relied on to govern development efforts in Kenya?

Neoclassical economic theorists glorified the market as the effective development tool. They argued that most production and distribution could be entrusted to the free competitive market forces with socially beneficial results. This theory that apotheosized the virtues of free market engineering was premised on the libertarian philosophy as discussed above. It was therefore popularized by the Western countries led by Britain and America, which countries have sought to impose it on the third world countries through the instrumentality of the World Bank and the International Monetary Fund. Two positive sides of the market mechanism can however be identified.

² Writing about the harrowing excruciation of poverty amidst the surfeit of plenty, John Steinbeck, in his book, "**The Grapes of Wrath**" narrates the poignant story of poverty and inequalities that followed the adoption of the free market paradigm in America thus: "The fields were full, and starving men moved on the roads. The granaries were full and children of the poor grew up rachitic, and the pustules of pellagra swelled on their side. The great companies did not know that the line between hunger and anger is a thin line".

³ In Britain, as in America, the adoption of the free market paradigm as the economic truism of the new world order resulted in more indigence than affluence, except that the affluent minority were too affluent while the indigent majority were too indigent. In his book, "**The Tale of Two Cities**," Charles Dickens³ narrates how the market mechanism kept the humble masses in inhuman subjection. He writes thus: "It was the best of times, it was the worst of times; it was the age of wisdom, it was the age of foolishness; it was the epoch of belief, it was the epoch of incredulity; it was the season of light, it was the season of darkness; it was the spring of hope, it was the winter of despair, we had everything before us, we had nothing before us; we were all going to heaven, we were all going the other way".

The main advantage of the free market paradigm is that, since it is based on competition, it discourages laziness. As Amartya Sen⁴ argues, distributionist paradigms have a tendency to encourage laziness on the part of the people in expectation of public provisioning of essential goods and services. The many limitations of the market mechanism, which usually encourage the growth of poverty and inequalities, however, overshadow these positive attributes. One limitation of the market mechanism is that it was constructed beneath a thick layer of restrictive assumptions, some of which may be unreal, especially, in the third world context. The free market paradigm assumes that information is either perfect, or is not affected by what is going on in the economy, and that there is no information asymmetry in the market, that one could buy insurance against any risk and that competition is perfect. Joseph Stiglitz argues that these assumptions are utterly false. He argues that even in developed world, markets do not operate as envisaged by the market ideology. This leads him to conclude that perhaps the reason why the invisible hand is invisible is because it does not exist.

There is also the question of the hypocrisy of the free market paradigm. Joseph Stiglitz⁵ for example reveals the disparity between the economic policies America practices at home and the policies it pushes abroad⁷. He argues further that the aid conditionalities that the World Bank and International Monetary Fund impose upon third world countries are insincere⁸. In view of the foregoing, it is evident that if Kenya is to achieve development in its communitarian sense, then it must look for an alternative paradigm.

⁴ Amartya Sen note 10 at 130 argues thus:

Any pure transfer – the redistributions of income or the free provisions of a public service – can potentially have an effect on the incentive system of the economy. For example, it has been argued particularly strongly that generous unemployment insurance can weaken the resolve of the jobless to find employment and that it has actually happened in Europe.

⁶ Joseph Stiglitz, "The Roaring Nineties" (Penguin Books) 2003

⁷ Id at XXVII

⁸ Id at XXVII

2.2 HUMAN RIGHTS: AN ALTERNATIVE PARADIGM?

Since the communitarian conception of development locates the end of development in social justice, it ipso facto identifies development with the granting to all individuals of the right to be provided by the state with all things that make it possible to live a dignified life. To this extent, therefore, the ideal paradigm for the realization of development, in its communitarian sense, is the human rights paradigm. Human rights law imposes on states the legally enforceable duty to provide all citizens with the basic essentials for a dignified life encapsulated in the language of rights. Three categories of rights are therefore recognized under the international human rights law; wit, the first generation rights, second generation rights and third generation rights⁹

The first generation rights comprises of the civil and political rights. These rights are enshrined in the International Covenant on Civil and Political Rights (which has been ratified by Kenya) – and in the constitution of the Republic of Kenya. They include *inter alia*, the right to life, prohibition of torture and human prison conditions, prohibition of slavery, right to liberty and the security of the person, freedom of movement, freedom of religion and of conscience, freedom of assembly, right to non-discrimination and to fair trial, right to equality before the law, right to privacy and to property. If the conception of development by Amartya Sen is anything to go by, then all these rights are instrumental for development. They are considered to be negative rights¹⁰ and are therefore thought to be less expensive to implement¹¹.

⁹ The division of human rights into 3 categories was done by a French philosopher Kavel Vasak: For a more details see Allan Rosas and Martin Scheinin, "Categories and Beneficiaries of Human Rights" in Rajji Hanski and Markku Suksi (ed) **An introduction to the International Protection of Human Rights (supra) at 49.**

¹⁰ This is not true because some of these rights involve taking positive steps by the state. The right to a fair trial, for example, involve the building of courts, police stations and even prisons and employing the relevant staff. This does not just entail the taking of positive steps by the government but is equally expensive.

¹¹ This is untrue because some of these rights require huge sums of money. The right to a fair trial, for example, involve the building of courts, police stations and even prisons and employing

The second generation rights comprises of the social, economic and cultural rights. These include among others the right to work, the right to fair conditions of employment, the right to join and form trade unions, the right to social security, the right to the protection of the family, the right to an adequate standard of living, including the right to good clothing and housing, the right to health, the right to education and the right to culture. These rights are enshrined in the International Covenant on Social Economic and Cultural Rights and in the African Charter on Human and Peoples' Rights both of which have been ratified by Kenya.

The International law obligation on the part of states to ensure full realization of these rights is imposed by in section 2(1) of the International Covenant on Economic Social and Cultural Rights, which provides as follows:

"Each state party to this covenant undertakes to take steps, individually and through international assistance and co-operation, especially economic and technical, to the maximum of its available resources, with a view to achieving progressively the full realization of the rights recognized in the present covenant by all appropriate means, including particularly the adoption of legislative measures".

According to Matthew Craven¹¹ four conclusions follow from this. First, whereas it is open to states to implement the rights in a progressive manner, they must take immediate steps to this end, and do so to the maximum of the available resources. Secondly, such immediate steps can be taken, either individually or through international assistance. This means that a state that lacks the requisite resources is under a duty to seek international assistance and that the international community, as argued by Philip Alston and Gerald Quinn¹³, is under

the relevant staff. This does not just entail the taking of positive steps by the government but is equally expensive.

¹¹ Mathew Craven "The International Covenant on Economic, Social and Cultural Rights in Rajji Hanski and Markku Suksi (ed) An introduction to the International protection of Human Rights (supra) at 101

¹³ Philip Alston and Gerald Quinn "The Nature and Scope of state parties obligations under the International covenant on the Economic, Social and Cultural Rights **Human Rights Quarterly (1987) 156 at 186**

a duty to assist. Thirdly, that lack of resources can only be pleaded by states in respect of fulfillment of such of the rights in the covenant that requires the expenditure of resources. This is because there are other rights or facets of rights in the covenant the realization of which do not require resources. Finally, that the measures to be undertaken by states in the implementation of the covenant are not limited to legislative measures, though such measures are preferable.

Unlike section 2(1) of the International Covenant on Economic, Social and Cultural Rights, section 2 of the African Charter on Human and Peoples' Rights is very clear. It provides that every individual is entitled to the enjoyment of the rights and freedoms recognized thereby.

What exactly, however, is the precise nature of the state's development obligation under the covenant and what is meant by progressive realization? Does the covenant legitimize individual claims against the state for the provision of certain social benefits such as housing, food, water, employment, health, education etc? Does this not amount to an unwarranted interference with the operation of the market? How can the market facilitate the realization of development when states are obligated under international law to interfere with its operations in pursuit of the same goal – development?

According to Matthew Craven¹⁴, the state's obligation under the covenant is to guarantee at least the minimum level of the enjoyment of the rights in the covenant, what the United Nations Committee on the Economic, Social and Cultural Rights has referred to as "the minimum core content of rights".

To ensure that states' obligation to facilitate the full realization of socio-economic rights is beyond doubt, these rights have been constitutionalised in many countries. South Africa for example has constitutionalised socio-economic rights

¹⁴ Matthew Craven (*supra*) at 109

and the recent developments in socio-economic rights jurisprudence now indicate that the government of South Africa is presently under a domestic as well as International law duty to ensure full realization of socio-economic right¹⁵ Kenya has followed suit. The Draft Constitution of Kenya 2004¹⁶ for example entrenches in the constitution the following rights; right to social security, right to health, right to education, right to housing, right to food and right to water in adequate quantity and satisfactory quality.

In South Africa, numerous suits have been brought against the government to enforce the socio-economic rights¹⁷. As soon as the draft constitution comes into force, a similar development will be witnessed here in Kenya.

Several other issues have been raised against the constitutionalisation of socio-economic rights, chief among them being the propriety of permitting a court to sit in judgment over administrative matters, and to order a minister or a department of government to adopt one policy decision over another or to implement a particular policy in a particular way. Does this not infringe on the principle of

¹⁵ For details on socio-economic rights jurisprudence in South Africa, read Anja Snellman "**The developments of socio-economic rights jurisprudence in South Africa**" Masters Dissertation, Department of Social Sciences, Orebro University (spring 2002) Read also Grootboom V. Oostenberg Municipality (2000 (3) BCLR 277), Treatment Action campaign and others V. Minister For Health Case No. 21182/2001 and Soobramoney V. Minister for Health (Kwa-Zulu Natal) 1998(1) SA 765.

¹⁶ This is the so-called "Bomas Draft", a full copy of which can be found in the East African Standard Newspaper as well as the Nation Newspaper editions of 26th March 2004

¹⁷ The major problem however has been the test that a court should follow when determining whether the government has duly complied with its constitutional obligations. It is not clear whether the court, in those circumstances is supposed to follow the "rationality test" – whereby the court simply considers whether the measures taken by the government were rational in the circumstances – as was applied by the South African Constitutional Court in the case of **Soobramoney V Minister of Health (Kwa-Zulu Natal)** or the "reasonableness test" – whereby it has to consider whether the measures taken by the government, apart from being rational, were the most "reasonable" measures in the circumstances – as was applied in the case of **Grootboom V Oostenberg Municipality** (2000 (3) BCLR 277) There is also the question whether the rationality or reasonableness of the policy measure being impugned should be considered at the local, provincial or national level. This is because the rationality or reasonableness of the policy decision will vary depending on the level at which the matter is being considered.

separation of powers? Would it not be more appropriate for such decisions to be made by elected representatives of the people rather than the unelected judicial officer, who may lack the requisite skills to make the most prudent decision in the circumstances? As Cass Sunstein argues that "The Court lacks the tools of a bureaucracy. They cannot create government programmes. They do not have a systematic overview of government policy"¹⁸.

Cecil Fabre however holds a different opinion. He argues that whether judges are competent to deal with constitutional social rights raises different issues. This is because judges can through training be afforded the requisite tools of bureaucracy¹⁹.

Two other reasons why the constitutionalisation of socio-economic rights have been opposed are that governments should not be compelled to interfere with the free-markets and that the inclusion of many positive and enforceable socio-economic rights could work against the efforts to diminish the sense of entitlement to state protection and encourage individual incentives. As Cass Sunstein argues, Constitutionalisation of socio-economic rights establish governmental interference with free - markets as a constitutional obligation. For countries that are trying to establish free - market economies, this is pervasive²⁰.

Cass Sunstein argues further that if positive dispensations from the state are seen as a matter of individual entitlement, there can be corrosive effects on individual enterprise and initiative.

Whatever the grounds of objections raised against the constitutionalisation of socio-economic rights, and whatever the merits of such objections, two things are

¹⁸ Cass Sunstein, *Against positive Rights* **2/1 Eastern European Constitutional Review** (1993) 35

¹⁹ Cecile Fabre "Constitutionalising Social Rights" **6 Journal of Political, Philosophy** (1998) 263 at 281

²⁰ Cass Sunstein – Note 53 (supra)

clear. First, that it has had a fundamental impact on the nature of governmental obligation to promote development. Governments no longer have a choice in the matter. They no longer have a wide discretion in matters of development as they have had for years. Secondly, it has shown that continued reliance on the markets as the perfect instrument for the realization of development goals is misplaced. This is because, as has been explained above, markets encourage the growth in poverty and inequality thereby inhibiting development..

2.3 **THE ROLE OF TAXATION IN HUMAN RIGHTS-MEDIATED DEVELOPMENT**

In chapter one, it was explained that the end of development is the realization of social justice for all. Social justice is said to exist when all people are able to enjoy the rights, freedoms and duties of full citizenship be they civil political economic, social or cultural rights. In his famous "Theory of Justice" also-discussed in chapter one – John Rawls argues that social justice can best be realized when people act co-operatively rather than when they act alone. He therefore discussed the principles for judging or choosing from among various potential arrangements, which arrangement can facilitate the realization, by all citizens, of the rights, freedoms and duties of full citizenship. These principles, according to Rawls, are the principles of social justice; they provide a way of assigning rights and duties in the basic institution of society and define the appropriate distribution of the benefits and burdens of social co-operation. Human rights law then defines the category of rights freedoms and duties to which every individual is entitled, be they civil, political, social, economic, cultural or environmental, and imposes on states a legally enforceable duty to ensure the realization, by every citizen, of those rights. Human rights law therefore provide a perfect instrument for the realization of development.

Poverty, however, militates against the enjoyment by all people of their rights, freedoms and duties of full citizenship and is therefore the biggest threat to the realization of human rights – mediated development. Any state that seeks to

promote development, and concomitantly fulfil its human rights obligations must therefore initiate poverty reduction programmes. This however, can only be effected through taxation and that is why it is important to examine the role of taxation in the realization of human rights – mediated development. For a more spectral analysis, it is important, first to examine the true meaning of poverty and thereafter examine the role of taxation in poverty reduction.

