AN ANALYSIS OF TAX REFORM POLICIES AND TAX REVENUES IN KENYA

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DECLARATION

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DEDICATION

This work is dedicated to my family members who have encouraged and stood by me throughout my life.

To my parents who have always wanted the best for their children and have been there for them. Their sacrifice to ensure that their children get the best is deeply appreciated.

To my brothers and sisters who have encouraged and assisted me in every way they could.

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ABSTRACT

Kenya introduced the Tax Reform Programme in 1986 with the hope that this would, among other things, enhance revenue collection, improve tax administration and reduce compliance and collection costs. Despite the tax modernization, there are concerns that the challenges that confront the Ministry of Finance and Kenya Revenue Authority today are not much different from the challenges that faced these revenue authorities before the reforms. There are also concerns that tax competitiveness in Kenya is low and the country remains among the most tax unfriendly countries in the world. This study reviewed tax revenue performance during the period 2001 - 2010 in order to identify priorities for further tax reform.

The tax structure is less buoyant and possibly inelastic although indirect taxes, and not direct taxes, hold the capacity to improve the flexibility of the tax system. The challenges that confront tax design include taxation of agriculture and the informal sector, repeal of tax holidays, high effective protection, high dispersion of tariff rates, detailed and rigid custom rules, poor response of VAT to reforms, weak capacity to process large volumes of returns and refunds for zero-rated transactions. In addition, Kenya's tax system is burdensome in terms of time taken to prepare and submit tax returns.

Since the inception of KRA, revenue collection has continued to grow while professionalism in revenue administration has been enhanced. However, challenges remain, inhibiting the achievement of a fully integrated and modern tax administration. The KRA Second Corporate Plan (2003/04 – 2005/06) set the stage for the Revenue Administration Reform and Modernization Programme (RARMP) to ensure that momentum was injected to consolidate the gains that had been made in tax administration. During the Third Corporate Plan Period (2006/07 – 2008/09), the RARMP made enormous strides in ensuring KRA transformed itself into a modern, fully integrated and client-focused organization.

KRA is currently implementing the Fourth Corporate Plan (2009/10 – 2011/12). This aims to entrench the reforms at the operational levels to achieve operational efficiencies and enhance service delivery.

TABLE OF CONTENTS

DECLARATION ..... **ii**
DEDICATION ..... **iii**
ACKNOWLEDGEMENT ..... **iv**
ABSTRACT ..... **v**
LIST OF TABLES ..... **viii**
ABBREVIATIONS ..... **ix**

CHAPTER ONE: INTRODUCTION **1**
1.0 Introduction 1
1.1 Background of the Study 1
1.2 Statement of the Problem 4
1.3 Objectives of the study 5
1.4 Importance of the Study 5

CHAPTER TWO: LITERATURE REVIEW **6**
2.0 Introduction 6
2.1 The Optimal System 6
2.2 Theories of Taxation 8
2.3 Tax productivity 9
2.4 Tax Administration 10
2.5 The Canons of Taxation 11
2.6 Taxation Policies 12
2.6.1 Fiscal Tax policy 14
2.6.2 Customs Policy 16
2.6.3 VAT and excise duty policy 17
2.6.4 Income tax policy 19
2.6.5 Organizational policy 20
2.7 Tax Modernization 20
2.8 Globalization in Kenya 22
2.9 Types of Taxes 24
2.9.1 Income Taxes 25
2.9.2 Personal Income Taxes (PIT) 26
2.9.3 Corporate Income Taxes (CIT) 26
2.10 Taxation Policies and Globalization 27
2.11 Tax Reforms Introduction 29
2.12 Empirical Literature 30
2.13 Summary of Literature Review 31

CHAPTER THREE: RESEARCH METHODOLOGY **33**
3.0 Introduction 33
3.1 Research design 33
3.2 Population 33
3.3 Sample 33
3.4 Data Collection 33

3.5 Data Analysis 33
3.6 Ethical Issues 34

CHAPTER FOUR: DATA PRESENTATION, INTERPRETATION AND DISCUSSION35
4.1 Introduction 35
4.2 Measures of central tendency 35

CHAPTER FIVE: SUMMARY OF FINDING, CONCLUSION AND RECOMENDATIONS 39
5.0 Introduction 39
5.1 Summary of finding 39
5.2 Conclusion 40
5.3 Recommendation 40

REFERENCES 43
APPENDIXES…………………………………………………………………………….. 47

LIST OF TABLES

PAGE

Table 4.1: Descriptive statistics for measures of performance 35

Table 4.2: Correlation between measures of performance before and after reforms.................... 36

Table 4.3: Paired t-test for tax reforms 37

ABBREVIATIONS

ANOVA	Analysis of Variance
IAS	International Accounting Standards
ITT	International Telephone and Telegraph
KLSE	Kuala Lumpur Stock Exchange
NSE	Nairobi Stock Exchange
CBK	Central bank of Kenya
SGX	Singapore Stock Exchange
TC	Total Board Compensation
U.K	United Kingdom

CHAPTER ONE: INTRODUCTION

1. Introduction

This chapter gives the background of the tax policy. It further highlights the problem that will be addressed in this study, mainly the effects of tax policies on tax revenues. The chapter further stipulates the objectives of the study together with the research questions that will be investigated. It concludes by laying out the significance of the study together with the scope of the study.

1.1 Background of the Study

Tax reform is the process of changing the way taxes are collected or managed by the government. It may involve the adoption of a Value Added Tax (VAT), the expansion of the VAT, the elimination of stamp and other minor duties, the simplification and broadening of personal or corporate income or asset taxes, or the revision of the tax code to enact comprehensive administration and criminal penalties for evasion (Mahon, 1997). Institutional aspects of tax reform involve the Semi-autonomous Revenue Authority Model, where traditional line departments are separated from the Ministry of Finance and granted the legal status of semi-autonomous authorities. Tax reform involves broad issues of economic policy as well as specific problems of tax structure design and administration (Musgrave, 1987). At the theoretical level, tax reforms are initiated either following an economic crisis or as a response to international pressure (Mahon, 1997).

In Kenya, taxation is the single largest source of government budgetary resources. Between 1995 and 2004, tax revenue constituted 80.4% of total government revenue (including grants). Relatively, the importance of non-tax revenue is also significant in sustaining the public budget, although its importance is much less than the role of taxation given that it’s share over the same period was 15.1%. Foreign grants play a minimal role as they have averaged only 4.5%. Given it’s central role, taxation has been applied to meet two objectives. First, taxation is used to raise sufficient revenue to fund public spending without recourse to excessive public sector borrowing. (Glenday, 2002)

Second, it is used to mobilize revenue in ways that are equitable and that minimize its disincentive effects on economic activities. Over time, Kenya has moved from being a low tax burden country to a high tax burden country yet the country faces the obvious need for more tax revenues to maintain public services. Given the high tax burden, prospects to raise additional revenue seem bleak. In addition, Kenyans are yet to accept a tax paying “culture”. On one hand, those with political power and economic ability are few and do not want to pay tax. On the other hand, those without political power are many, have almost nothing to tax, and do also resist paying taxes. Since no one enjoys paying taxes, there is mistrust between those collecting taxes and taxpayers. This mistrust generates a game theoretic coexistence between tax agents and tax payers, with agents perceiving taxpayers as criminals unwilling to pay their taxes, and tax payers wary of government agencies’ high-handedness in collection of taxes (KRA, 2004). This creates the need for the tax agents to improve their image by building trust and public confidence.

Even though the tax system has continuously changed, in pursuit of the objectives of the Tax Modernization Programme that came into force in 1986, the challenges that confront the tax authorities today are not much different from the pre-reform challenges. With Kenyan firms reporting that about 68.2% of profit is taken away in taxes, tax competitiveness is low and the country remains among the most tax unfriendly countries in the world. Tax evasion remains high, with a tax gap of about 35% and 33.1% in 2000/1 and 2001/2 respectively (KIPPRA, 2004a). The tax code is still complex and cumbersome, characterized by uneven and unfair taxes, a narrow tax base with very high tax rates and rates dispersions with respect to trade, and low compliance (KIPPRA, 2004b). Additional challenges include tax systems with rates and structures that are difficult to administer and comply with, are unresponsive to growth and discretionary policy hence low productivity, raise little revenue but introduce serious economic distortions, treat labor and capital in similar circumstances differently and are selective and skewed in favor of those with the ability to defeat the tax administration and enforcement system. (KIPPRA. 2004b)

The composition of taxes could also change as a result of increased difficulty in taxing mobile tax bases. The overall tax burden from income taxes on mobile tax bases like capital and skilled labor will likely decline across governments, while taxes on immobile tax bases will likely increase. In the face of tax competition, national governments may attempt to harmonize (or at least coordinate) their tax systems in an attempt to reduce the negative externalities that one government’s decisions impose on other governments. Such harmonization implies that there should be some convergence in tax rates across governments, and in the definitions of tax bases. Some also argue that neither a “race to the bottom” nor international tax convergence are universal outcomes of increased globalization. Analysts differ on whether these developments are positive (e.g., tax competition that reduces the size of government and government waste) or negative (e.g., tax competition that reduces the ability of governments to provide public goods, eliminating the welfare state). However, few question that globalization has led, and will continue to lead, to a significant reduction in the autonomy of governments**.** (Musgrave, 1987)

Given the destabilizing effects of the deficits and the fact that they were becoming unsustainable, the Government through Sessional Paper No 1 of 1986 (GOK, 1986)) came up with measures to address the problem. The most notable fiscal policy proposals were the Tax Modernization Programme (TMP) that was adopted in 1986 and the Budget Rationalization Programme that followed in 1987 (Muriithi and Moyi, 2003). The former programme was aimed at enlarging the government revenue base whereas the latter involved regulating expenditure through strict fiscal controls.