2.31 Poverty As Capability Deprivation

It was discussed in the last chapter, Amartya Sen's definition of development as the process of enhancement of the capability of individuals, that is, the substantive freedoms they enjoy to lead the kind of life that they have reason to value. In his said work Amartya Sen views poverty as the deprivation of basic capabilities of individuals, rather than merely as lowness of income, which is the standard criterion of identification of poverty. The perspective of poverty as capability deprivation, however, does not involve the denial of the sensible view that low income is clearly one of the major causes of poverty. It however emphasizes the fact that lowness of income is only **instrumentally** significant in the definition of poverty but ignores a number of issues that are **intrinsically** significant in the definition of poverty as illustrated hereunder:

- a) That the relationship between income and capability is strongly affected by various factors including age, gender, social roles, environmental factors, epidemiological factors and other variations. For example two people earning the same salary will have different capability if one of them is HIV positive and must therefore rely on regular intake of expensive medications while the other is not; or if one of them has a large family and has to take care of a large extended family as well while the other is single and has no other social responsibility.
- b) That the **relative** deprivation in terms of **Incomes** can yield **absolute** deprivation in terms of **capabilities**. Being relatively poor in a rich

country can be a great capability handicap even when one's absolute income is high in terms of general world standards. A poor person by American standards is no doubt a very rich person by Kenyan standards, though the poor American has a much lower ability to participate effectively in the life of his community than a person earning a similar salary here in Kenya. The poor American is more likely to suffer "social exclusion" compared to a person of the same income living in here in Kenya.

It is for these reasons that the perspective of capability poverty is much more superior to the perspective of income poverty. Moreover, the perspective of capability poverty includes income inequality as an aspect of poverty. For these reasons, poverty-reduction programmes must therefore aim to achieve the twin goals of eradicating both **absolute** as well as **relative** deprivations.

2.32 Taxation as Poverty-Reduction Tool

The definition of poverty as capability deprivation - or put in more practical terms, the inability to enjoy the substantive freedoms to lead the kind of life that a person has reason to value or the inability to enjoy the rights, freedoms and duties of full citizenship – brings into sharp focus the role of taxation in poverty reduction. All the rights, freedoms and duties of full citizenship have a cost element and it is only through taxation that states are able to ensure their realization by the citizens.

In their book entitled "The Cost of Rights: Why Liberty Depends on Taxes"²¹, Holmes and Sunstein, argue that all rights, whether described as negative or positive, have cost. This is a simple truism, but one that many theorists often ignore. They argue that states that cannot arrange prompt visits to jails by tax-

²¹ Stephen Holmes and Cass R. Sunstein" **The Cost of Rights: Why Liberty Depends on Taxes**". New York: W.W. Norton and Company (1991)

payer-salaried doctors, prepared to submit credible evidence at trial, cannot ensure full realization of the right to fair trial. The right to vote requires states to fund the electoral process. Holmes and Sunstein therefore conclude that all rights have cost and reject the cost-blind theory of rights such as that espoused by Nozick²². Though they succeed in bringing out the vitality of taxation in the realization of rights, Holmes and Sunstein only emphasize the role of taxation in funding the realization of rights. Through its effect on human behaviour taxation can be also used to encourage desirable behaviour or to discourage undesirable behaviour. This has given rise to the concept of "fiscal sociology"²³

Other than raising revenue to finance the cost of rights and freedoms as discussed above, taxation also raises revenues for the building of social, economic and physical infrastructure that aid poverty reduction. Moreover, taxation can also be used to facilitate the transfer of wealth from the rich to the poor especially through public spending on welfare programmes, manipulation of tax laws to encourage behaviour that in the long run is beneficial to the poor, and finally regulation of certain activities in a manner that promotes the interests of the poor²⁴.

Public spending has been the preferred or the most obvious instrument for ensuring the provision of socio-economic rights. As soon as the draft Constitution of Kenya 2004 comes into operation, the government of the Republic of Kenya will be duty-bound to ensure the provision, to all citizens of

²² Robert Nozick argues that individuals have rights which are sacrosanct and must not be interfered with by states. He argues that taxation amounts to unlawful interference with private rights. See Robert Nozick, **Anarchy state and Utopia** (Basic Books) New York 1974.

²³ Gerald Easter for example attributes the development of democracy in Poland after the collapse of communism to taxation, and attributes the failure of democracy in Russia after the collapse of communism to its failure to develop a proper tax system. See Gerald Easter, **The politics of Revenue Extraction in Post-Communist States: Poland and Russia compared** 30(4) politics and society 599 – 627. This article can be found at www.sagepub.com

²⁴ Vito Tanzi "Globalization and the Future of Social Protection" IMF working paper (January 2000) This article can be found at www.imf.org/external/pubs/ft/wp/2000/wp0012.pdf

social security, education, health care, housing, food, clean water as well as other infrastructural facilities such as good roads, cheap electricity and other facilities. Given the level of poverty in Kenya, this means that the government expenditure will have to increase by a very large percentage. The government will then need to raise this revenue through taxation.

Apart from raising the requisite revenue to fund the provision of social benefits, the government may use the structure of the tax system to ensure that individuals, through their own private initiatives, engage in activities that improve their access to social benefits. For example order to ensure that all citizens enjoy the right to education, the government may spend more money on education so as to lower its costs to a level that everyone can afford or it may provide education subsidies²⁵. The other alternative is for the tax system to provide deductions from taxable incomes for money spent on tuition fees, textbooks and other school-related expenses. This can be done to enhance access to virtually all social benefits guaranteed by socio-economic rights be they, health care, employment, housing, social security, food or water.

The final mechanism that has traditionally need employed by governments to ensure the realization of basic rights is regulation, through the instrumentality of public law. Various forms of social protection has been afforded through regulation of many areas such as labour markets, housing, financial markets and markets for several public services such as education, health services etc.

Third World countries for example, have relied heavily on regulation as a means of ensuring social protection. Taxation also offer a very useful tool for regulation

²⁵ For details on how education subsidies enhance access to education read Jane Armitage and Richard Sabot, "Efficiency and Equity implications of subsidies to secondary schools in Kenya", in David Newbery and Nicholas Stern (ed) **The Theory of Taxation in Developing Countries** World Bank Research Publication (OUP) 1987 at 589

since it can be used to discourage undesirable behaviour as well as to encourage desirable behaviour²⁶.

2.4 CONCLUSION

In chapter one, the perspective of social justice as the end of development was espoused. It became clear that no development can be realized unless social justice in the Rawlsian sense is institutionalized, or in other words, that no development can be achieved unless all citizens have equal opportunities to enjoy all the rights, freedoms and duties of full citizenship. This, it was seen could not be achieved unless a scheme of co-operation is fashioned. As discussed above this is the communitarian conception of development.

This chapter argues that the free market ideology militates against the realization of development in its communitarian sense and advocates the adoption of human rights paradigm. The human rights law defines the scope of rights enjoyable by all citizens by virtue of their being humans and places on the state the responsibility of ensuring that all citizens have equal opportunities to enjoy these rights. It concludes that for the state to effectively fulfil this role, it must rely on taxation.

²⁶ See Javier Estrada "Insider Trading: Regulation or Taxation?" Chapter 3 Phd. Dissertation, Department of Economics, University of Illinois (April 1996) In this chapter Estrada advocates for shift of policy from direct regulation through the use of public law to the use of taxation to discourage undesirable practices that usually encourage regulation

CHAPTER 3: GLOBALIZATION, TAXATION AND THE END OF THE WESTPHALIAN STATE: RESOLVING THE THIRD WORLD QUADRILEMMA

3 INTRODUCTION

"Taxes not only helped to create the state. They helped to form it...If the tax state were to fail and another form of providing for the wants of the community ensued....what we call the modern state would change its nature"

Joseph Schumpeter (1918)²⁰

Human rights law imposes legally enforceable obligations on the state to facilitate development. The state is obliged to promote ensure, fulfil and protect human rights which are considered as the irreducible minimum development standards. The very useful instrument that states can use to comply with this obligation is taxation. Accordingly, taxation and a powerful, sovereign and autonomous state therefore constitute the twin pillars of human rights development paradigm. This chapter considers the extent to which these two pillars of human rights development paradigm are threatened by globalization. It focuses on the global challenges to taxation as well as on how globalization has rendered statist mode of governance unviable and encouraged the emergence of polycentric regulation¹

3.1 GLOBALIZATION AND TAX SYSTEMS: ECONOMIC OBJECTIVES, TECHNOLOGICAL CONSTRAINTS AND TAX LAWS.

Globalization is knitting separate national economies into a single world economy². This is occurring as a result of globalization of production ,and

¹ Polycentric regulation refers to regulation that occur at - and through inter-connections among- municipal, provincial, national, regional and global bodies, organizations or corporations, and where no single level reigns over others as occurred with the primacy of the state over supra-state and substate spheres in territorialist circumstances. See Scholte J.A "Globalization and Governance: From Statism to Polycentrism"

² Christ Edwards and Veronique de Rugy, "International Tax competition: A 21st – Century Restraint on Government" 431 **Cato Policy Analysis (April 2002) at 1**

trade³, globalization of finance and capital⁴ and technological advancement in the field of transportation and telecommunications⁵.

The combined impact of globalization create conditions which reduce states' abilities to sustain high level taxation, or even to manipulate their tax systems to achieve other socially desired development – oriented goals. In a paper entitled "Globalization, Technological Developments and the Work of Fiscal Termites," Vito Tanzi⁶ discusses eight "fiscal termites"⁷ wrought by globalization that are busily gnawing at the foundations of tax systems. They include Electronic Commerce, electronic money, Transfer pricing, tax competition mobility of human and financial capital, derivatives and hedge funds and increased foreign shopping.

The biggest threat to taxation is posed by electronic commerce. According to Tanzi electronic commerce has been growing at a very fast rate and is expected to reach very high volumes within a few years. A large share of world commerce

³ Ramkishen S. Rajan "Economic Globalization and Asia" ASEA Economic Bulletin, April 2001 See also Arndt Sven, "Production Networks in an Economically Integrated Region" Contemporary **Economic Policy 56 (1998) 80 – 85**

⁴ See Ramkinshen S. Rajan (supra) at 2

⁵ John L. Campbell Globalization and Taxation in Advanced Capitalist Countries chapter 5 of a book entitled Institutional Change and Globalization

⁶ Vito Tanzi "Globalization, Technological Developments and the Work of Fiscal Termites" **IMF working paper WP/00/181**

⁷ Tanzi (supra) uses the term "fiscal termites" to depict how globalization and technological changes will impact on national tax systems. In other words, adaptation of tax systems to globalization is expected to be slow and subtle rather than discontinuous see Mukul G Asher and Ramkishen S. Rajan "Globalization and Tax System: Implications for Developing countries with particular reference to South East Asia" **Center for International Economic studies Discussion paper No. 99/23** (October 1999) at 1 see also Slemrod J "Tax Principles in an International Economy" in M. Boskin and C. Mclure Jr. (eds) **World Tax Reforms**. San Francisco: ICS press.

is already being carried out through the internet⁸. It is predicted that US\$ 3 Trillion worth of goods and services would be traded through the internet by the year 2003. This means that states are already losing substantial amounts of revenue as a result of e-commerce. But why does e-commerce impact negatively on tax systems?

National tax systems – as well as the international tax systems on which they are based – assume that commercial activity can be linked to a particular territory. Electronic commerce challenges this assumption because it is inherently non-territorial. Consequently, the task of locating e-commerce transactions in physical space – and of identifying the participants in this transaction – can be very difficult, or even impossible in certain circumstances given the advancements in technology. This disjuncture between the geographical foundations of modern tax systems on the one hand and the non-territorial character of e-commerce on the other hand, is at the heart of the challenge that e-commerce poses to taxation⁹. Consider, for example, the current methods of direct taxation, which includes personal and corporate income tax. There are two prevailing approaches to direct taxation. One based on **source principle** and the other based on **residence principle**. Taxation based on **source principle** presupposes that tax authorities can determine the geographical source of income while taxation based on **residence principle** requires information about the identity and the residency status of those engaged in income producing activities. Electronic commerce breaks down the necessary and clear connection between territory and commerce and makes this type of information more difficult to obtain. This makes taxation of e-commerce impossible.

⁸ See Vito Tanzi note 8 (supra) at 5

⁹ Roland Paris "Globalization of Taxation? Electronic commerce and the transformation of the state 47, **International Studies Quarterly** (2003) 153 – 182.

The foregoing challenges apply with equal force to indirect or consumption taxes on e-commerce, including Sales Taxes, and Value Added Taxes (VAT). Like direct taxes, the administration of indirect taxes assume that tax authorities are able to (1) identify transactions when they take place; (2) identify the parties involved in the transaction and their physical location; and (3) if necessary follow the "paper trail" in order to audit these transactions, all of which are conditions which e-commerce calls into question. Moreover, one further difficulty that tax authorities face in applying VAT to an e-commerce transaction is to determine the precise value of the different components of a single production process and to identify the specific jurisdiction in which each "value addition" takes place¹⁰

Another major challenge posed to taxation by e-commerce is the shift from the production and sale of **physical** to **digital** products. In contrast to products traditionally sold in shops and in forms that gave them physical content, many new products are losing their physical characteristics. Music, Writing, Photos, Engineering and Architectural Drawings, Medical, Legal and Financial Advice, Educational services and so on are nowadays being sold and delivered over the internet¹¹

Owing to the foregoing, cross-border electronic commerce is currently operating in a tax-free and tariff-free environment. For these reasons, developing countries – who rely predominantly on trade taxes – are losing substantial revenues¹². Moreover, they are unable to manipulate their tax laws to

¹⁰ Mann C.L (2000) **Global Economic Commerce**. Washington D.C: Institute for International Economics, see also McClure C.E Jr "Taxation of Electronic Commerce: Economic Objectives, Technological Constraints and Tax Law 52 **Tax Law Review** (3) 269 –424

¹¹ Tanzi note 8 above

¹² Susanne Teltscher, "Tariffs, Taxes and Electronic Commerce: Revenue implications for Developing Countries" **Policy issues in International Trade and Commodity Study series No.5** (2000)

encourage socially desirable conduct or vice versa, because they are often presented with model tax laws by their developed partners to enact as a condition for getting donor aid.

The second major global threat to taxation is the increasing use of electronic money (e-cash). The credit balances of individuals in banks and financial institutions are nowadays being embedded in chips of electronic cards which are increasingly being used to make payments and settle accounts. This is what is referred to as e-cash.

Electronic cash can be either online or offline¹³. Online e-cash takes the form of soft-ware based system whereby a user would purchase a soft-ware from a participating bank in which digital "coins" are stored to make micro-payments over the internet. Offline e-cash on the other hand refers to a card-based system functioning as a direct alternative to cash. E-cash in both forms can be made available either through accounted or unaccounted systems. In accounted systems, the issuer maintains records of all transactions – thereby making possible audit trails of the user's receipts and payments. In unaccounted system however, no records are kept. This makes it impossible for tax authorities to follow transactions for purposes of taxation. Moreover, even in accounted systems, there are ample opportunities and incentives on the part of the issuer to manipulate the records.

For these reasons, both E-money and internet banking present a major challenge to taxation. The third major global threat to taxation comes from what has been described in the literature as **Transfer pricing**. This is being practiced by multinational corporations to avoid taxation. **Transfer pricing** refer to the setting of prices for transactions among multinational enterprises that are

¹³ Fairpo, C Anne Taxation Implications of Electronic Cash" **Tax Planning International E-Commerce** (July 1999) at 11 – 12

subsidiaries to Multinational Corporations where prices are not subject to market determination¹⁴. Multinational corporations often manipulate transfer prices among subsidiaries in different tax jurisdictions to minimize overall tax liabilities. For example, two trading partners who are subsidiaries of the same multinational corporation may evade corporate taxation using the following tactic. The purchasing subsidiary might overstate the price of a product sold by the selling subsidiary when the selling subsidiary is subject to high tax rate and the purchasing subsidiary is subject to low tax rate.

The Organization for Economic Co-operation and Development (OECD) has adopted international tax rules that address the problem of transfer pricing by enabling tax authorities to adjust transfer prices using Arms Length prices (ALP) principle.

The ALP principle requires that if conditions made between associated enterprises in their commercial or financial relations differ from those that would have been made between independent enterprises, then profits that would have accrued to one of the enterprises may be included in the profits of that enterprise and thus be subject to taxation. The ALP principle is however not practiced in the third world, due to the fact that it can only be implemented through some co-operation among states. Third world countries are therefore losing substantial revenue through transfer pricing.

The fourth global threat to taxation is the international tax competition. Globalization has increased the international mobility of factors of production. The degree of mobility however varies among the factors of production, labour is typically less mobile than capital, though certain types of professional and

¹⁴ Kanokpan Lao-Araya "Emerging Tax Issues: Implications of Globalization and Technology" **ERD Policy Brief Series No. 16 (Asian Development Bank)** May 2003 at 3

technical human resources have not only become very sensitive to cross-border differentials in tax burdens but have become "footloose". Financial capital is also highly mobile and sensitive to tax induced changes in net returns. Foreign Direct Investments (FDI) has therefore become increasingly "footloose". This has led to harmful tax competition as countries have instituted low or nil tax regimes for non-resident individuals and companies. Such countries are popularly known as "Tax Havens" or "Off-shore Financial Centres".

In order to attract FDI, countries have therefore been forced to reduce their corporate income tax rates substantially. This has not only led to an inexorable decline in taxes levied on capital¹⁵ but has also resulted in the shifting of tax burden to the relatively immobile factors such as land and labour. This has adversely affected developing countries, in particular, because of the fact that, in most developing countries labour is relatively unskilled and is therefore unlikely to raise substantial revenue¹⁶

Apart from capital, globalization has also increased the international mobility of skilled labour as well as of consumers. This has led to increased activities being conducted outside of their countries of residence by some highly skilled

¹⁵ For the empirical data on how corporate tax has fallen over the years, see Dahl by Bev "Globalization and the Future of Corporate Income Tax. **Paper published by ATAX, University of New South Wales Discussion paper No. 9** see also Philipp Genschel "Globalization, Tax Competition and the Fiscal viability of the Welfare State **MPIfg working paper 01/1, May 2001**

¹⁶ Reuven S. Avi-Yonah, challenges the economists advice that developing countries should refrain from taxing foreign investors and instead shift the tax burden to less mobile factors like labour, and/or land, which advice he argues, is only valid with regard to portfolio investment. As regards FDI such advice is invalid for two reasons. First, the standard advice does not apply if foreign tax credit is available in the home country of the investor, which is usually the case with FDI. Secondly, the advice assumes that the host country is small contrary to the extensive literature on multinational corporations which suggest that typically they exist to earn economic rent. Avi-Yonah argues that there is a reason for the investor to be there and not anywhere else and that any tax levied on such rents will not necessarily drive the investor away. See Reuven Avi-Yonah "Globalization and Tax Competition" **University of Michigan Law School February (2001)** at 7

individuals, in circumstances that make it impossible for the tax authorities to tax their income from those activities. Developing countries have been the greatest losers in this regard particularly because of the high levels of brain drain that has been witnessed in recent years. Moreover, increased international mobility of consumers had led to increased international shopping. This allows people to shop for expensive but low weight items like mobile phones, laptops, etc in countries which have low sales taxes. This has been encouraged further by the phenomenon of duty free shopping at various airports. This also lead to substantial loses in tax revenue.

Finally, the growth of new financial institutions and agents for channeling savings such as derivatives and hedge funds also threaten the ability of states to sustain high level taxation. Many hedge funds operate from tax havens and financial centers and are therefore not regulated. They use new or exotic instruments which raise new challenges to tax authorities which often do not have the skills to deal with them¹⁷.

3.2 **HUMAN RIGHTS PARADIGM AND THE END OF THE WESTPHALIAN STATE**

As explained above, human rights law presupposes that states are sovereign in the westphalian sense¹⁸. Is this still the case in the wake of deepening globalization? An what are its implications for Development?

¹⁷ Tanzi, supra, note 8 at 12

¹⁸ The modern conception of sovereignty has its roots in the 1648 peace of westphalia which formalized the concept of a system of sovereign state. Westphalian sovereignty held that each state would exercise supreme, comprehensive, unqualified and exclusive rule over its territorial jurisdiction. With supreme rule, the westphalian sovereign state would answer to no other authority; it always had the final say in respect of its territorial realm and its cross-border relations with other states. With comprehensive rule, the westphalian sovereign state governed all areas of social life. With governed all areas of social life. With unqualified and absolute rule, the westphalian sovereign state respected a norm of non-intervention in one another's territorial jurisdictions. With exclusive and unilateral rule, the westphalian sovereign state did not share governance over its realm with any other party. See, Scholte J.A "Globalization and Governance: 36

As early as 1918, Joseph Schumpeter already predicted the end of the westphalian state¹⁹ He wrote that "Taxes no only helped to create the state. They helped to form it and that if the tax state were to fail (to raise revenue through taxation) and another form of providing for the wants of the community ensued then what we call the modern state would itself change its nature"²⁰

Schumpeter agued that the history of the state is inseparable from that of taxation. The modern state defined by the principle of exclusive sovereignty over bounded territory was born out of the fiscal crisis of the medieval European feudalism, which by 14th and 15th centuries was increasingly incapable of raising sufficient revenue to support the mounting welfare expenses. The state therefore emerged as the dominant political organization in Europe mostly due o its capacity to extract resources through taxation than its rivals. In short the modern state was able to survive and flourish because it made fiscal sense: It was the form of political organization that was particularly, well suited to taxing wealth and commerce. As was explained above states have lost this capacity due to globalization. This has substantially contributed to the end of the nation state²¹.

As Kenichi Ohmae argues²² nation "states are dinosaurs waiting to die. They have lost not only their ability to control exchange rates and protect their currencies, but they no longer generate real economic activity" He further

From Statism to Polycentrism" CSGR working paper No. 130/04 (February 2004) at page 6.
URL:<http://www.csgr.org>

¹⁹ Others have predicted the end of the Nation state: The Rise of Regional Economies, Harpercollins publishers 1995) while others only see evidence of the end of developmental state (see Adelman Irma and Yeldan A. Ering "The End of The Developmental State? A General Equilibrium investigation on the causes of the Asian crisis within a Multi-region Inter-temporal CGE model" paper presented a the 2nd Annual GTAP Conference, Odense, Denmark, June 1999.

²⁰ Joseph Schumpeter The Crisis of The Tax State (1918)

²¹ See Kenchi Ihmae, note 20 (supra)

²² Ibid

argues that though governments still cling to jingoistic celebrations of nationhood, the fate of states are increasingly being determined by choices made elsewhere.

In view of the above, the capacity of states to promote, protect, fulfil and/or ensure the realization of human rights, in general, and socio-economic rights in particular has been greatly diminished. This hampers the ability of states to faithfully implement the human rights development paradigm, and increases states susceptibility to global governance through the instrumental of global institutions such as the World Bank, World Trade Organization etc.

3.3 WASHINGTON CONSENSUS AND THE THIRD WORLD QUADRILEMMA: WITHER REFORM?

Globalization is increasingly reducing states' capacity to tax their citizens. This in turn threatens the viability of states themselves and further reduces their capacity to ensure the enjoyment of human rights by their citizens and to implement the human rights development paradigm. This has severe implications for development especially in developing countries.

Taxation is therefore key, not just for the survival of the state in the developing world but *a fortiori* for the process of development. Several questions emerge for consideration. How can the developing world sustain taxation in global economy? How can tax competition flourish between sovereign states, or how can unfair tax competition be eliminated? What is the most appropriate way to tax global enterprises? Does the global economy imply "new taxes" or a need to redesign "old taxes". How can the new opportunities brought by globalization be harnessed to enhance taxation or improve tax yield? Finally what is the role of tax administration in this new global economy?

The third world²³ can respond to the above global challenges in one of four ways hence their current quadrilemma²⁴. They can retreat behind national frontiers and try to move towards an "isolationist" approach to global tax issues. The second option is to press for harmonization of the international tax system; a sort of a global tax code administered by a global tax authority²⁵. The third option is embracing globalization **fully** and the final option is **partial** integration into the global economy, while still pursuing domestic institutional innovations aimed at promoting economic growth as a pre-condition of full integration into the global economy.

The feasibility of the first option is doubtful in the present day global environment. No country can successfully isolate itself to be able to ignore the international constraints and consequences of its tax reform nor would it be desirable. The second option, while appearing to be a rational response to increased internationalization of tax issues is neither desirable, feasible nor, for now, politically acceptable. It would imply governments giving up one of their sovereign rights: the right to tax in a way that best suits the political realities, economies needs and social and cultural values within each country. There is no reason why United States of America, Sweden, Japan and Kenya – or for purposes of comparison, Somali – should harmonize their tax systems.

²³ The phrase "third world" refer to the those countries of Asia, Africa, Oceania and Latin America that are considered "under developed" and are marked by a number of common traits: distorted and highly dependent economies devoted to producing primary products; traditional, rural social structures; high population growth and widespread poverty. See Kasdan A.R, **The Third World: A New Focus for Development** (1973); Hermassi E, **The Third World Reassessed** (1980) and Kleinpenning J.M, The **Third World in Perspective** in this dissertation, the phrase "third World" is used interchangeably with "developing world"

²⁴ Jeffrey Owens, "Taxation in a Global Environment", Paper Published in **Observer** and Public OECD an publication. March 2002

²⁵ Several commentators have argued for the establishment of a world tax organization see Vito Tanzi, "Does the world need a world tax organization? In Assat Razin and Efrim Sadka (ed) **The Economies of Globalization** (Cambridge University Press) at 173 – 186. See also, Frances M. Horner, "Do we Need International Tax Organization?" **24 Tax Notes International 179** (8th October 2001)

Moreover, there is no consensus on what such a harmonized tax system would or should look like, nor indeed is such a consensus likely to emerge in a foreseeable future²⁶.

The World Bank, International Monetary Fund (IMF), World Trade Organization (WTO) and other international organizations are pushing the third world to adopt the third option. Through the instrumentality of these international organizations, the developed world has imposed on the third world a set of tax reforms intended to enhance full integration into the global economy. These reform measures have been referred to as the **Washington Consensus Reforms**²⁷. These reforms, promoted in particular by the above organizations, are built around the following core elements: The abolition of trade taxes; the introduction of broad based commodity taxation in the form of VAT; prohibition on the use of tax system directly or indirectly to redistribute income, or to achieve some other social objectives or to change market signals; lowering of the marginal tax rates on company and private income, simplification of tax systems and the introduction of Autonomous Revenue Agencies (hereinafter referred to as ARAs).

How appropriate are these reform measures given the peculiar circumstances of the third world? Can a uniform set of tax reforms operate optimally in all countries given the major differences in terms of economic and other circumstances between the developed and developing world as well as between the developing countries *inter se*?

²⁶ Jeffrey Owens (supra)

²⁷ The term "Washington Consensus Reforms" has been used by Mick Moore and Aaron Schnieder in an article entitled "Taxation Governance and Poverty: Where do the Middle Income countries fit"? **[Institute of Development Studies Working Paper 230 (August 2004)]** to describe the set of tax reforms imposed on the third world by their developed colleagues.

Various commentators have pointed out a number of weaknesses with the so-called Washington consensus²⁸.