Kenya has various types of tax as a means of collecting revenue and Kenya Revenue Authority keeps on making amendments in order to achieve their target each financial year.

Pay As You Earn (PAYE): PAYE is a method of collecting tax at source from individuals in gainful employment. The employer deducts a certain amount of tax from his / her employee's salary or wages on each payday then remit the tax to the Authority. This relieves the employee from paying taxes at the end of the year and shifts the responsibility to the employers.

Every individual who receives income is granted a tax credit or a tax relief from the Authority, this is known as Personal Relief. Insurance relief and mortgage relief are also available for eligible persons. The total tax credit is spread evenly during the charge year. At the end of the year, an individual will submit his self-assessment on total income received from various sources. Should the tax credit be lower than actual tax charged during the year, the balance of tax due will be payable.

Corporation Tax: Corporation tax is a form of income tax that is levied on companies. Resident companies are taxable at a rate of 30% w.e.f year of income 2000 while non - resident companies are taxable at a rate of 37.5%.w.e.f year of income 2000.

Withholding Tax : Withholding taxes are deducted at source from the following sources of income: Interest, dividends, royalties, management or professional fees, commissions, pension or retirement annuity, rent, appearance or performance fees for entertaining, sporting or diverting an audience.

Advance Tax : Advance tax is applicable to Matatus and other Public Service Vehicles. It is not a final tax, but a tax partly paid in advance before a public service vehicle or a commercial vehicle is registered or licensed.

1.2 Statement of the Problem

An analysis of Kenya's fiscal structure reveals a number of important aspects. First, compared with a sample of low-income sub-Saharan countries, Kenya's tax/GDP ratio is higher than the sample average. Second, the imbalance between government revenue and expenditure results in large and chronic fiscal deficits. In theory, the financing of a deficit especially through foreign borrowing or additional foreign financing may have considerable effects on interest rates, the balance of payments and the external value of the currency, in this case the shilling. Third, Kenya initiated reforms in the tax structure with diverse objectives. Unfortunately, the reform process began at a time when the macroeconomic environment was unstable. When there is a rapid and significant change in macroeconomic policies, it is much more difficult for tax reforms to have important and identifiable revenue effects (Tanzi, 1988).

The impetus for reform in tax system came primarily from the need to raise additional revenue to deal with problem of continuing and in some cases, rising deficits, but since structural reform of the real sector of the economy was also being attempted, efficiency consideration were also an important cause (Chelliah, 1996). While it was felt that there is a need to raise revenues to fund the activities of the government, economists were also tasked with figuring out how to design a revenue system that is both efficient and equitable (Ulbrich, 2003).

Analysts have observed (Karingi et al. 2004a) that little personal income tax was collected in the top brackets of the tax schedule, The main factors contributing to an improved revenue performance are changes in tax legislation, tax administration and minimal tax evasion (Morrisset and Izquierdo, 1993). Using VAT to replace commodity taxes in order to minimize disincentives for investments and exports

(Thirsk, 1991), none attempted to establish the impact of reform policies on revenue collection. This research will attempt to fill this gap in knowledge with more specific on Kenyan perspective.

1.3 Objectives of the study

The general objective is to evaluate the Tax Reform Policies and the Tax Revenues in Kenya.

1.4 Importance of the Study

This study will be of value to:

Kenya Revenue Authority, Central bank of Kenya and any other Government agencies, as it will add knowledge on the understanding of the importance of tax policies. It will be of benefit to academicians and researchers by providing more insight into the effect of tax policies.

It will also be useful to policy makers in the money market, the capital market and the government. These bodies would be interested in knowing the effect of tax policies on the performance of companies at the stock exchange. Investors and other market players who may be interested in knowing the effect of tax policies on the price and the general trade.

CHAPTER TWO: LITERATURE REVIEW

2. Introduction

In this chapter, a literature review of the various research objectives was undertaken. It further presents a review of past studies and the critical review and lastly it presents a summary of the chapter.

2.1 The Optimal System

The standard theory of optimal taxation posts that a tax system should be chosen to maximize a social welfare function subject to a set of constraints. The literature on optimal taxation typically treats the social planner as a utilitarian: that is, the social welfare function is based on the utilities of individuals in the society. In its most general analyses, this literature uses a social welfare function that is a nonlinear function of individual utilities. Nonlinearity allows for a social planner who prefers, for example, more equal distributions of utility. However, some studies in this literature assume that the social planner cares solely about average utility, implying a social welfare function that is linear in individual utilities. For our purposes in this essay, these differences are of secondary importance, and one would not go far wrong in thinking of the social planner as a classic "linear" utilitarian. (Prest, 1985)

To simplify the problem facing the social planner, it is often assumed that everyone in society has the same preferences over, say, consumption and leisure. Sometimes this homogeneity assumption is taken one step further by assuming the economy is populated by completely identical individuals. The social planner's goal is to choose the tax system that maximizes the representative consumer's welfare, knowing that the consumer will respond to whatever incentives the tax system provides. In some studies of taxation, assuming a representative consumer may be a useful simplification. However, as we will see, drawing policy conclusions from a model with a representative consumer can also in some cases lead to trouble. (Thisen, 2003)

After determining an objective function, the next step is to specify the constraints that the social planner faces in setting up a tax system. In a major early contribution, Frank Ramsey (1927) suggested one line of attack: suppose the planner must raise a given amount of tax revenue through taxes on commodities only. Ramsey showed that such taxes should be imposed in inverse proportion to the representative consumer's elasticity of demand for the good, so that commodities which experience inelastic demand are taxed more heavily. Ramsey's efforts have had a profound impact on tax theory as well as other fields such as public goods pricing and regulation. However, from the standpoint of the optimal taxation literature, in which the goal is to derive the best tax system, it is obviously problematic to rule out some conceivable tax systems by assumption. Why not allow the social planner to consider all possible tax schemes, including nonlinear and interdependent taxes on goods, income from various sources, and even non-economic personal characteristics? (Taliercio, 2004)

But if the social planner is allowed to be unconstrained in choosing a tax system, then the problem of optimal taxation becomes too easy: the optimal tax is simply a lump-sum tax. After all, if the economy is described by a representative consumer, that consumer is going to pay the entire tax bill of the government in one form or another. Absent any market imperfection such as a preexisting externality, it is best not to distort the choices of that consumer at all. A lump-sum tax accomplishes exactly what the social planner wants. In the world, there are good reasons why lump-sum taxes are rarely used. Most important, this tax falls equally on the rich and poor, placing a greater relative burden on the latter. When Margaret Thatcher, during her time as the Prime Minister of the United Kingdom, successfully pushed through a lump-sum tax levied at the local level (a "community charge") beginning in 1989, the tax was deeply unpopular. As the *New York Times* reported in 1990, "Widespread anger over the tax threatens Mrs. Thatcher's political life, if not her physical safety. And it may prove to be the last hurrah for her philosophy of public finance, in which the goals of efficiency and accountability take precedence over the values of the welfare state" (Passell, 1990). The tax was quickly revoked, and not coincidentally, Thatcher's term of office ended not long after.

As this episode suggests, the social planner has to come to grips with heterogeneity in taxpayers' ability to pay. If the planner could observe differences among taxpayers in inherent ability, the planner could again rely on lump-sum taxes, but now those lump-sum taxes would be contingent on ability. These taxes would not depend on any choice an individual makes, so it would not distort incentives, and the planner could achieve equality with no efficiency costs. Actual governments, however, cannot directly observe ability, so the model still fails to deliver useful and realistic prescriptions. James Mirrlees (1971) launched the second wave of optimal tax models by suggesting a way to formalize the planner's problem that deals explicitly with unobserved heterogeneity among taxpayers. In the most basic version of the model, individuals differ in their innate ability

To earn income. The planner can observe income, which depends on both ability and effort, but the planner can observe neither ability nor effort directly. If the planner taxes income in an attempt to tax those of high ability, individuals will be discouraged from exerting as much effort to earn that income. By recognizing unobserved heterogeneity, diminishing marginal utility of consumption, and incentive effects, the Mirrlees approach formalizes the classic tradeoff between equality and efficiency that real governments face, and it has become the dominant approach for tax theorists.

Keeping track of the incentive-compatibility constraints required so that individuals do not produce as if they had lower levels of ability makes the optimal tax problem much harder. Since the initial Mirrlees contribution, however, much progress has been made using this approach. General treatments of the Mirrlees approach are found in Tuomala (1990), Salanie (2003), and Kaplow (2008a).

2.2 Theories of Taxation

The breakthrough of the modern theory of optimal taxation in the early 1970s opened up a new fertile area of research, but it also created a larger communication gap between theorists and practitioners of public finance. To many applied economists working for governments and international organizations, the new theories of optimal taxation seemed highly technical and abstract, and hence of little policy relevance. Even today it is a widespread view that optimal tax theory has produced very few robust results that can serve as a basis for concrete useful policy advice. (Torrance, 2005)

The theory of optimal taxation does in fact provide many important lessons for policy makers and that recent theoretical progress in this area may help to bridge the gap between academic research and practical policy advice. The theory of optimal taxation is normative, essentially assuming that policy is made by a benevolent dictator who respects individual preferences as well as some 'social' preference for equality. One can choose to dismiss this body of theory by pointing out that actual policy makers typically represent specific interest groups and that actual policies tend to reflect some compromise between conflicting interests rather than the maximization of a Bergson-Samuelson social welfare function. Indeed, this is why models of Public Choice and Political Economy help us to understand what is going on in the real world. But one could likewise dismiss models of competitive markets by pointing out that the Walrasian auctioneer does not exist and that many economic agents have market power. Yet few if any economists would deny that the theory of perfect competition and the First Theorem of Welfare Economics provide a useful benchmark for evaluation of resource allocation in actual market economies. In a similar way, assuming that one accepts its philosophical foundations in utilitarianism and methodological individualism, optimal tax theory provides a benchmark against which to evaluate actual public policies. (Fitzgerald, 2003)

The debate on uniformity and neutrality in taxation involves indirect as well as direct taxation. The question whether indirect taxes should be uniform or differentiated has already received a lot of attention in the literature, especially in the early years following the breakthrough of optimal tax theory (Atkinson and Stiglitz (1972, 1976), Sandmo (1974, 1976), and Sadka (1977)). Today the theoretical case for differentiated commodity taxes seems widely accepted, but at the same time there is a widespread feeling that governments do not have the information needed to determine the optimal tax rates on specific goods and services so that, on administrative grounds, a case can be made for uniform commodity taxation.