The obsession with the abolition of trade taxes, the removal of import tariffs and their replacement with consumption taxes (in the form of VAT) that is supposed to keep prices unchanged, has been found to have been premised on certain assumptions that are quite unrealistic given the circumstances of the third world. In their article entitled "Price-Neutral Tax Reform with an Informal Economy" Joseph Stiglitz and Shahe Emran²⁹ argue that the theory that abolition, or reduction of trade taxes and the introduction or increase of consumption taxes, like VAT, keeps prices unchanged while at the same time increasing revenue and thereby promoting development, critically depend on dubious assumption that there is no informal sector in the economy and that each and every commodity in the economy can be taxed through VAT.

Stiglitz and Emran demonstrate, using econometric analysis, that, when the feasibility restrictions on the tax instruments imposed by the presence of a large informal and shadow economy is taken into account, the abolition or reduction or trade taxes, followed by the introduction of VAT reduces revenue and militates against development. Stiglitz and Emran's argument has been confirmed theoretically. In his article entitled "Globalization and the Fiscal Autonomy of States"³⁰, Rao illustrates how the third world countries of sub-saharan Africa in particular have been confronted with a trade-off between reduced protection and

²⁸ Dani Radrik in a report entitled "Global Governance of Trade As If Development Really Mattered", Report submitted to UNDP on April 2001 argues that Washington consensus focuses on intergration rather than development

²⁹ Joseph Stiglitz and Shahe Emran "Price-Neutral Tax Reforms with an Informal Economy (mimeo) **George Washington University and Columbia University** (September 2003) see also Shahe Emran and Joseph Stiglitz, "On selective Indirect Tax Reform in Developing countries **George Washington university and Columbia University**.

³⁰ Rai J.M "Globalization and the Fiscal Autonomy of the State" Human Development Report Background papers (1999) Vol. 1 New York UNDP

reduced revenue from liberalization. Specialized economic researches have further revealed the sophistry inherent in the argument that VAT is a non-cascading tax, and hence it has little or no distortionary effect.

The other argument that has been raised against the introduction of VAT is its regressivity, it does not distinguish between the rich and the poor who pay VAT at the same rate. This has severe implications for third world countries where the majority of the people live below poverty line.

Apart from the problems associated with the introduction of VAT there are even worse problems associated with the abolition of trade related taxes in the third world. Third world economies are heavily depended on trade taxes³¹. Most third world countries rely on the export of raw materials and unfinished agricultural products. Unlike the developed world, they do not have alternative sources of revenue. To compel them to abolish or reduce drastically their reliance on trade taxes would be to spell their doom³².

Washington consensus also prohibits the use of tax system to redistribute income or to change market signals. This reform prescription is equally problematic given the role of taxation in development as was discussed in chapter two and in view of the wide inequality gaps in developing countries. It should be noted that the Washington consensus reforms were originally designed for, and are ideal for OECD countries which have elaborate social security schemes. Poverty is not so much of a problem in the OECD countries as it is in the third world. That is why tax systems may not be utilized to address poverty concerns in the OECD while in the third world, tax systems must put in place more efficient and equitable regimes that not only permit the governments to

³¹ Thomas Baunsgaard and Michael Keen "Tax Revenue and/or Trade Liberalization" Fiscal Affairs Dept, International Monetary Fund (20th September 2004)

³² Rohinton Medhora "Tariffs and Trade Liberalization in Developing countries" IDRC Reports.

raise more resources to address poverty and under development, but which would also change the distribution of income in favour of the poorer people³³.

As opposed to the other prescriptions of the Washington consensus reforms discussed above, lowering of corporate and personal income tax the simplification of the tax system and the establishment of ARAs appear to be less problematic, save to add that simplification should not be confused with harmonization of tax regimes or wholesale adoption of reform measures imposed by the developed world, and that the structure and organization of the ARAs in the third world need not conform to the pattern set by the Washington consensus.

The final option that is open to the third world in response to the challenges of globalization is to integrate only partially into the global economy as it built its economic base through the instrumentality of domestic institutional innovations. Once it acquires an economic muscle and is able to compete favourably in the international market then it can fully integrate into the global economy³⁴.

3.4 CONCLUSION

In chapter 2, the instrumental role of taxation in the realization of development was emphasized. It became quite clear that any state intending to develop needs, among other things, to reform its tax laws to maximize tax yield as well as to encourage behaviour that is beneficial to the course of poverty reduction.

This chapter looks at the phenomenon of globalization and illustrates how it threatens the future of both taxation and the state to an extent that calls for an

³³ Toye J. (2000) Fiscal crisis and Fiscal Reform in Developing countries 24 *Cambridge Journal of Economics* No. 1 21 – 44

³⁴ Dani Rodrik "Global Governance as If Development Really Mattered" Report submitted to UNDP April 2001

urgent remedial action. The international financial institutions such as the World Bank and International Monetary Fund therefore took upon themselves the responsibility of formulating the structure of such a remedial action. They proposed a set of tax reform measures which, in their view, would address the problem especially in the developed world. These were so-called **Washington Consensus Reforms**. Their main aim were to facilitate integration into the global economy, mostly in the interest of developed countries. As John Williamson³⁵ argues, these reform measures were meant to serve primarily the interests of the rich nations. They were therefore not targeted at poverty reduction which is the biggest problem in developing countries.

This chapter further discusses how the third world countries soon found themselves being forced by the international financial institutions into adopting the **Washington Consensus Reforms** as the only way out of the quadrilemma in which they found themselves owing to the deepening globalization. Without considering whether they were inimical or beneficial to their interests, they found themselves adopting them one by one.

The next chapter, therefore examines how Kenya responded to this challenge with a view to ascertaining whether the adoption of Washington Consensus Reforms has had a positive impact on its tax revenue and/or administration.

³⁵ See John Williamson "What should the World Bank Think About Washington Consensus?" **World Bank Observer** Vol.15, No.12 (August 2000) pp 251-64

CHAPTER 4: GLOBAL CHALLENGE TO THE KENYAN TAX SYSTEM: A CRITICAL APPRAISAL OF ITS STRUCTURE AND ADMINISTRATION.

4. INTRODUCTION

"Opening up the economy is hardly ever a key factor at the outset. The initiating reforms instead tend to be a combination of unconventional institutional innovations with some of the elements drawn from the orthodox recipe"

Dani Rodrick¹

This chapter examines the Kenyan tax system in general and its structure and administration in particular, to ascertain the extent to which it has been fashioned by the forces of globalization, or in other words whether it is a product of the so-called Washington consensus reforms or not. It will also examine whether the Kenyan tax structure and administration can effectively respond to the global challenges to taxation. Finally, and more importantly, it seeks to investigate whether the Kenyan tax system has the capacity to promote or inhibit development and poverty reduction.

In order to understand what needs to be done in an endeavour to improve the capacity of the Kenyan tax system to facilitate development in a global economy, a comparative study of the Korean tax system, is undertaken. Korea is more ideal for comparison purposes because, like Kenya, Korea emerged out of colonialism as a very under developed country but has managed to achieve development within the space of a few years partly because it was able to initiate and implement tax reform measures that tended to be a combination of unconventional institutional innovations with some elements drawn from the Washington consensus guidelines discussed in chapter 3 above.

¹ Dani Rodrick "Global Governance of Trade As If Development Really Mattered" Report submitted to the UNDP (Harvard University, April 2003)

4.1 **LEGAL FRAMEWORK OF THE KENYAN TAX SYSTEM**

The legal framework of the Kenyan tax system is to be found in the following Acts of parliament.

- The Income Tax Act²
- The Customs and Excise Act³
- The Value Added Tax Act⁴
- The Road Maintenance Levy Fund Act⁵
- The Air Passenger Service Charge Act⁶
- The Entertainment Tax Act⁷
- The Traffic Act⁸
- The Transport Licensing Act⁹
- The Second Hand Motor Vehicle Purchase Tax Act¹⁰
- The Widows and Children's Pension Act¹¹
- The Parliamentary Pension Act¹²
- The Stamp Duty Act¹³
- The Betting, Lotteries and Gaming Act¹⁴
- The Directorate of Civil Aviation Act¹⁵

² Chapter 470 of the Laws of Kenya

³ Chapter 474 of the Laws of Kenya

⁴ Chapter 476 of the Laws of Kenya

⁵ Act No. 9 of 1993

⁶ Chapter 475 of the Laws of Kenya

⁷ Chapter 479 of the Laws of Kenya

⁸ Chapter 483 of the Laws of Kenya

⁹ Chapter 484 of the Laws of Kenya

¹⁰ Chapter 484 of the Laws of Kenya

¹¹ Chapter 195 of the Laws of Kenya

¹² Chapter 196 of the Laws of Kenya

¹³ Chapter 480 of the Laws of Kenya

¹⁴ Chapter 131 of the Laws of Kenya

¹⁵ Chapter 394 of the Laws of Kenya

These statutes prescribe the various taxes that are levied by the laws of Kenya.. The main taxes are, of course, Income Tax, Customs And Excise Tax and Value Added Tax (VAT).

The first income tax legislation was enacted in Kenya in 1937. That legislation was a synthesis of the United Kingdom Income Tax Act of 1920. With minor amendments, this ordinance remained in force until 1950. In 1958, the East African Income Tax (management) Act 1958¹⁶ was passed. This Act established the East African Income Tax Department under the general control of a Commissioner General of Income Tax and three separate commissioners of Income Tax for the three East African countries of Kenya, Uganda and Tanzania. The final development of the Kenya Tax system came about in 1973, following the break-up of the East African Community, with the enactment of the Income Tax Act 1973¹⁷ which made provisions for the charging, assessment and collection of Income Tax. Save for minor amendments¹⁸, this Act remains the primary income tax legislation in Kenya todate.

The second major tax legislation is the Customs and Excise Tax Act. This Act was passed in 1977. Excise taxes are imposed by the government for three main reasons. First, they are used to correct negative externalities arising from consumption of certain products such as tobacco, alcoholic drinks etc. The second criterion for excise taxes include their ability to raise substantial revenue for the government at relatively low administrative or compliance costs. Thirdly Excise taxes are used to improve vertical equity in the country. It is for this reason that vehicles with higher engine capacities are subjected to very high excise taxes.

¹⁶ Act No. 10 of 1958

¹⁷ See Note 13 above.

¹⁸ Minor amendments were effected in 1989 and 1996

The third major tax legislation in Kenya is Valued Added Tax (VAT) Act. VAT was introduced in Kenya in 1990 in replacement of Sales Tax which had been in operation since 1972¹⁹ VAT is levied on consumers but is collected stage by stage through the chain of production and distribution. To avoid the undersirable cascading effect of sales tax, the liability at each stage is reduced by the tax already suffered on purchases, leaving the net payment to relate only to the value added at each stage²⁰. VAT is chargeable on Imports, domestic production and the supply o goods and services.

All goods are chargeable to VAT at a standard rate unless otherwise stated, that is to say, unless it is either Zero-rated or exempt from VAT. In contrast, only listed services are taxable at the standard rate while all unlisted services are exempt from VAT.

Apart from the three principal tax legislations discussed above, several non-tax revenue form an important component of Kenyan's tax system.²¹ These are imposed by the numerous statutes listed above such as the Traffic Act, Transport Licensing Act, Stamp Duty Act etc.

4.2 **INSTITUTIONAL FRAMEWORK OF THE KENYAN TAX SYSTEM**

Prior to 1995, the numerous tax legislations discussed above were administered by different departments of the government under the various ministries of the government.

¹⁹ Nicholas T.T Simiyu, Taxation in Kenya (2003) at page 175

²⁰ Ibid

²¹ Stephen Njuguna Karingi, Revenue Design: The Kenyan Experience (paper prepared by Kenya Institute of Public Policy Research and Analysis for the World Bank Institute and the World Bank in June 2001)

Income Tax Act for example was administered by the Commissioner of Income Tax while both VAT and Customs and Excise Taxes were administered by the Commissioner of VAT and Commissioner of Customs and Excise Taxes, respectively.

This institutional arrangement led to numerous cases of corruption, theft and fiscal inefficiencies. This arrangement encouraged the establishment of patronage networks between the ruling elite and the tax administrators. Accordingly the government was unable to raise sufficient revenue to meet its budgetary requirements. For this reason the government was left with no option but to rely heavily on donor aid and loans from international financial institutions, an option, which only served to exacerbate Kenya's development crisis. This coincided with the period when aid donors and international financial institutions were pressurizing developing countries to create (semi) autonomous revenue agencies (ARAs) Kenya therefore found itself under intense pressure to establish an ARA. The two central features of ARAs were:

- a) The centralization of all (or most) national-level tax collection activities within a single agency.
- b) The granting of considerable administrative and/or political autonomy to the management of those agencies.

The donors' attachment to ARAs stemmed from the following sources:

- A perception of the existence of major problems in the existing tax administrations including corruption, the use of tax laws to harass perceived political enemies, and inefficiencies arising from low public service salaries which created an incentive to engage in corrupt activities.
- The natural inclination of donors to support tax reforms focused on administrative issues to favour considerable administrative re-organisation

and creation of a single powerful tax authority to which they could conveniently relate.

- The recent popularity in national and international circles of the general notion of providing major public economic agencies with the "autonomy" from immediate political masters that might enable them to take decisions influenced by long term and collective – rather than short-term and narrow – consideration.

It should be noted however that despite the insistence by the aid donors and the international financial institutions on the creation of ARAs by developing countries, ARAs have never been a feature of their own tax systems. This raises the question whether we really needed an ARA.

On 1st July 1995, the government of Kenya succumbed to international pressure and established an ARA in the name of **Kenya Revenue Authority** which was established through an Act of Parliament²² and charged with the responsibility of collecting revenue on behalf of the government. A board, whose membership is drawn from the public and the private sector makes policy decisions which are implemented by the Kenya Revenue Authority Management. The chairman is appointed by the President of the Republic of Kenya. The chief executive of the Authority is the Commissioner General who is appointed by the Minister for Finance.

The purposes of the Authority are assessment of taxes, collection of revenue and administration and enforcement of laws relating to revenue.

The Authority is divided into four divisions each of which is headed by a commissioner. These are Income Tax division, Value Added Tax division,

²² The Kenya Revenue Authority Act

Customs and Excise Tax division, Road Transport division and the support services division.

The evidence on the ground suggest that despite the fact that its creation was as a result of demands made by the aid donor countries, - which themselves never had an equivalent institution – the establishment of the Kenya Revenue Authority has greatly improved the revenue collection in Kenya. According to the Central Banks economic statistics²³ the collection of taxes has improved greatly. By 29th April 2005 the government had collected Kshs.227.4 Billion taxes out of its budgeted target of Kshs.238.3 Billion. This reflect a 95% of its budgeted tax.²⁴

The marked improvement in collection of taxes has however not been accompanied by an improvement in development. Although there are signs of economic growth in the future as stated in the **Economic Survey 2005**, the quality of life for the ordinary Kenyan's has continued to deteriorate²⁵ Kenyans are therefore getting poorer by the day as poverty levels increase.

4.3 **CRITICAL APPRAISAL OF THE KENYAN TAX SYSTEM**

Thus far, I have attempted to show that poverty levels have continued to soar in Kenya despite the numerous tax reforms that have been effected in Kenya since independence. This shows that there is need to critically appraise the Kenyan Tax system, otherwise referred to as "revenue design"²⁶ in an endeavour to create a propitious environment for effective taxation that can facilitate development. What follows, therefore, is a critical appraisal of the Kenyan tax

²³ See Central Banks' **Weekly Economic Report** dated 6th May 2005

²⁴ See **Sunday Nation** Edition of 15th May 2005 at page 19.

²⁵ See the **Economic Survey 2005** released by the Minister for Planning Prof. Anyang' Nyong'o on 25th May 2005.

²⁶ See Stephen Njuguna Karingi: "**Revenue Design: the Kenyan Experience**" Paper prepared by KIPRA for World Bank Institute in June 2001 at 2.

system. In order to illustrate that what Kenya needs are domestic institutional innovations rather prescriptions from abroad, I will thereafter undertake a comparative study of the Korean tax system which adopted the latter rather than the former.

With the onset of globalization in the early 1980s the Kenya tax system found itself under a lot of pressure. The tax structure became unproductive. Growth in revenue failed to catch up with government spending pressures, a situation which occasioned huge imbalance between the demand and supply of public budgetary resources. Kenya found itself squarely faced with the quadrilemma discussed in chapter 3 above. It had to reform its tax system to cope with the new challenges. At around the same time the developed world was busy pushing the third world to reform their tax systems in conformity with the Washington consensus reforms. The main elements of the Washington consensus reform programme included²⁷:

- Imposing a small number of taxes with the broadest possible base and moderate rates
- Phasing out tariffs and trade related taxes completely
- Using VAT to replace tariffs and commodity taxes
- Avoiding tax incentives and instead shifting to broader simpler tax bases on which lower rates are applied
- Reducing corporate and individual tax rates.
- Establishing Autonomous Revenue Agencies (ARAs)

As already discussed, these measures were intended to facilitate full integration into the global economy. Could these reform measures – without more – be sufficient to enable the Kenyan tax system to adequately address the challenges

²⁷ Moses K. Muriithi and Eliud Dismas Moyi "Tax Reforms and Revenue Mobilization in Kenya" **Africa Economic Research Consortium Research Paper No. 131** May 2003

of globalization? Were they consistent with the goal of development and poverty-reduction? In more practical terms, was integration into the global economy the key factor in Kenya at this time?

Dani Rodrik argues that the advocates of globalization – who glorify the theory that globalization holds the key to development everywhere – have got it all wrong. He argues that the purpose of world trade is to raise living standards – rather than to maximize trade as an end in itself. Since globalization presupposes capacity to effectively compete in the global market, it presupposes equality in terms of economic power. The ideal situation according to Rodrik is for the third world countries to strive to achieve significant economic growth before they can open their economies to international competition. This they can achieve through the instrumentality of domestic institutional innovations that often depart from the prevailing orthodoxy. He opines that transitions to high economic growth are rarely sparked by blue prints imported from abroad and that opening up the economy is never a key factor at the outset.

The development experience of the Asian Tigers²⁸ bear this out. In their quest for development, the Asian Tigers adopted tax systems which contradicted virtually all the prescriptions of the Washington Consensus Reforms. This is how they managed to achieve development within a very short time.

Kenya, on the other hand embarked on a process of reforming its tax system to bring it in line with the Washington consensus reform. The initial reforms were the introduction of sales tax in 1972; the establishment of income tax in 1973; and the introduction of customs and excise taxes in 1977.

²⁸ The term Asian Tigers refer to the newly developed countries of East Asia comprising of Korea, Japan, Singapore, Taiwan and Malaysia.

From mid 1980s, Kenya embarked on ambitious tax reforms intended to bring its tax system on all fours with the Washington consensus reforms. These emphasized the introduction of either new taxes or new rates on existing bases, more stringent changes to seal loopholes that encourage tax evasion, and the need to widen tax bases and reduce exemptions. These reform measures were intended to restore the buoyancy and elasticity of taxes. Massive tax reforms commenced in 1986 following the passing of the sessional paper No.1 of 1986. These focused on the reduction of direct taxes through a widening of tax brackets and gradually lowering income tax rates. Indirect taxes have been increased to cover revenue shortfall. Though this conforms to the prescription of the Washington consensus, they encourage poverty and under-development in Kenya. This is because indirect taxes are regressive and therefore impose greater burden on the poor and accordingly reduce the redistributive effect of the tax system. This has a negative impact on development.

Notably there has also been a shift from international trade taxes to taxes on domestic goods and services. In order to offset the shortfall in revenue, VAT has been introduced and has become the primary source of revenue in Kenya, generating about two-thirds of domestic taxes on goods and services²⁹. This is based on the assumption that, since VAT is an indirect tax, and non-cascading in effect, it does not distort the operations of the market.

In line with the objectives of Washington consensus reform agenda, Kenya's customs taxes under-went significant changes during the reform period in the direction of restricting duty exemptions, encouraging exports, reforming tariff structure and strengthening the administration of customs duties. Broadly, these reforms were aimed at encouraging a free market atmosphere and increasing the level of integration into the global economy.

²⁹ Moses K.Muriithi and Eliud Dismas Moyo (Note 4 supra).

During the 1987 to 1998 the top tariff rate was reduced from 170% to 25% while the rate bands were reduced from 24 – 5 (including duty free) As a result of these changes, the simple average rate fell from 40% to 16%.

Before 1991, the exemption system was more generous in the interest of poverty reduction and development. Agricultural commodity aid was exempted to boost agricultural activities on the part of the poor. Non-Governmental Organizations were given generous exemptions to enable them promote development especially among the poor. These exemptions were however removed in the interests of greater integration into the global economy between 1994 and 1998.

In the same period, a number of tax measures which were introduced to encourage export were removed. Export compensation scheme for example, was introduced by the Kenya tax system to encourage export. Export compensation scheme was also abolished in 1993 since it was also distortionary of the market operation and was therefore inimical to full integration in the global economy. Similarly, export duties and export licencing were also abolished. This reforms went hand in hand with Similar reform measures which were intended to facilitate full integration into the global economy. These included Export Processing Zones (introduced in 1991) full import liberalization (introduced in mid 1993) and exchange liberalization (introduced in late 1993).

In order to compensate for the loss of revenue caused by the reduction and/or the phasing out of International Trade taxes, Value Added Tax (VAT) was introduced in Kenya in 1990. The introduction of VAT was motivated by the argument that VAT is less distortionary, that it has a higher revenue potential and that its collection and administration are more economical, efficient and expedient.

There are three types of VAT: the first is a tax on consumption which allows for tax deduction on capital and intermediate goods. The second type is a tax on income which amortizes purchases of capital inputs over the expected life of such goods. The third is a tax on gross products which does not allow VAT deduction on Purchases of Capital. Kenya first adopted the first type – the credit/invoice VAT system on consumption.

In order to enhance the productivity of VAT, a number of steps have been taken to rationalize and strengthen it. These included moving several items subject to VAT from specific to ad valorem rates, and broadening the VAT coverage in the service sector. They also included the reduction of the maximum rate from over 150% to 15% between 1990 and 1997 and the reduction of the rate bands from 15 to 3. Moses K. Muriithi and Eliud D. Moyi³⁰ however report that these reforms failed to increase the elasticity and bonyancy of VAT. But has VAT succeeded in compensating for the loss of revenue caused by the reduction and/or phasing out of international trade taxes? Has VAT succeeded in increasing, in a sustained manner, revenue for the government?

The above question is answered in the negative by Tony Addison and Jorgen Levin³¹. They argue that VAT productivity³² declined over the 1990s period, having fallen from 41% at the introduction to 36% in 2000. They argue that this productivity level is too low especially in comparison to the VAT productivity in Latin America countries whose VAT productivity are much higher.

The failure on the part of VAT to successfully compensate for the loss of revenue caused by the reduction of international trade taxes is partly contributed to by

³⁰ Ibid

³¹ See Tony Addison and Jorgen Levin "Tax Policy Reform in Developing Countries" UNU/WIDER, HelsinkiFinland and Orebro University, Sweden, Third Draft 2006-06-17 at page 13

³² VAT productivity is defined as VAT revenue as a percentage of GDP divided by VAT tax rate.

the specific weaknesses of VAT discussed in Chapter 3. These include, the fact that VAT is after all not a non-cascading tax – contrary to conventional wisdom – and accordingly it has a distortionary effect on the economy, and the fact that VAT productivity is greatly hampered by the presence of a large informal sector in the economy.

The failure of VAT successfully compensate for revenue loss caused by the reduction of international trade taxes not only illustrate how the government of Kenya has continued to lose substantial revenue due to the adoption of Washington consensus reforms, it also undermines the intellectual foundation of the said Washington consensus reforms. The government's capacity to undertake the provision of public services as part of its development agenda has therefore been greatly hampered.

Despite the efforts aimed at cushioning the poor against the effect of VAT through the exemption³³ and Zero-rating³⁴ of products and services consumed mainly by the poor – such as food and other agricultural products, educational services, health related services etc - VAT remains a very regressive tax. It increases a greater burden on the poor and reduces the redistributive effect for the tax system. To minimize this, Excise Taxes were introduced in Kenya in 1991. the advantage of excise taxes is that they have the potential to raise substantial revenue at very low administrative or compliance costs. Excise taxes can also be used to correct negative externalities arising from the consumption of excise taxed products, which include alcoholic drinks, cigarettes and petroleum products.

³³ Exempt goods and services refer to goods and services on which no VAT is chargeable at all

³⁴ Zero-rated goods and services are good and services which are chargeable to VAT but at Zero rates. This enables traders and manufacturers to claim VAT paid in inputs.

The final category of tax in Kenya are taxes on income and profits. In line with the Washington consensus recommendations, these taxes have also been broadened over the years by reducing the maximum rates. The top rate for individual tax was reduced from 65% in 1987 to 32.5 in 1998. Furthermore, the basic tax allowances (tax credits) were increased and simplified while the single credit per individual was introduced in 1997. Similar changes were reflected in the corporate tax structure which have been reduced from 45% between 1989 and 1998³⁵.

Individual income tax as well as corporate taxes have also been rationalized to improve their productivity. These reforms included the abolition of the classical double taxation with the current single-stage taxation, limiting the taxation of dividends to a final tax, introduction of a compensating tax to ensure that all corporate taxes are paid out of after tax profits, the introduction of person identification Number (PIN) to ensure identification of all taxable persons, and the introduction of Pay-as-You-Earn (PAYE), withholding tax and the presumptive income tax. The Income Tax Act also provide personal relief to tax payers. To ensure that low-income tax earners are cushioned against bracket creep and while ensuring that high income earners bear a larger proportion of tax burden, these tax reliefs have been reviewed over the years.

Finally, pursuant to the conditions set by the Washington consensus reforms that required third world countries to establish Autonomous Revenue Agencies (ARAs), Kenya Revenue Authority was established by an Act of parliament on 1st July 1995. The authority is charged with the responsibility of collecting revenue for the government, assessing tax liabilities of individuals and the administration and enforcement of all laws relating to revenue.

³⁵ Stephen Njuguna Karinga (supra)

From the foregoing, it can be seen that the recent reforms of Kenyan tax system have been tailored to comply with the provisions of the Washington consensus reforms. This was largely due to the pressure exerted by the World Bank, the World Trade Organization and the International Monetary Fund. A useful insight into the question whether these reform measures have the capacity to reduce poverty and promote development is provided by the growth of poverty and inequality in Kenya which followed the adoption of these reforms.

A report recently published by the society for International Development³⁶, reveals how poverty and inequality continued to grow steadily in Kenya between 1980 and 2004 which coincided with the implementation of these reforms. This confirms two things: First, Washington consensus reforms failed to enhance the capacity of the tax system in Kenya to respond adequately to global challenges. Secondly these reforms also failed to engender development, *au contraire*, they exacerbated poverty and inequality. This means that if Kenya is to successfully improve its development record then it must seriously consider major reforms of its tax structure and administration. In doing so, Kenya needs to follow the advice of Dan Rodrik discussed above. Learning from the experience of the Asian Tigers, Kenya needs to put in place tax system that will assist it to achieve substantial economic growth before it considers full integration into the global economy. Once it achieves substantial economic growth using domestic institutional innovations that need not conform to the Washington consensus reforms, then it can consider full integration into the global economy along the lines drawn by the Washington consensus. In what follows, I will examine the Korean Tax System to illustrate how they managed to achieve development outside the Washington consensus proposals.