In the area of direct taxation the predominant view is that taxes on (income from) capital and labour should be uniform or ’neutral’. The issue whether neutrality in direct taxation is actually desirable seems to have attracted relatively little attention in the literature, perhaps because the fundamental Production Efficiency Theorem of Diamond and Mirrlees (1971) established a presumption in favour of neutral taxation. Instead, much of the literature on capital income taxation has tended to focus on how the tax system can be designed to achieve neutrality.

2.3 Tax productivity

In evaluating the productivity of a tax system, two measures are normally considered. These are the (income) elasticity and the buoyancy of tax revenue (Asher, 1989; Osoro, 1991). The former measures the change in tax revenue attributable to changes in income. The latter refers to changes in tax revenue due to changes not only in income but also other discretionary changes in tax policy. The various methods for deriving these measures and the required modifications to the underlying data have been elaborated upon by Prest (1962) and Singer (1968). They have also been adapted by several researchers, including Mansfield (1972), Rao (1979) and Osoro (1991). As Osoro (1991) indicates, buoyancy can be measured by the following equation: TR = aYb er (1) where TR is total tax revenue, Y is the gross domestic product (GDP) at current prices, and er is the error term. A log-transform of Equation 1 enables us to derive the elasticity coefficient. This is represented as: log TR = log a + blog Y + er (2) whereby b provides an estimate of tax buoyancy. It measures in percentage terms the change in total tax revenue due to a change in GDP and the effect of discretionary changes in tax policy.

To measure elasticity, it is necessary to isolate the effect of discretionary changes in tax policy on tax revenue. Two approaches have been suggested for the exercise. One method suggested by Prest (1962) involves isolating the data on discretionary revenue changes based on data provided by the Treasury Department of the government. Mansfield (1972) describes this approach as follows: T1, T2, ... Tn are actual tax yields for a number of years D1, D2, ... Dn measures the effect of a discretionary tax change in the ith year on the jth year's revenue outturn Tij indicates the jth year's actual tax yield adjusted to the tax structure that existed in year I Let i = 1 represent the reference year. Hence, the series t11, T12, T13 .... Tin depict the tax receipts attainable if the tax structure remained unchanged, coupled with the removal of the effect of all discretionary changes introduced over the period following year 1. At least two problems are associated with this approach. First, there may be no data on revenue receipts directly and strictly attributable to discretionary changes in tax policy. Second, the approach assumes that the discretionary changes are as progressive as the underlying tax structure. This assumption is not likely to hold. Third, the approach is highly aggregative, whereas, other methods that decompose the elements of productivity measurement and thereby provide a better insight into how each component affects the overall productivity of a tax system.

2.4 Tax Administration

Kenya, like many other developing countries, seeks to apply the tax weapon so as to meet the objectives of raising enough revenue and ensuring that revenue is raised in ways that are equitable and that minimize the disincentive effects of taxation. The three main factors of production –labor, capital and land- are used in varying proportions in the productive process of the economy. The returns to these factors- wages, profits and rent –should therefore be taxed if the objectives of the tax policy are to be met. (KIPPRA. 2005)

In Kenya, the tax system has mainly concentrated on taxing individual income (Personal Income Tax-PIT), profits (Corporate Income Tax-CIT) and goods and services (VAT, excise duties). However, for purposes of administrative feasibility as well as for political economy reasons, a tax on land has not yet been well developed in Kenya. The main challenges facing the taxation of factors of production in a low income country like Kenya includes structure of the economy which makes it difficult to impose some taxes. The larger the size of the informal economy, the more challenging taxation becomes. Limited capacity in tax administration and poor quality of basic data to estimate optimal taxation, forecast revenues adequately, undertake micro-simulations and tax modeling. An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms. The political elite, who posses high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. The above challenges prevent the setting up of an efficient and effective tax system. (KRA. 2006)

2.5 The Canons of Taxation

The canons of taxation are considered criteria in classifying policy considerations but are not considered complete in themselves. Decisions on taxation involve trade-off and political or value judgments. There is no unique technically correct solution for the optimal tax system only various and diverse sub-optimal tax systems each with their own specific advantages and disadvantages. The tax system in order to achieve certain objectives chooses and adheres to certain principles, which are, termed its characteristics. A good tax system, therefore, is one designed on the basis of an agreed appropriate set of principles. However, tax objectives conflict with each other and there is usually a need for compromise usually at the political level. (Mahon, 1997)

Adam Smith enunciated the first four of these principles. He believed that the private sector was more efficient than the public one, and that the prime responsibility of the economic growth should vest with the private sector. However, in view of developments in economic philosophy and problems of the modern state, five additional principles were also suggested by latter writers and have also been generally accepted. Adam Smith's cannons include, firstly, the cannon of equality or equity. This cannon looks to economic justice. It states that the richer should pay more taxes because state protection and allowed for the earning and enjoying of extra income. Secondly, the cannon of certainty. Taxpayers should not be subjects to the arbitrariness and discretion of the tax officials is that breeds a corrupt tax administration. Thirdly, the cannon of convenience. The mode and timings of tax payment should be, as far as possible, convenient to the 'taxpayer'. Fourthly, the cannon of economy. This cannon recommends that the cost of collection tax should be the minimum possible both to the government and the taxpayer. (Morisset, 2001)

Other scholars have added on , fifthly the cannon of productivity. Also called the cannon of fiscal adequacy, the tax system should be able to gain enough revenue for the Treasury and government is such that there should be no need to resort to deficit financing. Sixthly, the cannon of buoyancy. The tax revenue should have an inherent tendency increased along with the increasing national income even if the rates and coverage taxes are not revised. Seventhly, the cannon of flexibility. It should be possible for authorities without undue delay, to revise the tax structure, both with respect to its coverage and rates, to suit the changing requirements of the economy and of the Treasury. Eighthly, the cannon of simplicity. The tax system should not be too complicated. It should be easy to understand, administer and not breed problems of interpretation and legal disputes. Finally, the cannon of diversity. Tax revenue should not depend upon too few sources of public income. Despite the fact that there are no specifics on which of these principles are most important, Joseph Stiglitz, summarised the characteristics of a good tax system as consisting mandatorily of a combination of the following principles. First, economic efficiency, the tax should allow for efficient allocation of resources. Secondly, administrative simplicity, the tax should be easy and inexpensive to administer. Thirdly, flexibility, the tax system should respond easily to changes in economic conditions. Fourthly, transparency, the tax burden should be easily ascertainable and be politically tailored to what society considers desirable. Finally, fairness, the tax system should be fair in its treatment of different individuals. (Wagacha, 1999)

2.6 Taxation Policies

The cannons of taxation feature of a good tax system and objectives of taxation overlap and interact with each other. However the focus of objectives is upon what is sought to be achieved through it, principles are the rules to be observed in formulated tax structure while features amount to a broad description of the tax system devised in conformity with foregoing principles. Objectives of the tax system in any economy are connected with the overall government policies. Objectives differ between developed and underdeveloped countries. These objectives can be contradictory and must be best resolved by the tax system. A tax system cannot be expected to achieve all the goals fully. For example, Value Added Tax is considered an ideal form of indirect taxation, but its adoption in developing countries, is not as comprehensive as in European countries. (KIPPRA. 2004b)

The main and generally accepted objectives of imposition of tax include: firstly, raising government revenue; secondly, redistribution of income equality; thirdly, to clear market imperfections; fourthly, to stabilize the economy; fifthly, to combat anti-social behaviour; sixthly, to implement government policy; seventhly, to moderate social variances within society to enable the poor to live a life of in material dignity. Eighthly, certain indirect taxes may be emphasized in a portfolio of taxes because they are less visible to the public and hence less subject to political mobilization. Finally, the influence that national traditions and 'path dependence' exert on the contemporary choices of tax policy. They tax a particular way because they have always taxed that way but the influence of historical patterns is not considered systematically. (Kiringai, 2002)

In Kenya, one of the main challenges of taxation is the large informal sector. The MSE sector in Kenya is large and growing in numbers. The first National Baseline Survey of 1993 identified 910,000 micro and small enterprises (excluding agro-based activity) employing about 2.0 million people. The second National Baseline Survey of 1999 identified 1.3 million enterprises with about 2.4 million people involved. This sector requires treatment other than that provided by refined methods of tax administration and provisions in the revenue code. Small producers are notoriously difficult to tax and subsistence agriculture does not generate large surpluses. An experiment with presumption tax (abolished in 1993 and re-introduced in 1995) was a particularly notable attempt to formalize parts of the informal agricultural sector (Cheeseman and Griffins, 2005). Further attempts focused on the use of advance tax and tax on rental incomes. However, given the invisibility of the informal sector and scarce empirical work to understand tax-relevant information, the presumption tax approach and the advance tax approaches failed to achieve the intended objectives. It is not difficult to understand why they could not work. If the Government does not know about the income received by farmers, farm workers and small-scale entrepreneurs, it can have no prospects of taxing it. (Moyi, E. 2003).

This creates the need for a proper income survey to determine the optimal tax yield and the ability to pay. The need to tax the MSE sector is therefore obvious. It arises from the need to encourage compliance; de-institutionalize tax evasion as normal part of doing business; enhance credibility of the tax system and theoretically embed tax equity; encourage the sector to carry its fiscal responsibility, create dis-incentives for the formal sector to sub-divide into smaller business entities below tax thresholds and thus erode the realized tax base and endanger internal balance which goes to exacerbate economic distortions inherent in taxation. (Karingi, S. 2002). Simplifying the registration process and reducing exposure to registration red tape will therefore be key towards this end. Consequently, there is need to design a special/simplified registration/formality package for the sector that takes into account the local peculiarities. Such a system should, in addition to providing the firms with legal protection, develop a tax paying culture, devoid of bureaucracy, amongst the participants; introduce good business practices and encourage existing businesses to grow and new businesses to be started by supporting a one-stop-shop approach to registration and tax administration.

2.6.1 Fiscal Tax policy

Confronted with acute resource gaps, which have over time impeded growth, developing nations have to play an even greater role in promoting economic development. As a prerequisite, these countries must mobilize their own internal resources. This has the implication that among other approaches, they adopt and implement effective tax policies. If well designed, taxation has the capacity to raise the incremental savings ratio, which is one of the main determinants of growth (Prest, 1985).

The growth in tax revenue must approximate the growth in expenditure for macroeconomic stability to hold (World Bank, 1990). On its part, the tax structure must be stable and flexible. Stability of a tax structure allows revenue to be predicted with certainty. Revenue instability can complicate fiscal management especially if expenditures are inflexible downwards, and the options open to policy makers are limited. During the period 1964–1977, the government of Kenya was able to finance all its current expenditure and part of its development expenditure using recurrent revenue receipts, and hence incurred minimal fiscal deficits. This was made possible by a healthy flow of donor assistance in terms of grants and project/programme aid. From the late 1970s, after a series of both internal and external shocks, the government experienced chronic fiscal deficits. The persistence of these deficits has been attributed to uncontrolled public expenditure and possibly an inelastic tax system. Neither tax policy nor tax administration managed to mobilize additional resources on a sustainable basis.

To bring down the deficit, it was imperative that the government improve domestic revenue mobilization while keeping public expenditures under control. Kenya's fiscal operations for the period 1986 to 1998. The deficit has persisted even though the fiscal target has been to achieve a balanced budget through measures such as lowering current expenditures on salaries and wages and on total interest, ensuring efficiency in tax collection, and raising the flexibility of the overall system. To attain a balanced budget, however, a structural transformation is required to define the core functions of government expenditure. The financing of a budget deficit can have serious ramifications in an economy. In a bid to ease such a deficit, the government may resort to one or more of the following approaches: opt for discretionary tax measures (DTMs); monetize the debt; sell the debt to the public; or raise international borrowing. The government could also fall back on its reserves on the assumption that the problem is short term. (KRA 2005 Annual Revenue Performance Report)

The first option tends to raise the tax burden and is usually politically unpopular. Borrowing from the Central Bank fuels inflationary tendencies, whereas borrowing from the public, especially through high yielding treasury bills, exerts an upward pressure on other interest rates hence impeding private sector borrowing. Bearing in mind debt servicing problems and the stiff conditionalities imposed on foreign loans by donors, the fourth option is considered expensive. It is, therefore, clear that chronic deficits stifle economic growth and impinge on other macroeconomic aggregates (Broadway et al., 1994).

Against this background, the Kenya government adopted the Tax Modernization Programme in 1986 and the Budget Rationalization Programme in 1987. While the modernization programme sought to enlarge the government revenue base in order to enhance the elasticity of the tax system, rationalization involved regulating expenditure through strict fiscal controls. Specifically, the modernization programme sought to: Raise the tax revenue–GDP ratio from 22% in 1986 to 24% by the mid 1990s, reduce compliance and administrative costs through low and rationalized tax rates and wider tax bases, improve tax administration by sealing leakage loopholes, making wider use of computers and enhancing audit surveillance, and enhance the institutional capacity to manage tax policy by establishing effective database management systems. However, by 1992, these objectives were expanded to include: raising the revenue–GDP ratio to 28%, invigorating the growth of the fledgling capital market, emphasizing self-assessment systems, strengthening taxpayer education and service, and implementing organizational reforms that would modernize tax administration. (Karingi et al. 2004b).

The Central Bank of Kenya Amendment Act (1996) became law after its signing on 14 April 1997. This act limits CBK direct credit to the government to no more than "five percent of the gross recurrent revenue of the government as shown in the appropriation accounts for the latest year for which those accounts have been audited by the Controller and Auditor General". The amendment grants the CBK autonomy and reduces the authority of the Minister of Finance to override CBK's decisions. Only a Cabinet resolution can do so. The implications of this act are that the government has to meet its expenditure wholly by relying more on revenue collected by the Kenya Revenue Authority (KRA). Second, the act gives CBK more independence in controlling money supply, which is the main source of inflation and price instability. Third, the amendment requires the government to spend within its budgetary limits or risk borrowing expensively from the open market where the repayment will further constrain its development expenditure. Given the problems associated with foreign borrowing, especially in the 1990s, the overall reaction has been to mobilize greater resources internally through the tax system.

2.6.2 Customs Policy

Kenya's customs taxes underwent significant changes during the reform period in the direction of restricting duty exemptions, encouraging exports, reforming the tariff structure and strengthening the administration of customs duties. Broadly, these reforms were aimed at encouraging a free market atmosphere and therefore increasing the level of foreign direct investment. During the period 1987 to 1998, the top tariff rate was reduced systematically from 170% to 25%,while the rate bands were reduced from 24 to 5 (including duty free). As a result of these changes, the simple average rate fell from 40% to 16%. (KIPPRA 2005).

Before 1991, the exemption system had been rather generous, and several measures were implemented to restrict this generosity. Such restrictive policy included the reduction in the range of exempt goods, making imports by all parastatals tax deductible, abolishing discretionary exemptions3 (in 1992) and eliminating exemptions on agricultural commodity aid (except during cases of a national disaster or refugee support) in 1995. The reforms during the period 1994 to 1998 also targeted the non-government organization (NGO) sector by imposing restrictions on NGO exemptions, introducing the bonding of major project aid-funded imports and initiating post project reconciliation. Similarly, NGOs and other relief organizations were required to register for purposes of income tax in order to qualify for exemption. (Nyamunga, J. 2004a).

The reforms were also aimed at expanding the export capacity of the country by among other things introducing duty/VAT exemption on direct and indirect imports of raw materials for use in the production of exports, duty-free items for the domestic market, and inputs for aid-funded projects. Under the manufacturing under bond facility, machinery and raw material were classified under duty/VAT exempt products so long as the manufactured products were meant for export. If the products were sold in the domestic market, then normal duties plus 2.5% surcharge would apply. Other export support programmes included export compensation (from 1974 to 1993), export processing zones (from 1991), full import liberalization (from mid 1993) and full foreign exchange liberalization (from late 1993). Export compensation was abolished in 1993 to save government revenue and to limit the abuse of the incentive by some unscrupulous local manufacturers. Export duties were abolished to give impetus to export growth, while export licensing was also abolished to minimize the delays and inconveniences that had been a common feature under the system. (Warlters, M. (2005).

In order to achieve these reforms, the administrative capacity of the tax system had to be strengthened. (Taliercio, R. 2004).The measures undertaken towards this end include the re-introduction of the selective examination/rapid release system and the re-establishment of the intelligence and investigation functions. Others were strengthening the transit controls system, revising the pre-shipment inspection programme (from 1994), implementing limited “modularized” computerization on selected functions, introducing warehouse controls and strengthening cargo control at Mombasa port (from 1996).

2.6.3 VAT and excise duty policy

VAT was introduced in Kenya in 1990 to replace sales tax. This shift was motivated by the argument that VAT (relative to sales tax) had a higher revenue potential, and that its collection and administration were more economic, efficient and expedient. Since 1991, a number of steps have been taken to rationalize and strengthen the VAT, most importantly by moving several items subject to VAT from specific to ad valorem rates and broadening VAT coverage in the service sector. Generally, four measures were applied to broaden the base of VAT. First, retail-level sales tax was changed to manufacturer-level VAT including business services (from 1990). Second, the tax point was gradually moved from the manufacturer to the retail level in a number of sectors including jewellery, household appliances and entertainment equipment, furniture, construction materials, vehicle parts, and pre-recorded music. As a result, the coverage of VAT on goods supplied at retail level expanded tremendously from 1990 through 1995. Third, "goods" were redefined to exclude the supply of immovable tangible and all intangible property and rental or immovable property. Fourth, the coverage of the service sector was expanded (from 1991) to include business services; hotel and restaurant services; entertainment; conferences; advertising; telecommunications; construction; transportation; the rental, repair and maintenance of all equipment (including vehicles); and a range of personal services. (KIPPRA. 2004b).

Measures aimed at VAT rationalization 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. Whereas the low rate was increased from 50% to 78%, all the other rates were reduced; the top rate from 150 to 15% and the standard rate from 18% to 16%. Additional measures included raising the minimum turnover level for compulsory registration from Ksh10,000 to Ksh40,000 and introducing stiff penalties for defaulters in the following areas: late VAT returns, failure to issue VAT invoices and failure to maintain proper books of account. Another aspect of VAT that elicited much interest from the taxpayers was the tax refund system. At the time of inception, the refund system was characterized by weak controls and corruption that led to loss of revenue (Nyamunga, 2001). Administrative changes were undertaken thereafter (mid 1990s) to streamline the refund system. The improved management that followed has been behind the introduction of tighter verification measures and the elimination of the large backlog of claims. Since 1991, the coverage of excise duties has expanded from domestic production to include imports. Excise duties were rationalized to cover the luxury goods tax element on wine, beer, spirits, mineral water, tobacco products, matches, luxury passenger cars and minibuses. Automotive fuels and cosmetics were also introduced into the excise tax net.