³⁶ The report which was entitled "Pulling Apart: Facts and Figures on inequality in Kenya" was referred tin chapter 1 of this dissertation. See note 28 of chapter one.

4.4 COMPARATIVE STUDY OF THE KOREAN TAX SYSTEM

Korea achieved unprecedented performance in eliminating poverty and emerged as a new industrial economy in a very short period of time. Until the early 1960s, Korea was one of the poorest countries in the world. Most Koreans suffered poverty and famine. Korea exhibited the typical pathology of the third world countries: large population in a small area, lack of natural resources, high rates of unemployment and poverty. Between 1960 and 1995, Korea moved upward to join the newly industrialized economies and its per capita GNP increased from US\$ 80 to US\$ 10,000³⁷. How did Korea achieve this feat?

Seung-hum³⁸ attributes this remarkable record to a tax system that was specifically tailored to facilitate high economic growth, using domestic institutional innovations that departed from the prevailing economic orthodoxy, and which-once substantial economic growth had been achieved – was reformed to allow for full integration into the global economy.

Between the 1950s and 1960s the Korea government used loans borrowed from the Bank of Korea and funds from US aid formed the major portion of government revenue. The Korea Tax system provided only 40% of the government revenue³⁹. The contribution of the tax system was considered to be too low. The tax system was therefore reformed, first, to raise revenue as well as restoring fiscal balance and secondly providing tax incentives to the private sector to induce desirable investment activities. In 1961 major tax reforms were effected to promote revenue collection, establish equitable tax system and use tax as a policy means to support economic development strategies. In 1966,

³⁷ See Seung-hun Chun "

³⁸ Ibid

³⁹ Cha Byung-Kwon and Choi Kwang "A Study of Korean Taxation (in Korean) Korea Development Institute, The 40 year History of Public Finance in Korea 1991

there was a major tax reform in the history of tax administration in Korea. The office of National Tax Administration was established. Its administrative competence was soon reflected in the increase in tax revenue.

The General tax system reform at this stage laid the foundation for lasting, modern tax system, and provided the fiscal foundation to support sustained economic development. These reforms focused on mobilization of financial resources and building social overhead capital as well as modernizing the tax system. Between 1960s and 1970s the Korean tax base was significantly enlarged. The resulting substantial revenue was employed to build heavy and chemical industries. In order to protect these government sponsored heavy chemical industries the Korean tax system imposed high tariffs. The Korean tax policy therefore encouraged infamous import substitution industrialization.

In order to provide the right environment for growth and encourage savings, tax exemptions, tax deductions and special depreciation schemes were employed as fine tuning tax measures⁴⁰.

In 1973, when the oil shocks affected low-income groups the tax system was used to cushion the poor from the disastrous effects of the oil shock. The 1974 tax reforms corrected the prevailing defects in personal income tax by replacing the schedular system with one in which virtually all personal income previously included in the five different schedules that would be taxed under a global system. In December 1976, the Korean government carried out large scale tax reforms that saw the introduction of Value Added Tax (VAT) and special Excise Tax. Contrary to the Washington consensus reforms that glorified simplification of taxes, Eighteen new tax laws were introduced as well. This reform measure

⁴⁰ Yoo Ilho "Overview of Korean Taxation" **Programme on Korean Tax System and Administration** Korea Institute of Public Finance 2000

was aimed at meeting the fiscal demand for continued economic development. A single flexible rate of 10% was applied to all items subject to VAT⁴¹.

By the early 1980s when globalization started becoming a major phenomenon in world affairs, Korea has achieved substantial development. It was now able to compete favourably in the global economy. Korea therefore shifted its tax reforms in the direction of integration into the global economy. Despite this notable change in tax policy, there were still some reforms that tended to militate against full integration into the global economy. Examples of these include the tax on excessive land holding which was passed in January 1988 to force those who owned too much land which was not being utilized to facilitate economic growth to either sell them or suffer high tax penalties. This tax was also intended to control speculative increases in land prices. Another major tax introduced in this period was the Education Surtax introduced 1982. The major objective of this tax was to provide financial support to the educational infrastructure.

From the 1990s, major tax reforms in Korea were aimed at enhancing global integration. They therefore encourage simplification of the tax system, mitigation of the tax burden and the reduction of marginal tax rates for both individual and corporate income tax. Korean tax system therefore defied the **Washington Consensus Reforms** before 1980 because they still needed to build sufficient economic muscle before they could openly embrace integration and the consequent competition in the global economy through the adoption of **Washington Consensus Reforms**. After 1990, when they were sure that they were now ready to compete in the global economy, they reformed their tax system to allow for integration into the global economy. They therefore fully

⁴¹ Ibid

adopted the prescriptions of the Washington Consensus Reforms including the simplification of their **hitherto complex tax system**.

4.5 LESSONS LEARNT FROM THE KOREAN EXPERIENCE

A number of useful lessons can be learnt from the Korean experience.

First, it is instructive to note how the Korean authorities defied **Washington Consensus Reforms** for as long as they considered that they lacked the necessary economic wherewithal to effectively compete and therefore relied heavily on a complex system of tax laws designed to protect their young and infant industries. However, after mustering significant economic muscle and feeling satisfied that they were now ready to compete effectively in the global market, they reformed their tax system to encourage integration into the global economy through wholesale adoption of the **Washington Consensus Reforms**. This is an important lesson for Kenya. It should therefore be cautious before adopting some of the **Washington Consensus Reforms**, especially those that are inimical to its own interests. Once it has acquired sufficient economic muscle then it can embrace them wholesale.

Secondly, like Korea, Kenya should rely on the tax system to create incentives to induce the private sector investments. This it can do through the provisions of tax advantages to the poor, for example agriculture and animal husbandry.

Thirdly Kenya can learn a lot from the way the Korean Tax System cushioned the poor from the adverse effects of the harsh global economy. There are a number of products that are consumed mainly by the poor but whose prices are determined by the laws of supply and demand as they operate in the global market. One such product is paraffin. There are, however, many other products which fall in the same category. If the prices of paraffin, for example, soar in

the world market, its prices in Kenya must necessarily soar, with the attendant risk that it may climb beyond the reach of the poor. To cushion the poor from such eventualities, the tax system should be designed in such a manner as to be able to prevent price fluctuations in the international market from adversely affecting the retail prices of such products.

Another major lesson learnt from the Korean experience is how the tax system can be used to encourage maximum utilization of the available resources. Korean authorities introduced property taxes which were intended to force property owners to put the same to profitable use. This discouraged the phenomenon of absentee landlords. Kenya similarly needs to introduce property taxes. This will force the owners of large tracts of land which are currently lying idle to put such land to some profitable use.

The final lesson that Kenya can learn from Korean is the need to channel the tax revenue into areas that are more likely to improve the capability of the poor. These include such areas as health, education and welfare. This will greatly assist the poor to escape from the current poverty trap and consequently enable them to participate effectively in the economic life of this country. There is therefore an urgent need to redirect public expenditure priorities to fields offering both high economic returns and the potential to reduce poverty such as primary healthcares primary education and infrastructive especially in rural areas.

4.6 CONCLUSION

This chapter has tried to show how Kenya dealt with the challenge posed to its tax system by the phenomenon of globalisation. It has attempted to show that before 1980 the Kenya Tax System suffered from the twin problems of insufficiency of tax revenue owing largely to its tax structure as well as poor tax administration. From 1980 onwards owing largely to the influence of the

international financial institutions, Kenya embarked on aggressive tax reforms along the lines of **Washington Consensus Reforms**. These were intended to improve its tax yield as well as its tax administration. Although these reform measures were not intended for a country such as Kenya, they ended up with mixed results.

Measures such as fiscal discipline, interest rates liberalization, competitive exchange rates, simplification of the tax structure and the establishment of Autonomous Revenue Agencies (ARAs) produced very positive results. They resulted in a slight improvement in terms of both revenue yield as well as tax administration. The simplification of tax system as well as the establishment of Kenya Revenue Authority to administer the thus simplified tax system, has for example, greatly revolutionized tax administration in Kenya leading to improved tax yield.

The other prescriptions of the **Washington Consensus Reforms** however worked against the interests of Kenya. These included inter alia, the shift from reliance on international trade taxes to consumption taxes such as Value Added Tax, exposing infant local industries to the vagaries of the global economy through the abolition of import taxation, the reduction of tax rates for both corporate and individual income taxes, and the abolition of the use of taxation as a macro-economic tool.

Owing largely to the influence of these negative aspects of the **Washington Consensus Reforms** the post 1990 tax reforms failed to show any definite impact on poverty reduction. On the contrary, poverty levels increased in the period between 1990 and 2004 despite the tax reforms which targeted poverty reduction.

It is for this reason that this dissertation recommends new tax reform measures that will deal effectively with the challenges of globalization and consequently impact positively on poverty reduction in the interests of development.

**CHAPTER FIVE – MANAGING THE GLOBAL ECONOMY:
PROSPECTS FOR A NEW TAXATION ARCHITECTURE FOR
ECONOMIC RECOVERY IN KENYA**

5 INTRODUCTION

"If globalization is caused by technological advancement then it is here to stay, and trying to reverse it would rather be like flogging a dead horse.....what is needed are innovating ways of managing the global economy"

Flavio Machado Galvao Pereira¹

The hallmark of a global economy is greater mobility of economic transactions and economic agents. Firms and households enjoy far more geographic choice for purchases of goods and services, for locations to invest in and for places to work and retire². These choices often spill across national borders as firms and households seek to buy at the lowest price, to invest at the preferred combination of risks and returns and to live in communities that best meet their needs³. In the long run, the outcome of greater choice is more efficient economies and better living standards. Along with these advantages are numerous social, economic and political challenges. Among these challenges is the threat to customary systems of taxation⁴. How should Kenya respond to these challenges.

¹ Flavio Machado Galvao Pereira "Globalization and Tax Systems-Brazilian Experience" Paper prepared for Latin American Issues (CKAI) December 2003 at page 2.

² Gary Clyde Hufbauer "Tax Policy in a Global Economy: Issues facing Europe and the United States of America" **Paper prepared for AICGS Taxation seminar**, Washington DC February 12 1999.

³ Ibid

⁴ Ibid

As Flavio Machado Galvao Pereira⁵ argues “globalization is here to stay and trying to reverse it would rather be like flogging a dead horse”. What is called for are innovative ways of managing the global economy by minimizing its negative effects on tax systems while at the same time taking advantage of its positive effects. In order to manage the global economy, Kenya must reform its tax system to minimize the negative effects of globalization while at the same time maximizing its positive effects⁶

5.1 **IS THERE NEED FOR FURTHER TAX REFORMS IN KENYA?**

The tax reforms measures which were implemented by Kenya between 1980 and 2000 were mainly dictated by the dominant North. Their aim was to encourage integration into the global economy. They did not take into account the local circumstances, nor were they influenced-as they should have been-by our own local economic, social and political circumstances. On the contrary, these reforms measures were clearly against the interests of Kenya as illustrated by the pressure to phase out of trade taxes and replace them with Value Added Tax.

Like all other third world country, Kenya relied heavily on revenue resulting from trade taxes. The move to cut tariffs in order to encourage integration into the global economy and to replace the same with VAT therefore led to substantial revenue losses⁷. VAT could not compensate for the loss of revenue caused by the reduction of trade related taxes. The reason for this has been ascribed to

⁵ Flavio Machado Galvao Pereira “Globalization and Tax System – Brazilian Experience” paper prepared for the centre for Latin American Issues (CKAI) in December 2003.

⁶ Michael J. Boskin and Charles E. McLure Jr. World Tax Reforms: case studies of Developed and Developing countries (Note 1 above).

⁷ Michael Keen and Jenny E Lighthart, “Co-ordinating Tariff Reduction and Domestic Tax Reforms Under Imperfect Competition” **Review of International Economics** May 29 2003 at 1

the incomplete coverage of VAT due to the presence of large informal economy⁸. In their article entitled "VAT versus Trade Taxes: The (In) Efficiency of Indirect Tax Reform in Developing Countries Emran and Stiglitz⁹ focus on the revenue-neutral reform of VAT and trade taxes in the presence of a large informal economy in the context of developing countries. They argue that the critical assumption for the validity and applicability of existing results on revenue-neutral selective reform of tariffs and consumption taxes is that it is feasible to impose and collect VAT on the commodity bearing the lowest indirect tax on consumption. While this assumption is automatically satisfied when an economy consists of only the formal sector, they argue that it is not a plausible assumption in the presence of a large informal sector that is not included in the tax net. For this reason, Emran and Stiglitz argue that productivity of VAT has been below expected levels in virtually all developing countries with large informal sector such as Kenya. In their paper entitled "Tax Reforms in Developing Countries" Tony Addison and Jorgen Levin¹⁰ illustrate how the productivity of VAT in Kenya has shown a steady decline over the 1990s period, having fallen from 41% at the time of introduction to 36% in 2000.

The decline in productivity of VAT is partly attributable to the fact that the introduction of VAT was influenced more by political rather than economic reasons. As AZIZUI Islam¹¹ argues the International Monetary Fund pushed third world countries to phase out trade taxes and to replace the same with VAT in the hope of creating favourable conditions for integration into the global

⁸ See Piggot J and Whalley J. "VAT base broadening self supply and the informal sector" NBER working paper Series Working paper 6349 National Bureau of Economic Research

⁹ Emran M.S and Stiglitz J. "VAT versus Trade Taxes: The (in) Efficiency of Indirect Tax Reforms in Developing Countries" (mimeo) Stanford University and Brookings Institution, Washington D.C

¹⁰ Tony Addison and Jorgen Levin "Tax Reforms in developing countries" Third Draft 2006 – 06 - 07

¹¹ Azizul Islam "Issues in Tax Reform" **Asia-Pacific Development journal Vol.8 No.1 June 2001** at page 4

economy in the interests of the dominant North but against the interests of the third world. The circumstances of the third world countries were not considered. The powerful countries of the North which control the International Monetary Fund-such as the United States of America,-glorified VAT as the panacea to the third world woes and went ahead to force third world countries to implement reform measures intended to phase out trade taxes and replace them with VAT while they themselves failed introduce VAT on the grounds that it had many hidden risks and would actually harm their economy.