2.6.4 Income tax policy

Income tax is a direct tax charged on business income, employment income, rent income, pensions, investment income and so on. The main goal of income tax reforms has been to enhance collection by broadening the tax base while reducing the maximum rates. The top rate for individual tax was reduced from 65% (in 1987) to 32.5% in 1998. Further, basic tax allowances (tax credits) were increased and simplified while the single credit per individual was introduced in 1997. Changes in the company tax structure included reducing the top rate from 45% to 32.5% between 1989 and 1998. The rate was rationalized by unifying the structure across all types of business. There were efforts to lower and equalize company and individual marginal tax rates. This was aimed at increasing the disposable income for both corporate and individual capital investments, thus encouraging private investment through the consumption transmission mechanism. The income tax structure was integrated in the following ways. (KIPPRA. 2004b).

First, there was a shift from the classical system that encouraged double taxation to the current system that encourages single-stage taxation. The taxation of dividends was limited to a final tax while a compensating tax was introduced to ensure all corporate distributions are made out of after-tax income. The interest and penalty system9 has been rationalized along with the introduction of the installment and self-assessment tax systems, as well as the reintroduction of the personal identification number (PIN) for purposes of tax assessment. The PIN was aimed at improving tax information management by identifying all taxable persons in the country so that any transaction made by them could be systematically identified and the appropriate tax captured. Another element of income tax reforms was the timing of collections and rationalization of the withholding tax system. The system of paying tax on business income was changed from delayed payment to current payment through a seven-year phase-in (from 1990 to 1996). The withholding tax net was expanded to cover interest income from discounts on debt instruments, royalties, payments to contractors and self-employed persons without the PIN. Again, withholding tax on interest was raised from 10% to 15% but was made a final tax when received by an individual from a financial institution.

Measures to expand the income tax base included taxation of employer provided benefits, PAYE amnesty (in 1993), application of presumptive income tax on selected agricultural produce and taxation of foreign exchange gains. Businesses having assets and liabilities denominated in foreign currency were required to pay tax on such assets and liabilities on a realization basis. Presumptive income tax on agricultural produce (which was abolished in 1993 and re-introduced in 1995) required farmers of direct agricultural exports to pay 20% of their total earnings in tax. Currently, the rate of the deduction is 2% of the gross amount paid. Presumptive income tax was used to expand coverage of farmers while also raising tax compliance. (Nzioki 2004)

The Income Tax Act provides for personal relief to taxpayers. Since 1990, tax brackets and tax relief have been reviewed with the objective of cushioning low-income earners against bracket creep while ensuring that high income earners bear a larger proportion of the tax burden. In the period 1990 to 1997, there were sustained increases in the single and family relief. Thereafter, a single personal relief of Ksh7,200 was introduced to replace the family relief, single relief and insurance relief. The personal tax relief introduced in 1997 has been subjected to 10% annual increments. These increments have had the effect of raising the minimum monthly income at which income tax becomes payable from Ksh6,000 to Ksh8,000.

2.6.5 Organizational policy

One of the main objectives of the tax modernization programme (1986) was to implement organizational reform that would modernize tax collection. Before the reform period, tax administration was under five separate departments (custom duty, excise duty, sales tax, income tax and corporation tax departments) in the Ministry of Finance. The Kenya Revenue Authority was incorporated in 1995 in order to strengthen revenue collection and harmonize the separate tax collection arms. It was expected that KRA would put in place an efficient and effective system to seal the widespread loopholes in the tax system, bring down the vice of tax evasion, and enlist as many eligible taxpayers into the tax net as possible. To accomplish this, it was allocated more budgetary support to enhance the pay structures of the revenue officers and attract and retain professional staff. Structures for identifying and dismissing incompetent or corrupt staff were strengthened. This was necessary since efficient revenue collection was seen as a means to lower government borrowing and, therefore, of easing pressure on inflation and interest rates (Griffiths. 2005)

2.7 Tax Modernization

The magnitude of government surplus or deficit is probably the single most important statistic measuring the impact of government fiscal policy on an economy (Siegel, 1979). In view of its phenomenal growth, it is now widely accepted that public sector finances and related policies constitute a central aspect of economic management. The quality of this management in no small measure influences overall macroeconomic performance as well as the distribution of resources between the public and private sectors. Fiscal deficit has become a recurring feature of public sector financing all over the world. Its widespread use is partly influenced by the desire of various governments to respond positively to the ever-increasing demands of the populace and to enhance accelerated economic growth and development (Ariyo, 1993). This tendency toward deficit financing is more pronounced in developing countries where the populace looks to the government for the satisfaction of most needs.

Kenya, like many other developing countries, seeks to apply the tax weapon so as to meet the objectives of raising enough revenue and ensuring that revenue is raised in ways that are equitable and that minimize the disincentive effects of taxation. The three main factors of production labour, capital and land- are used in varying proportions in the productive process of the economy. The returns to these factors- wages, profits and rent –should therefore be taxed if the objectives of the tax policy are to be met. (WEF. 2004)

In Kenya, the tax system has mainly concentrated on taxing individual income (Personal Income Tax-PIT), profits (Corporate Income Tax-CIT) and goods and services (VAT, excise duties). However, for purposes of administrative feasibility as well as for political economy reasons, a tax on land has not yet been well developed in Kenya. The main challenges facing the taxation of factors of production in a low income country like Kenya includes: Structure of the economy: This makes it difficult to impose some taxes. The larger the size of the informal economy, the more challenging taxation becomes. Administration: Limited capacity in tax administration. Tax data: Poor quality of basic data to estimate optimal taxation, forecast revenues adequately, undertake micro-simulations and tax modeling; and Politics: An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms. The political elite, who posses high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. The above challenges prevent the setting up of an efficient and effective tax system. (GOK. 2003)

2.8 Globalization in Kenya

Actual empirical evidence on the impact of globalization on tax policy remains quite mixed. Although there have been some changes in tax policies along the predicted lines, to date these changes on the level of collections, the composition of revenues, the convergence in tax rates have been minimal, even when present. While the economics of these changes may well be plausible, the process by which they occur seems slow, erratic, and uncertain, and disentangling the empirical evidence remains difficult. Faced with these difficulties, some analysts have applied a standard tax competition model to globalization issues. For example, Wilson (1986) and Zodrow and Mieszkowski (1986) assume labour is taxed and capital is mobile, and that globalization adversely affects consumer welfare due to the externality imposed by capital mobility. In particular, increased tax competition (i.e., globalization) leads to lower public good provision and inefficiently low tax rates on the mobile factor. By contrast, the Leviathan view of government argues that government competition is beneficial because it reduces the size of government and wasteful government bureaucracy. Janeba and Schjelderup (2002) combine these two strands of literature to examine the effect of increasing capital mobility (globalization) on the externality and the possible reduction of rents to politicians.

A dominant theme in international economic relations in recent years is the increased integration of the world's economy. Whether one defines such "globalization" in terms of liberalized trade and capital flows (Grunberg, 1998; Fox, 1998), greater factor mobility (Grubert, 1998), or, more broadly, the "internationalization of production and sales and new forms of delivering goods and services to consumers across countries, new developments in information and communications technologies, and the growing importance of e-commerce" (OECD, 2001) there is little question that globalization is on the rise. Globalization is often thought to imply that the ability of governments to choose tax policies independently of those in other jurisdictions is greatly curtailed.

Beginning in the mid-1980's, tax reforms became part of the larger Structural Adjustment Programmes that were incorporated in the economic restructuring agreement between the Government of Kenya and the International Financial Institutions (Fjeldstad and Rakner, 2003). Unfortunately, such reforms focused on the Central Government tax system but left out local government tax reforms. Substantial tax reforms followed fiscal crises that were being experienced at the time and the resulting pressures for reform from the IMF and World Bank. The pressure to liberalize happened simultaneously with the realization within the Government that the economic situation was untenable (Cheeseman and Griffiths, 2005). Thus, Kenya's tax reform was adopted voluntarily to gain favor with powerful international donors. Prior to the reforms, especially in the 1964-1977 period, the country's fiscal operations were somehow less troublesome. The Government incurred minimal fiscal deficits and was able to contain its expenditure (current expenditure and part of development expenditure) within the recurrent revenue limits. The lower fiscal deficits were also as a result of a generous flow of donor grants and aid. However, the onset of internal and external shocks in the late 1970's seriously upset the budget balance and resulted into fairly large fiscal deficits.

As part of the reform package, the Kenya Revenue Authority (KRA) was incorporated in 1995. KRA was designed with autonomy (self-governance) enhancing mechanisms, including self financing mechanisms, a Board of Directors with high-ranking public and private sector representatives, and sui generis personnel systems (Taliercio, 2004). Thus, KRA amalgamated the five main revenue departments that were initially in the Ministry of Finance namely Customs Duty, Excise Duty, Sales Tax, Income Tax and Corporate Tax). By running on business principles and by being semi-autonomous, KRA was designed to be less vulnerable to political interventions and to have the leverage to recruit, retain, dismiss and promote quality staff by paying salaries above civil service terms. This was intended to motivate staff and reduce corruption. But there are concerns that KRA exists mainly to respond to the demands of IMF and World Bank and not domestic concerns over equitable taxation and the disincentive effects of taxation on economic activity. It is estimated that in the fiscal years 2000/2001 and 2001/2002, respectively, only 65 per cent and 66.9 per cent of the potential income tax revenue was collected by the Kenya Revenue Authority (KIPPRA, 2004a).