In an article entitled“ **How Value Added Tax would harm the U.S Economy**”, Daniel J. Mitchell¹² argues that the proponents of VAT relied on a number of myths to convince the third world and a few developed world, that VAT was the most efficient tax economically.

The phasing out of trade taxes has therefore resulted in loss of revenue for the government of Kenya and VAT has not been able to compensate for this loss. On the contrary, VAT has only exacerbated the problem. It has expended the size and cost of government, slowed economic growth and destroyed jobs, increased budget deficit, imposed heavy administrative costs and increased prices. This has been partly responsible for the decline in development that has been witnessed in Kenya in the period between 1990 and 2002¹³.

The tax reform measures implemented by Kenya in the period between 1980 and 2000 also failed to address the challenges posed by globalization, nor could they be employed to take advantage of the opportunities presented by globalization. Accordingly the burning issues in tax reforms have not been addressed. These

¹² Daniel J. Mitchell “How a Value Added Tax would Harm the US Economy” **The Heritage Foundation Publication on policy research and analysis** dated 11 May 1993.

¹³ Vito Tanzi “Trade Taxes and Trade Liberalization” **A paper prepared for the meeting of Trade and Integration Network**, August 14-15 2003

include the problems for tax policy posed by globalization and the attendant increase in mobility of goods, services and labour. There is therefore need to institute fresh tax reforms that will adequately address the following issues:

- a) The problem of achieving both economic stabilization and liberalization through appropriate reform measures that maintains a delicate balance between these two conflicting ideals.
- b) The problem of funding basic public services that can both reduce poverty and stimulate economic growth in the context of liberalization and stabilization policies which require a reduction in public expenditure and a shrink in the role of the state in the economy.

Appropriate tax reforms for Kenya should therefore not be influenced by prescriptions from abroad, but should instead be guided by domestic institutional innovations that takes into account domestic social, economic and political circumstances. Taking into account over our local circumstances the following are some of the issues that critically need to be addressed by tax reforms in Kenya.

- i) How can taxation of human capital be made more productive to compensate for the loss of revenue through reduction in corporate tax rates as a result of international tax competition as well as the increased mobility of skilled labour.
- ii) How can the internet be transformed into a taxable forum first to deal with the problem of loss of revenue through e-commerce as well as to remove the fiscal incentives for interest porn.

- iii) What reform measures need to be put in place to deal with the problem of increased opportunities for tax avoidance and evasion through transfer pricing.
- iv) How can Kenya respond to international tax competition and what reform measures are needed to effectuate such response?

In what follows, I will attempt a brief discussion on the appropriate reforms that I believe can adequately address these issues.

A. REFORMS AIMED AT IMPROVING TAX REVENUE

5.2 Reforming The Taxation Of Human Capital In Kenya Modest Proposals For Economic Growth

There are three main reasons why globalization and the advancements in technology create a very urgent need for substantial reforms to the system of taxation of human capital. First, globalization pushes governments into an internecine "race to the bottom" in financial capital taxation-owing to international tax competition-thereby undermining the financing of the welfare state and the provision of public goods. This necessitates a shift from the taxation financial capital to taxation of human capital¹⁴.

Secondly, globalization encourages increased foreign activities as highly skilled individuals take up jobs outside their countries in search for better pay, a phenomenon otherwise referred to as "brain drain"¹⁵ This limits the capacity of states to tax income from their highly skilled citizens in whose education they

¹⁴ Kenneth G. Stewart and Michael C. Webb "Capital Taxation, Globalization and International Tax Competition" Working Paper E W P O 301 Department of Economics, University of Victoria.

¹⁵ Mihir A. Desai, Devesh Kapur and John McHale "Sharing the spoils: Taxing International Human Capital Flows", **Vol 11. International Tax and Public Finance 2004** page 3

have spent very substantial resources whether in terms of tax-payer-funded education subsidies, and loans or in terms of the public provision of educational infrastructures and facilities. This leaves states with the option of taxing mainly unskilled and semi-skilled individuals whose incomes are usually too low to raise substantial revenue upon taxation, and who usually operate in the informal economy which in most exist outside the tax net.

Thirdly, globalization has shifted the focus of development from a bricks and mortar industrial base to a knowledge-based economy¹⁶. This means that any state intending to develop must invest heavily in the education of its citizens. With a firm intellectual base, it will be very easy to attract external debt and equity capital for development.

There is therefore urgent need to reform taxation of human capital to address these challenges. The following are some of the reforms that need to be put in place in Kenya in an effort to address the above challenges.

- a) Taxing international human capital flows
- b) Encouraging investment in human capital formation by permitting full deductibility of private costs of education and training
- c) Taxing the informal economy

a) TAXATION OF INTERNATIONAL CAPITAL FLOW

Kenya, like other developing countries, spend substantial amounts of resources on education of its citizens. Every year, education constitute the largest share of

¹⁶ Report of the Canadian standing committee on Banking Trade and Commerce entitled "The Taxation of Capital Gains" www.parl.gc.ca/36/20/parlbus/commbus/senate/com-c/bank-E/rep05may00-ehm-601k

budgetary allocation. However, once the students finish their studies, they migrate to other countries in search for "greener pastures". This problem, which is otherwise known as "brain drain" has reached a critical stage in Kenya and now demands urgent remedial measures. As a result of brain drain Kenya has lost the cream of its highly-skilled citizens. This has had a negative implications for development in a knowledge-based global economy. Moreover, it implies that every year Kenya wastes substantial resources in the education of its citizens who end up contributing to the development of other countries. Finally, owing to the inadequacies of the current tax system, Kenya is unable to tax its highly skilled citizens who choose to work abroad. Such individuals are however taxed handsomely wherever they are and Kenya therefore loses substantial revenue in the process. There is therefore need to institute tax reforms that will not only discourage brain drain, but which will also enable Kenya to raise substantial revenue from its citizens who have acquired lucrative jobs abroad.

There is one other reason why it has become indispensable for Kenya to reform its tax laws to allow for taxation of international income; that is the implications of demography and globalization in the developed world. In their book entitled "**The Decline of the Welfare state: Demography and Globalization**". Assaf Razin and Efraim Sadka¹⁷ analyse the effects of aging populations, migration and globalization on the deteriorating welfare state in the developed world. They argue that the proportion of the population in much of the developed world is currently aged 60 and over, and is expected to rise dramatically over the coming years from 35% in 2000 to a projected 66% in 2050. This means that the problem of acute shortage of human capital in the developed world is expected to worsen in the coming years. This creates an excellent development opportunity for developing countries-Kenya included-which have stocks of human capital in abundance and most of which is

¹⁷ Assaf Razin and Efraim Sadka "**The Decline of the Welfare State: Demography and Globalization**" (MIT PRESS) January 2005

unemployed. Kenya therefore urgently needs to reform its tax system to encourage investments in human capital formation-which human capital can then be exported to the developed world-as well as to tax the income of its citizens abroad. Already, the manpower shortages in the health sector has reached a chronic condition in United States of America, Canada, the United Kingdom and Ireland¹⁸. These countries have recently reformed their immigration laws and policies to attract skilled manpower from the developing world, and a number of Kenyan nurses, doctors etc are now migrating to these countries.

In view of the foregoing, time has come for Kenya to put in place a tax system that (a) encourages investments in human capital formation (b) encourages migration in search of lucrative employment opportunities abroad and (c) taxes, handsomely, the income earned by its citizens abroad.

Despite the fact that presently, very few countries tax international income¹⁹ recent trends in economic thought posit that, if states are to respond adequately to challenges of globalization, then they must shift from taxing domestic income only to taxing both domestic and international income. In his article entitled **"Taxing international income: Inadequate principles, outdated concepts and unsatisfactory policies"** Michael J. Graetz²⁰ argues that taxation of international income has been opposed for a long time owing to limited choice or compromise between capital export neutrality (CEN) and capital import neutrality (CIN), both of which inhibit an adequate understanding of the normative perspectives of international income tax policy and improperly limits serious consideration of alternative policies. He therefore urges states to reform

¹⁸ Mihir A. Desai, Devesh Kapur and John McHale "Sharing the spoils: Taxing International Human Capital Flows" *Not 15 (supra)*

¹⁹ At present, only three countries in the World Tax International Income. These are United States of America, the Phillipines and Eritrea

²⁰ Michael J. Graetz, "Taxing International Income; Inadequate principles, outdated concepts, and unsatisfactory policies Vol.54 TAX LAW REVIEW (Spring 2001) at page 261

their tax systems to allow for taxation of international income as part of their response to the challenges of globalization.

There are three different alternatives that Kenya can employ in taxing the incomes of its citizens abroad. It can employ the American model, or adopt a co-operative regime for tax sharing. Finally, it can impose an exit tax on accumulated human capital.

The most ideal model that Kenya can employ in taxing its citizens abroad is the American model. By most metrics, the United States has most expansive, detailed and best-enforced efforts to tax world wide income of its citizens and former citizens abroad. While American Citizens and permanent residents that reside and earn income abroad are required to file tax returns in the United States, several provisions exist that mitigate the effects of double taxation of their income. In particular American citizens can choose to employ the exclusions provided in section 911 of Inland Revenue Code or the foreign tax credit provisions of section 901 of the code²¹. Following the American example, Kenya can alter the basis of its income taxation from residency to citizenship.

Two other alternative modes are, **a co-operative regime for tax sharing and an exit tax on accumulated Human Capital**²². A co-operative regime for tax sharing involves lobbying for a co-operative regime whereby payroll and income taxes paid by a country's emigrants are collected by host countries. Such a regime would require a web of bilateral treaties or the creation of a multilateral institution to manage these transfers.

²¹ Mihir A. Desai, Devesh Kapur and John McHale, "Sharing the Spoils: Taxing international Human Capital Flows" Note 15 supra

²² Ibid

An exit tax on accumulated human capital is tax that must be paid before a citizen is allowed to emigrate or expatriate to another country based on the skill or income of the emigrating or expatriating citizen. If well administered, such taxes can raise substantial revenue for Kenya.

b) ENHANCING HUMAN CAPITAL FORMATION THROUGH TAXATION

In a knowledge-based economy, development depends on the skill and expertise possessed by the citizens of a particular state. The existence of highly specialized skills and expertise in a country not only attracts external debt and equity capital, but also enable such a country to export such skills and expertise other countries that need the same. This means that, in a global economy, every effort should be made to encourage the formation of human capital. The tax system should not just raise sufficient funds to enable the funding of education by the state. It should also provide incentives that encourage private funding of educational activities.

The current tax systems however tend to favour investments in other types of capital formation as against investments in intangible human capital. Purchases of agricultural implements, expenses incurred in the process of earning an income and purchases of intermediate goods in the production channel are usually tax deductible. Expenses incurred on education and training are however not tax deductible. This renders the entire tax system inefficient and exacerbates distortions due to progressive income taxation. Moreover, it discourages investments in education and training.

In order to solve the above problem, Paul A. David²³ proposes a scheme of personal income taxation that permits full deductibility of private costs on

²³ Paul A. David, "Reforming the taxation of Human Capital: A modest proposal for promoting Economic Growth (mimeo) Stanford University (15th November 2000)

education and training. Kenya can borrow a leaf from this, in its effort to encourage private investments in education and training.

c) **TAXING THE INFORMAL ECONOMY**

Revenue yield in most developing countries is very low. One of the current explanation for the low level of revenue is the existence of large informal economy that escapes taxation. In Kenya, it is argued that the declining productivity in VAT has been the result of the existence of a large informal economy that escapes VAT coverage²⁴. Kenya is one of the countries in Africa that has the largest informal sector²⁵. This results in loss of substantial revenue. The question that needs an answer therefore is: Should the informal sector be included in the tax net or not?

In their article entitled "**Taxing the Urban Unrecorded Economy in Sub-Saharan Africa**", Catherine Araujo-Bonjean and Gerard Chambas²⁶ give three main justifications for taxing the informal sector, First, activities not recorded by the tax and customs administrations succeed in evading, in part, the tax burden which they should otherwise bear or collect and this result in loss of revenue. Secondly, submitting both the formal and the informal sectors to similar tax obligations is not only favourable to public revenue objective but also reduces the distortions in the incentive system defined by the national tax authorities via

²⁴ See Tony Addison and Jorgen Levin "Tax Reforms in Developing countries" Note 10 (supra) at page 22.

²⁵ See the publication by Women in Informal Sector Employment: Globalizing and Organising (WIEGO) entitled "Addressing informality and Reducing Poverty-A policy Response to the informal Economy. www.wiego.org/papers/policybooklet.pdf

²⁶ Catherine Aranjo-Bonjean and Gerard Chambas "Taxing the Urban unrecorded Economy in Sub-saharan Africa, **paper presented at the Communication for the "Hard to Tax" conference in Atlanta**, May 2003.

tax and trade policies. Finally, it is inequitable to tax the formal sector while the informal sector escapes taxation.

How then, can the informal sector be brought within the tax net? Catherine Arango-Bonjean and Gerard Chambas argue that the easiest way to bring the informal sector within the tax net is through the introduction of a unified business tax on informal activities. The scale of this tax would be determined according to objective indicators²⁷ of contributory capacity with no reference to turnover. The extreme simplicity of this unified business taxation would facilitate its understanding and acceptance by the tax payers.

The introduction of such a unified tax in Kenya would greatly enhance revenue productivity of the informal sector in Kenya.

5.3 **Taxation Of Electronic Commerce:**

Cross border electronic commerce is currently operating in a tax and traffic-free environment. This combined with the predictions of steep increases in e-commerce during the next five years has prompted governments and tax authorities to discuss modification to existing tax systems to take account of these developments²⁸. But why should electronic commerce be brought within the tax net?

²⁷ These can be the nature of the activity, its geographical situation, the equipments used etc. For restaurants, it could be the number of tables, seats, employees etc

²⁸ Susanne Teltscher, "Tariffs, Taxes and Electronic Commerce: Revenue implications for Developing countries" Study series No.5 Policy Issues in International Trade and Commodities

Two reasons have been advanced for bringing e-commerce within the tax bracket: first, to address the problem of loss of revenue due to e-commerce. Secondly, to remove fiscal incentives for internet pornography²⁹

The most debated topic in electronic commerce at present time, among policy makers and the business community is whether and how to collect tariffs and taxes on cross-border electronic commerce. According to Forrester Research Estimates³⁰ business to business e-commerce transactions accounted for US\$150 billion in 1999 and that this figure was expected to reach US\$ 3 trillion by 2004. Such huge volumes of transactions currently escape taxation. This result in huge revenue losses especially on the part of developing countries like Kenya.

Apart from the increasing volume of trade that is currently conducted through the internet with the resulting revenue losses, the digital age has also been characterized by tension between the internet's promise of economic productivity and the protection of social norms through national law-making. Currently, the tax and tariff-free internet environment fosters electronic sales of pornographic materials, This state of affairs is quite inimical to our moral and cultural development. As Aldo Forgione argues in his article entitled "**Taxing Obscene Profits: Removing The Fiscal Incentives For Internet Porn**"³¹ states should take immediate steps to introduce taxation on e-commerce. The European Union (E.U) recently extended Value Added Tax (VAT) laws to e-commerce. The E.U recognized that foreign e-commerce enterprises were enjoying unfair advantages over E.U businesses due to lack of any legal obligation to impose or collect VAT on e-commerce sales made to E.U residents.

²⁹ Aldo Forgione "Taxing obscene profits: Removing the Fiscal incentives for internet porn <http://www.innovationlaw.org/pages/taxingobsceneprofits2004.doc>.

³⁰ See Sussane Teltscher Note 28 Supra at page 1

³¹ See Aldo Forgione No. 29 supra at page 13

Arthur J. Cockfield, in an article entitled "**Transforming the Internet Into a Taxable Forum**"³² argues that internet not only pose challenges to international taxation, but also "represent opportunities that could resolve a number of vexing problems that plague international taxation". Cockfield advocates the creation of a segment of the internet that is secure from outside access (a so-called "extranet") that can identify the location of consumption for tax purposes assess and collect taxes on online payments and serve as international "online tax clearing house". This according to him would reduce compliance costs for online companies, protect the source of states' ability to tax online transactions and reduce harmful tax competition.

While Cockfield's proposal for an "extranet" exists so much in the future, the European Union's innovative idea of introducing tax on electronic commerce transactions is an idea whose time has come. But this does not have to be VAT. It can be given any other name. Developing countries in general and Kenya in particular should consider introducing tax on electronic commerce transactions. This will greatly boost their revenue base. A tax can be levied on goods sold through the internet just as has been done on goods stored in storefront business. Similarly, tax can be levied on online services from service providers to their customers. A number of services are provided online from internet service providers to the customers which can be subjected to tax. Finally, tax can also be introduced on the sale of digitized goods through the internet. These include computer software books, music, pictures, visual materials etc³³.

³² See Arthur J. Cockfield "Transforming the Internet into a Taxable Forum (2001) Vol 85 No. 5 Minnesota Law Review 1171-1266

³³ See Giuo an Wang and Le Jiang "On the Challenges in Taxation and the Development of E-commerce (Mimeo) **College of Business Hangzhou Institute of Electronic Engineering China**. See also Georgi Smatralalev **Taxation and Tax Policy in the E-World** <http://www.papers.ssrn.com/so13/papers.efm?abstract-id=317480-20k>

5.4 Instituting "Transfer Pricing-Specific" Tax Reforms

One of the most conspicuous impacts of globalization of production and trade as well as the recent developments in the field of technology has been the increasing dominance of multi-national corporations (MNCs) in international trade. Developing countries, Kenya included, are nowadays losing substantial sums of revenue to MNCs through transfer pricing. The circumstances of the global economy increased the opportunities for high level tax evasion at the behest of MNCs, through the instrumentality of what has been referred to as "Transfer Pricing".

Transfer pricing, as has been explained above, refers to the setting of prices among multinational enterprises that are subsidiaries of an MNC, in a manner that does not conform to market determination with a view to minimizing their overall corporate tax liabilities. For example where two subsidiaries of the same MNC located in different countries are trading with each other, the purchasing subsidiary may overstate the price of the product sold by the selling subsidiary if the selling subsidiary is located in a high tax country while the purchasing country is located in a low tax country. Such practices have become the order of the day in contemporary world and developing countries in particular are losing substantial revenue as a result.

The Organisation for Economic and Co-operation and Development (OECD) had developed international tax rules intended to deal with the problem of transfer pricing modeled on the **Arm's Length Principle** (ALP). The ALP principle states that if the conditions between associated enterprises in their commercial or financial relations differ from those that would have been made between independent enterprises, then profits that would have accrued to one of the enterprises may be included within the taxable income of that enterprise.

The ALP principle has been adopted by a number of countries both within and outside the OECD, China, for example had developed an extensive transfer pricing tax system. In 1991 China introduced extensive transfer pricing-specific amendments to its income tax law which not only defined what "associated enterprises" meant, but went ahead to define the scope of the tax authority's powers in applying the ALP principle as well as the guidelines and rules to be followed in the application of ALP principle.

Kenya can borrow a leaf from China and institute transfer pricing specific tax reforms to deal with the problem of transfer pricing.

5.5 **International Tax Competition And The Need For Appropriate Tax Reforms In Kenya**

As was discussed above globalization has led to rising trade and investment flows, greater mobility of labour and capital and rapid transfers of technology. This had led to an internecine tax competition between states. States compete with each other for foreign portfolio or direct investment and the only way to attract the same is to lower corporate tax rate below the rate offered by the neighbouring or competing states.

Smart states treat international tax competition as an opportunity and not a threat. Ireland, for example, has had remarkable economic success as a result of its low-tax strategy adopted in the 1980 with regard to investments by foreigners. Accordingly Ireland has attracted more foreign direct investments than Japan or even Italy. As a result Ireland now has a per-capita income level higher than that of Great Britain or France³⁴.

³⁴ See Chris Edwards "Tax competition spurs globalization-(world view – countries develop low-tax strategies to lure business <http://www.findarticles.com/p/articles/mi-m1272-131/01-98829800>

Some states are responding to international tax competition in defensive and unproductive ways. High tax countries such as United States of America and Britain have for example prodded international organizations such as the organization for Economic Co-operation and development (OECD) to curtail tax competition. OECD has responded to this by developing rules and guidelines to deal with the problem of tax competition. Those rules and guidelines are however unlikely to have any meaningful impact in the absence of an international tax regulatory authority or framework.

Developing countries must follow the example of Ireland if they intend to develop. Accordingly Kenya should lower its corporate tax on foreign investors to as low as 10%. This will attract both foreign direct investments as well as foreign portfolio investments. Such a move will enable Kenya to attract investments that would otherwise land in neighbouring countries such as Uganda and Tanzania.

B. REFORMS AIMED AT IMPROVING TAX ADMINISTRATION

Over and above the reforms discussed so far which are aimed at enhancing the tax yield, a number of reforms are also needed in the area of tax administration. This is because the first set of reforms discussed so far can only bear fruit if they are accompanied by improved systems of tax administration. The following are some of the reforms that would go along way towards revolutionizing tax administration in Kenya.

a) Intensifying International Co-operation

To face the challenges stemmed by the new economic order it is crucial to intensify international co-operation in tax administration. This will provide a framework within which countries can work together to establish harmonious and

advantageous co-existence of the various national tax systems, and the sharing of information across borders.

The exchange of information among tax administrations is also widely recognized as an effective means of deterring and discovering non-compliance in cross-border transactions.

In this context, many regional tax organizations have emerged to which Kenya may wish to join if it has not joined any of them. These include The African Association of Tax Administrations (AATA).

The Commonwealth Association of Tax Administrators (CATA), the Inter-American Centre of Tax Administration (CIAT), The Caribbean Organisation of Tax Administrators (COTA), "Le Centre de Rencontre des Dirigeants, des Administrations Fiscales" (CREDAF), The Intra-European Tax Administrations (IOTA) The Pacific Association of Tax Administrators (PATA) and the Study Group on Asia Tax Administration and Research (SGATAR).

Membership to such organization would enable Kenya to effectively deal with cases of cross-boarder tax evasion and avoidance; will provide it with a forum for the exchange of experiences in search of solutions to tax issues worldwide; provide it with information on normative systems, models, standards and prototypes and finally enable it to modernize as tax administration systems based on the experience drawn from other member countries.

To strengthen co-operation among international organizations, the IMF, OECD and the World Bank have proposed International Tax Dialogue (ITD) According to that joint proposal it is consistent with the revised draft outcome of the UN Conference on Financing Development.

b) Broadening the Use of Electronic Tax Administration

Another innovative way of revolutionizing tax administration in Kenya is through what has now come to be known as **e-Tax Administration**. This involves the use of the internet to collect tax. Through the internet a number of services can be offered to the tax payers and similarly the tax payer can furnish lots of useful information to the tax authorities. Through the internet it is possible to obtain a negative certification of debts, to verify whether the income tax refund is available, to download programmes, to access the Kenya Revenue Authority and obtain any needed information and even to file electronic tax returns.

In Kenya, the concept of **e-Tax Administration** was only recently introduced but only with regards to VAT. Its introduction has however been met with staff opposition owing largely to the fact that the proper legal framework was not put in place before its introduction.

What Kenya needs to do is to broaden the use of electronic tax administration and to extend its use to the collection of all taxes and not just VAT alone. A proper legal framework should however be put in place before this can be done.

c) Abolition Of The Ad Valorem System In The Collection Of Customs And Excise Taxes

Customs and excise taxes constitute one of the main source of revenue in Kenya accounting for over 40% of the revenue collected by the Kenya Revenue Authority. Kenya however has persisted in the use of **ad valorem** system of tax collection. This system created a lot of incentive for corrupt activities. This is why it has been abolished in many other countries.

Kenya needs to shift to the use of purchase price as the basis upon which the tax payable is assessed. This will prevent losses caused by collusion between the valuation officers and importers.

5.6 CONCLUSION

Chapter 4 discussed the tax reform measures implemented by Kenya in the period between 1980 and 2004 with a view to addressing the global challenges to taxation and concluded that they failed to effectively address the global challenges to taxation. It pointed out that there is an urgent that will improve the capacity of the Kenyan tax system to effectively deal with the global challenges.

This chapter has now responded to this need and has accordingly given a series of reform measures which it is hoped will enable Kenya to effectively manage the global economy.

6 **CHAPTER 6 - CONCLUSION**

This dissertation examines the interplay between taxation and development, against the background of deepening globalizations with a view to resolving the development crisis in Kenya. It starts by undertaking a jurisprudential analysis of development to reveal its true meaning and rejects the traditional economic conceptions of development-which identified development with such things as GNP growth, industrialisation, modernization etc- for being too narrow. It re-conceptualises development in terms that identifies it with the realization by individuals of substantive (fundamental) freedoms and the achievement of social justice. Given the culturally relativistic character of justice, this dissertation concludes that in Africa in general and Kenya, in particular, the appropriate conception of development is a communitarian conception.

It then becomes necessary to consider whether the free market paradigm, which has traditionally been considered as the ideal paradigm for the realization of development in its narrow economic sense, can facilitate the realization of development in its broader communitarian sense. Given its tendency to exacerbate rather than eradicate poverty and inequality, this dissertation finds that the free market paradigm cannot facilitate the realization of development in its communication sense and recommends its replacement with a human rights paradigm. The success of a human rights paradigm however rests against two indispensable pillars: and efficient system of taxation and a powerful, and autonomous state, both of which pillars are threatened by globalization. Accordingly, the quest for development translates into a quest for an appropriate response to globalization. Since no state can reverse or avoid globalization, this dissertation concludes that the only option for states is to "manage" globalization by minimizing its negative impacts while at the same time maximizing its positive impacts.

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In the context of Kenya, this dissertation finds that the fundamentals of a human right development paradigm already exist since Kenya has ratified virtually all human rights instruments that impose international law obligations upon states to ensure, fulfil and respect the realization, by their citizens, of the right to development. At municipal level, Kenya has constitutionalised civil and political rights and is presently in the process of constitutionalising economic, social and cultural rights. There is therefore adequate normature and institutional framework for the application of human rights development paradigm. However, the two indispensable pillars upon which the success of a human rights paradigm vest, as discussed above, are lacking. This is because Kenya has fallen victim to global governance and is therefore unable to faithfully facilitate the full realization of development thorough the application of the human rights paradigm, despite having brought itself under both domestic and international law obligations so to do. Secondly owing to global governance, Kenya reformed its fax system to allow entry of the cold winds of globalization – mostly in the interest of the west- but has been unable to reform its said tax system to address the negative impacts of globalization as well as to take advantage of its positive impacts-which would be in development crisis in Kenya as witnessed by the recent surge in the level in levels of poverty and inequalities.

This dissertation therefore recommends that Kenya urgently needs to reform its tax system again to enable it to effectively “manage” The global economy in the interests of development. It recommends various reform measures which in the opinion of the author will enable Kenya to successfully address the negative impacts of globalization while at the same time taking advantage of its positive impacts.