Has reform been without challenges? One of the most prominent challenges to reforms is the presence of a large untaxed informal sector as well as high levels of revenue leakage. Similarly, VAT has responded very poorly to reforms yet it is the most important indirect tax. There has been the problem of ambitious and rapidly changing tax/GDP targets that are externally induced as well as the failure to reform local government taxation. One of the mistakes of the Kenyan tax reform program was poor sequencing, which resulted in policy reforms preceding administrative tax reforms (Karingi et al, 2005). Whereas tax policy reforms commenced in 1986, administrative reforms were initiated in 1995 when KRA was established. This discrepancy resulted in lagging collections amounting to Ksh 61.8 billion for income tax and Ksh 27.7 billion for VAT by 2004. There was also the problem of domestic resistance to reforms including the opposition by local sugar producers to the liberalization of the sugar sub-sector to COMESA imports and the opening up of the cereals sector under the Free Trade Area agreements. In 1998, the Minister of Finance proposed to increase the tax levied on subsidized loans to bank employees as a way of broadening tax base through taxing employer provided benefits. In response, around 12,000 bank employees began a nation-wide strike. As the strike entered its sixth day, paralyzing businesses, their employers announced that the striking workers would be sacked. In response, Kenya's trade union federation threatened to call a national strike and, recognizing the difficulty of the situation, the Minister was forced to reverse the decision.

The KRA recommended the introduction of Electronic Tax Registers (ETRs) in 2005 to ensure full remittance of VAT by retailers. This was resisted openly through strikes and street demonstrations in major towns in the country. Currently, ETRs are the subject of court battles between KRA and Traders (under the United Business Association). The introduction of Simba 2005 system, an online value declaration customs system, has been strongly resisted, especially after it became evident that some imported vehicles had escaped the net following collusion between importers and customs officials. An unfriendly political economy that is not amenable to rational tax policy may prevent significant tax reforms. The political elite, who posses high personal income, wealth and property, may use their political influence to oppose the imposition of wealth and property taxes. This is what happened in November 2006, when Parliament rejected some of the June 2006 budget proposals by the Minister of Finance. The proposals rejected included a tax on entertainment and house allowances for holders of constitutional offices, a tax on yearly donations to political parties exceeding Ksh 1 million, tax on sale of houses by individuals (capital gains tax), an increase in tax on fortified wines from 45% to 65%, a proposal to tax cigarettes differently, and the proposal to shift the 7% sugar cane development levy from consumers to farmers. (KRA. 2006)

2.9 Types of Taxes

The most important taxes in Kenya are taxes on goods and services. According to Musgrave (1987), consumption should be the preferred tax base because, unlike income taxation, consumption taxation is associated with low deadweight loss or efficiency losses and do not discriminate in favor of present consumption over future consumption. Despite the policy shift towards indirect taxation, taxes on income and profits have continued to play a significant role in Kenya's revenue structure. Income taxation allows the tax authorities to introduce some progressivity into burden distribution. When taxes on goods and services are broken down, VAT contributes the largest share (over 60%) of taxes on goods and services. The importance of taxes on international trade in Kenya's revenue share has been declining in line with trade policy shifts away from protectionism. For instance, tariff rationalization started in 1988/89 reduced the number of tariff categories from 25 to 17. These changes led to lower import duty rates in line with trade liberalization regime (Karingi, 2004b).

An important property of the tax system is to generate automatic growth in fiscal revenues over time without necessarily resorting to discretionary policy or inflationary financing (Martinez-Vazquez, 2001). Such a system allows revenues to grow faster than the growth in GDP. Changes in tax revenues result from growth in the economy with widening of tax bases as changes in the tax laws broaden the tax bases, increase in tax rates and better enforcement of an existing tax structure. When all these changes occur, the effect is captured by the buoyancy, which measures the responsiveness of the tax system to changes in economic activity as well as changes in discretionary policy. However, elasticity is a more refined measure than buoyancy as it measures the responsiveness of the tax system to changes in economic activity (GDP) alone. (Mahon, 2007)

2.9.1 Income Taxes

In Kenya, income tax has been designed to target corporate profits (Corporate Income Tax -CIT) and employment (Personal income tax (PIT) and Pay As You Earn (PAYE). Income tax is charged directly on business income, employment income, rent income, pension earnings, investment income (dividends, royalties) and commissions. Income from self-employment is subject to the Personal Income Tax (PIT) while employment income is subject to Pay As You Earn. The PIT and PAYE are charged at the same graduated scale while CIT is charged on profits on limited liability companies. Other income taxes include fringe benefits tax, advance tax, taxes under Widows and Orphans Act and Parliamentary Pensions Act. At the theoretical level, income taxation is applied to achieve broad objectives of income redistribution and revenue mobilization. In practice, Kenya has relied heavily on income taxation on the basis of ease of collection rather than on the basis of abstract principles of equity. This explains why the pre-reform period was characterized by high top marginal rates, very wide brackets between the lowest and highest brackets, discrepancy between CIT and PIT rates, too many income tax brackets, and low levels of compliance. Given these features, the main challenges of income tax reforms were to reduce the maximum rates, reduce the dispersion between the minimum and maximum rates, and rationalize the income tax brackets. (KRA, 2004)

2.9.2 Personal Income Taxes (PIT)

Personal income taxes are justified on the basis of several theoretical arguments. It is argued that that PIT is income elastic since its revenue grows in proportion to income. Second, it is argued that PIT is progressive in its distribution of tax burdens. Third, PIT can be relatively neutral in its effects on economic decisions, thus reducing distortions in the economy. The incidence of PIT falls entirely on the salaried persons and wage employees working in the formal sector. Before the reforms, the PIT system suffered from several setbacks. These include high marginal tax rates, discrepancies between nominal and effective progressivity, complexity of the system and tax evasion.

One of the most pertinent challenges facing the tax authorities has to do with differential treatment of dividend and interest income; they attract different rates even for the same income. The next challenge remains taxation of agriculture and the informal sector. Despite the use of presumptive taxes, this has been a problematic tax weapon (it was abolished in 1993 and re-introduced in 1995). The performance of the tax has been poor, despite the reform efforts at introducing it. (Karingi, 2004)

2.9.3 Corporate Income Taxes (CIT)

Theoretically, a positive case can be built for the imposition of a corporate tax. This is based on several factors: On equity grounds; Ease of administration for those companies that comply with statutory accounting standards; Political considerations make it more prudent to tax corporations - which have no votes - than taxing individuals; and The benefit principle where corporations should pay taxes in return for the benefits conferred by incorporation. There are, however, negative sides to the imposition of corporate taxes. These include; Corporation taxes have a retarding effect on he corporate sector to the extent that they discourage existing corporations from growing or deterring unincorporated businesses from adopting a corporate form or even encourage existing corporate to discard their corporate identity; Revenue yields from corporate income tax may be at the expense of private savings rather than consumption because corporate taxes mean that dividends are less than they should be; and Corporate income tax may become a deterrent to foreign capital inflow. (Prasad, 2003)

Prior to the reforms, the main problems of corporate income taxation included low levels of compliance, inefficient tax assessment and collection procedures of tax administration. Since enterprises are the engine of job creation and growth, lower corporate tax rates encourage investment, entrepreneurship and production by increasing the net reward for productive effort. In addition, lower corporate tax rates make Kenya tax competitive and therefore a suitable destination for foreign direct investment. Given this viewpoint, the most prominent feature of corporate tax reform was the reduction of the top rate from 45% in 1989 to 30% currently. Similarly, the top CIT rate and the top marginal PIT rate were unified as a means of increasing the disposable income for both corporate and individual capital investments. As well as reducing incentives for tax avoidance that results from differentiated top CIT and PIT rates. Similarly, the differentiated CIT rate structure was also rationalized by unifying the structure across all types of business. However, differentiated rates between local and foreign companies have persisted even during the reform period. This may act as a disincentive to local companies, which are not eligible for incentives that are available for their foreign counterparts. (Gallagher, 2004)

2.10 Taxation Policies and Globalization

Taxes (other than lump-sum taxes) distort behavior, yet society needs to collect revenue to pursue various social objectives. The optimal taxation literature identifies tax systems that minimize the excess burden of taxation, subject to various restrictions on tax instruments and information available to the government, and under different assumptions about population heterogeneity and the functioning of private markets. Historically, there are three strands in the development of the optimal taxation literature. One, initiated by the seminal work of Ramsey (1927) and carried on, perhaps most notably, by Diamond and Mirrlees (1971), concentrates on the design of commodity taxes. A second set of contributions, beginning with Mirrlees (1971), considers more general nonlinear income taxes and focuses on the role of such taxes in addressing distributional concerns. Finally, the work of Pigou (1947) and others analyzes the use of taxes to address two types of market failures: financing “public” goods not provided by the private sector, and correcting externalities associated with incomplete private sector markets.8 Although these three strands in the literature have converged, it is still useful to consider them separately in turn before discussing their interrelationship.

The analysis to this point concerns the optimal design of tax policies in economies with perfectly competitive industries. Since some economic situations are characterized by imperfect competition, it is useful to consider the implications of differing degrees of market competition for optimal tax design. One of the difficulties of summarizing the implications of imperfect competition for optimal taxation stems from the multiplicity of imperfectly competitive market structures. Nevertheless, it is possible to identify common welfare implications by considering a range of tax instruments and market situations. Our analysis follows closely that of Auerbach and Hines (2001).

A good tax administration system should identify all those required to pay taxes and issue unique identification numbers that are fed into a master file upon which updates are made and from which retrievals can be made. KRA has made some progress in this area by increasing the number of VAT taxpayers in its registry from 17,106 in 1997 to 26,591 in 2000 (an increase of 55%) (Talierco, 2004). According to KRA (2006), a total of 33,923 taxpayers and 33,141 taxpayers were recruited in 2003/04 and 2004/05, respectively. In 2005/06, a total of 40,537 taxpayers were recruited. Despite this, KRA has to contend with the problem of low filing compliance, which stood at 29% in 2000. Another challenge for KRA is integrating the processes of registration and filing. Since these processes are poorly integrated, most of the operations are still manual. Similarly, the registration function is yet to be integrated – different taxes still require separate identification numbers and different offices are charged with the registration function. KRA should move towards an integrated tax payer registration system where a uniform Tax Identification Number (TIN) would apply regardless of whether a tax payer is registering for Personal Tax, Corporate Tax or VAT. (KRA, 2006)

Estimating taxable income and tax liability: "Self-assessment" systems enhance tax compliance by making it easy for taxpayers to assess their own tax liability, file a return, report that assessment and pay the taxes due. Compliance is less burdensome when tax laws are simple, tax return forms are easy to understand and taxpayers do not need the help of tax specialists to file their returns. Compliance surveys by KIPPRA, KRA and MoF (KIPPRA, 2004) indicate that 51% of taxpayers view the corporate tax rates as high while 29.8% view them as being fair. In addition, about 85.9% of taxpayers view PAYE rates being either very high or high. About 62.5% of tax payers hire paid accountants to prepare VAT returns while 64.9% hire paid consultants to prepare the IT returns. This implies that the income tax and VAT rates are punitive and lack in-built mechanisms that would enhance self-assessment. There is need to simplify tax laws, forms and procedures. Some of these have compounded the problem of high compliance costs. (KIPPRA, 2004)

2.11 Tax Reforms Introduction

Whereas tax policy reforms commenced in 1986, administrative reforms were initiated in 1995 when KRA was established. This discrepancy resulted in lagging collections amounting to Ksh 61.8 billion for income tax and Ksh 27.7 billion for VAT by 2004.

As part of the reform package, the Kenya Revenue Authority (KRA) was incorporated in 1995. KRA was designed with autonomy (self-governance) enhancing mechanisms, including self-financing mechanisms, a Board of Directors with high-ranking public and private sector representatives, and sui generis personnel systems (Taliercio, 2004). Thus, KRA amalgamated the five main revenue departments that were initially in the Ministry of Finance namely Customs Duty, Excise Duty, Sales Tax, Income Tax and Corporate Tax).

In 1998, the Minister of Finance proposed to increase the tax levied on subsidized loans to bank employees as a way of broadening tax base through taxing employer provided benefits. In response, around 12,000 bank employees began a nation-wide strike. As the strike entered its sixth day, paralyzing businesses, their employers announced that the striking workers would be sacked. In response, Kenya’s trade union federation threatened to call a national strike and, recognizing the difficulty of the situation, the Minister was forced to reverse the decision.

The KRA introduced Electronic Tax Registers (ETRs) in 2005 to ensure full remittance of VAT by retailers as a result tax revenue increased from Ksh 127. 03 billion to Ksh 145.81 billion

The introduction of Simba 2005 system, an online value declaration customs system, has been strongly resisted, especially after it became evident that some imported vehicles had escaped the net following collusion between importers and customs officials.

2.12 Empirical Literature

Tax is a central but neglected element of development policy. The structure and administration of taxation are frequently omitted from discussion and research agenda. Questions of a primarily redistributive nature may be deemed political, and so unsuitable for neutral economic analysis, and moreover as questions to be resolved by the democratic process in individual countries. On the other hand, many questions are posed in terms of system reform and these may instead be considered as purely 'technical' – matters of economic and bureaucratic efficiency to be settled by experts. (Martinez-Vazques, 2001)

As a result, tax generates neither the sort of attention given by independent empirical academic research such as questions of optimal exchange rate arrangements, nor the level of NGO advocacy focus devoted to e.g. multinational investment behavior. This twin neglect may explain how an element of such importance for human development has such a low profile – and possibly why its contribution may have been damaging. This neglect, it is argued, has led to two main developments. First, the treatment of tax as a specialist area, with a resultant focus on 'efficiency' rather than theoretical analysis or practical research, has contributed to a lack of knowledge of potentially important peculiarities of individual countries. This in turn has contributed to treatment of poor countries' systems as simply underdeveloped versions of rich country equivalents. Technical assistance has then focused on helping the former to reach 'our level', rather than a more careful and constructive engagement. (Crowe, 2005)

Problems of this nature are increasingly widely recognized. The World Bank's study of its own performance in this area during the 1990s is damning: Such recognition has brought with it efforts to improve assessment, including a recent USAID project (Gallagher, 2004) which attempts to construct a series of international benchmarks by which to compare tax systems internationally. One issue stemming from the previous neglect, and which may not necessarily be addressed in this approach, is that – as in other areas, but perhaps with less resistance and attention – a pattern can be traced of poor countries playing an impossible (and under funded) game of catch-up with a moving target of rich countries' tax structures.

2.13 Summary of Literature Review

The magnitude of government surplus or deficit is probably the single most important statistic measuring the impact of government fiscal policy on an economy (Siegel, 1979). In view of its phenomenal growth, it is now widely accepted that public sector finances and related policies constitute a central aspect of economic management. The quality of this management in no small measure influences overall macroeconomic performance as well as the distribution of resources between the public and private sectors. Fiscal deficit has become a recurring feature of public sector financing all over the world. Its widespread use is partly influenced by the desire of various governments to respond positively to the ever-increasing demands of the populace and to enhance accelerated economic growth and development (Ariyo, 1993). This tendency toward deficit financing is more pronounced in developing countries where the populace looks to the government for the satisfaction of most needs.

The literature suggests three issues that should guide decisions on the fiscal deficit profile for an economy. The first issue relates to the usefulness of fiscal deficit as a tool for enhancing accelerated growth and development. This is an issue on which there is as yet no consensus among economists, given the divergent findings of reported studies. While some studies (e.g., Thornton, 1990) indicate a net positive effect, others (Baily, 1980; Feldstein, 1980; Landau, 1983) suggest a net negative effect. Mixed results have also been reported by some studies (e.g., Ariyo and Raheem, 1991). The second issue relates to the mode of financing the deficit. Some of the financing options include the running down of government accumulated cash balance, net borrowing from the banking system or from abroad, issuing of new currency as well as drawing down of foreign assets (Ariyo and Raheem, 1990). Each mode of financing could have a differential impact on the economy (Chibber and Khalizadeh-Shirazi, 1988; Yellen, 1989). Third, and most importantly, a fiscal deficit profile must be sustainable (Buiter, 1983). Otherwise, the country will become perpetually insolvent (Wickens and Uctum, 1990).

Of concern to economists and interested observers in recent times is the rising magnitude of deficits by various governments. There is therefore a growing recognition that the formulation and implementation of macroeconomic management proposals, most especially for economic reforms, should explicitly recognize the implications of fiscal deficit on the economy. These reforms should cover not only the size and financing patterns of government deficits but also the structure of taxation and the level and composition of public expenditure (Chibber and Khalizadeh-Shirazi, 1988).

CHAPTER THREE: RESEARCH METHODOLOGY

3. Introduction

This chapter defines the design of the study and the research method, which was used to get responses from the target population. It further highlights data collection procedures including data collection instruments that was used. The chapter concludes with a highlighting how data was analyzed.

3.1 Research design

The research design of this study was descriptive that used survey methods. The descriptive design method was suitable in this case because it addresses the major objectives and the research questions proposed in the study adequately. The study intended to determine how the tax reform policies proposed by the Government impacts on tax collection.

3.2 Population

The researcher used secondary data. The researcher used tax collection statistics before and after policy reforms for the period under study from the Kenya Revenue Authority.

3.3 Sample

The sample consisted of 10 years, 5 years before reforms and 5 years after reforms. The data from the years under study was obtained from different published statistics from Kenya Revenue Authority.

3.4 Data Collection

The study used mainly the secondary data from annual reports of Kenya revenue authority published facts and figures and reports for the period under the study.

3.5 Data Analysis

Descriptive statistics was the basis of analyzing the data. Descriptive statistics describe data on variables with single numbers while analysis of variance (ANOVA) tests for any significance difference between mean values of variables. Arithmetic mean and the standard deviation are some of the main descriptive statistics applied in data analysis. The arithmetic mean, the average of values in an observation, was used to represent the entire data by a single value. The standard deviation is a measure of variation and was used to determine how the mean was a representative of the observations. The paired t-test was used to compare the two sets of measures of performance before and after reform policies. The paired t-test brought out the effects of tax reform policies on tax revenues.

3.6 Ethical Issues

Data was moved from the field only by the researcher to ensure confidentiality was observed, any discussion and clarification from Kenya Revenue Staff remained confidential and used only for the purpose of this study.

CHAPTER FOUR: DATA PRESENTATION, INTERPRETATION AND DISCUSSION

4.1 Introduction

The main objective of this study was to analyze the tax reform policies and tax revenue in Kenya. In order to achieve this objective, the entire set of data for total tax, sales tax, income tax, excise tax and import tax, average for five years before reforms was compared with average data for the same measures of performance for five years after tax reforms to take into account difference in tax revenue collections.

4.2 Measures of central tendency

The basic analysis begun with the determination of various measures of central tendency; namely mean, minimum and maximum. Standard deviation was used as measures of dispersion (variation). Calculations were carried out for correlation, significance and paired t- test.

Table 4.1: Descriptive statistics for measures of performance

	Minimum Million	Maximum Million	Mean Million	Std. Deviation Million
Total tax	111430.00	145806.00	125429.40	9934.50
Sales tax	29850.00	38343.00	34326.00	2771.20
Income tax	38314.00	56390.00	45042.50	5488.80
Excise duties	20550.00	28583.00	24691.80	2645.20
Import duties	11501.00	24431.00	17988.90	5371.60

The table above displays the mean value and standard deviation, values for the pair(s) of variables compared in the Paired Samples T Test procedure. Since the Paired Samples T-test compares the means for the two variables, for this research the measures of performance before and after reform, it was useful to know what the mean values are. The researcher found out the average minimum value for total tax as 111430 million, 29850 million for sales tax, 038314 million for income tax, 20550 million for excise duties and 11501 million for import duties. For maximum average values were 145806, 38343, 56390, 28583 and 24431 millions for total tax, sales tax, income tax, excise duties and import duties respectively. The mean and standard deviations for total tax was 125,429 and 9,934 millions for sales tax was 34,326 and 2,771 millions, for income tax was 45,042 and 5,488 millions, for excise duties was 24,691 and 2,645 millions and for import duties was 17,988 and 5,371 millions.

Table 4.2: Correlation between measures of performance before and after reforms

		Sales tax before	**Sales tax after**	**Income tax before**	**Income tax after**	**Excise tax before**	**Excise tax after**	**Import tax before**	**Import tax after**
Sales tax before	Pearson Correlation	1	.610	-.380	-.116	.380	.115	.793(*)	.410
	Sig. (2-tailed)	.	.145	.400	.804	.400	.806	.033	.361
Sales tax after	Pearson Correlation	.610	1	-.391	-.733	.391	.732	.874(*)	.815(*)
	Sig. (2-tailed)	.145	.	.386	.061	.386	.061	.010	.026
Income tax before	Pearson Correlation	-.380	-.391	1	.154	-1.000(**)	-.152	-.454	.045
	Sig. (2-tailed)	.400	.386	.	.742	.	.745	.306	.924
Income tax after	Pearson Correlation	-.116	-.733	.154	1	-.154	-1.000(**)	-.450	-.472
	Sig. (2-tailed)	.804	.061	.742	.	.742	.000	.312	.285
Excise tax before	Pearson Correlation	.380	.391	-1.000(**)	-.154	1	.152	.454	-.045
	Sig. (2-tailed)	.400	.386	.	.742	.	.745	.306	.924
Excise tax before	Pearson Correlation	.115	.732	-.152	-1.000(**)	.152	1	.449	.473
	Sig. (2-tailed)	.806	.061	.745	.000	.745	.	.312	.283
Import tax before	Pearson Correlation	.793(*)	.874(*)	-.454	-.450	.454	.449	1	.688
	Sig. (2-tailed)	.033	.010	.306	.312	.306	.312	.	.088
Import tax	Pearson	.410	.815(*)	.045	-.472	-.045	.473	.688	1

after	Correlation								
	Sig. (2-tailed)	.361	.026	.924	.285	.924	.283	.088	.

Correlation is significant at 0.05 level (2-tailed)

The correlations table displays Pearson correlation coefficients and the significance values. Pearson correlation coefficients assume the data are normally distributed. The Pearson correlation coefficient is a measure of linear association between the measures of performance before and after reforms. The values of the correlation coefficient range from -1 to 1. The sign of the correlation coefficient indicates the direction of the relationship (positive or negative). The absolute value of the correlation coefficient indicates the strength, with larger absolute values indicating stronger relationships. The correlation coefficients on the main diagonal are always 1.0, because each variable has a perfect positive linear relationship with itself.

The significance of each correlation coefficient is also displayed in the correlation table. The significance level is the probability of obtaining results as extreme as the one observed. If the significance level is very small (less than 0.05) then the correlation is significant and the two variables are linearly related. If the significance level is relatively large then the correlation is not significant and the two variables are not linearly related.

Table 4.3: Paired t-test for tax reforms

	Paired t - test
Total Tax	-2.152
Sales Tax	-1.018
Income Tax	-0.335
Excise Tax	0.641
Import Tax	-0.638

The mean values for the measures of performance before and after reforms are displayed in the Paired Samples Statistics table above. A low significance value for the t-test (typically less than 0.05) indicates that there is a significant difference between the measures of performance before and after reforms. The t-test for total tax was -2.152, for Sales tax was -1.018, -0.335 for income tax, 0.641 for excise tax and -0.638 for import tax.

CHAPTER FIVE: SUMMARY OF FINDING, CONCLUSION AND RECOMENDATIONS

5. Introduction

This chapter discusses the findings gathered from the analysis of the data, as well as the conclusions reached. Findings have been summarized alongside the objectives of study, conclusions have been drawn from the study and the recommendations for actions are given.

5.1 Summary of finding

Basic analysis begun with the determination of various measures of central tendency; namely mean, minimum and maximum. Standard deviation was used as measures of dispersion (variation). Calculations were carried out for correlation, significance and paired t- test.

The researcher found out the average minimum value for total tax as 111430 million, 29850 million for sales tax, 038314 million for income tax, 20550 million for excise duties and 11501 million for import duties. For maximum average values were 145806, 38343, 56390, 28583 and 24431 millions for total tax, sales tax, income tax, excise duties and import duties respectively. The mean and standard deviations for total tax was 125,429 and 9,934 millions for sales tax was 34,326 and 2,771 millions, for income tax was 45,042 and 5,488 millions, for excise duties was 24,691 and 2,645 millions and for import duties was 17,988 and 5,371 millions.

The Pearson correlation coefficient is a measure of linear association between the measures of performance before and after reforms. The values of the correlation coefficient range from -1 to 1. The sign of the correlation coefficient indicates the direction of the relationship (positive or negative). The absolute value of the correlation coefficient indicates the strength, with larger absolute values indicating stronger relationships. The correlation coefficients on the main diagonal are always 1.0, because each variable has a perfect positive linear relationship with itself.

The significance level is the probability of obtaining results as extreme as the one observed. If the significance level is very small (less than 0.05) then the correlation is significant and the two variables are linearly related. If the significance level is relatively large then the correlation is not significant and the two variables are not linearly related.

The mean values for the measures of performance before and after reforms are displayed represented in the analysis. A low significance value for the t-test (typically less than 0.05) indicates that there is a significant difference between the measures of performance before and after reforms. The t-test for total tax was -2.152, for Sales tax was -1.018, -0.335 for income tax, 0.641 for excise tax and -0.638 for import tax.

5.2 Conclusion

The main objective of this research was to assess the tax reform policies and tax revenues in Kenya. In line with the objectives data from tax collection reports was compared after and before the implementation of the reform policies. Five measures of performance were used in arriving at the conclusion; they were total tax, sales tax, income tax, excise duties and import duties. The average data for five years before implementation of reform policies and five years after implementation was computed and analyzed. The paired t-test was performed on the average figures for all the measures of performance.

The results for four of the measures of performance out of five showed a significance difference in paired t-test. Total income, sales tax, income tax and import tax had the paired t-test of below 0.05 significance level, while excise tax had the paired t-test of over 0.05.

From the above results, the research concludes that there was significance improvement in tax revenue after the implementation of reform policies by Kenya.

5.3 Recommendation

KRA should shift towards an integrated tax payer registration system where a uniform Tax Identification Number (TIN) would apply regardless of whether a tax payer is registering for Personal Tax, Corporate Tax or VAT.

Simplify the tax code: Since income tax and VAT rates are punitive and lack in-built mechanisms that would enhance self-assessment, there is need to simplify tax laws, forms and procedures.

Developing systems that can enhance access to third-party sources of information. KRA still lacks adequate and frequently updated information systems on registered taxpayers. Computerization of taxpayer records is still incomplete. There is need to develop systems that can access third party sources of information, such as withholdings, bank transactions, foreign exchange transactions, transactions in securities and large transactions (involving real estate, cars, tax-deductible transactions, customs payments). Use of tax amnesties can prove useful.

Enhancing administration through measures such as entrusting sensitive negotiations to special teams; minimizing contacts between tax payers and tax collectors and reducing the discretionary powers of tax officers; setting up supervisory systems with at least three hierarchical levels to reduce opportunities for collusion; and devise incentive systems that match public and private interests. There is the possibility of relying on banks in collecting taxes.

5.4 Limitations of the study

Limited resource-since the research involved personal collection of data from several publications, and making follow-ups through visits and telephone contacts, were constraint by finance.

Given the nature of the study, the time allowed was not sufficient enough to exorsitively carry out the project.

Getting an appoint with the KRA deputy director posed a challenge making the researcher to go through several protocols and even after getting the appointment the researcher could only be with him for a shorter period of time.

The researcher could only access the data through hard copies and the soft version of the publications could not be shared, this increased the work through typing of the data before computation and analysis.

KRA is the main body mandated with the tax collection role, however there are other agencies which collect taxes among them the local authorities, the data from this agencies could not be accessed to give the whole picture of the effect of reform policies on tax collection

5.5 Further study

The challenge is to address the scarcity of data on income distribution, data on consumer expenditure and distribution of property and wealth. There is need for research on household budgets firm levels of self employed persons which can be used to generate information that would allow progressivity analysis.

Although the Central Government Tax system has changed substantially under the reform period, there is little information on changes in taxes at the Local Authority level. There is also little coordination between the various levels of Government. All these attributes provide the impetus for much more analysis of Local Government Taxation, especially on issues of revenue adequacy, economic efficiency, effects on equity.

Research needs to be undertaken to ensure that viability of implementing land based taxes. Specifically there is need to ensure that the implementation of property taxes should take account of a number of issues ownership side by side with land shortages and low agricultural productivity.

Further work is required in quantifying the costs and benefits of tax incentives, with the objective of establishing their net worth. This is justified by the fact that overwhelming evidence has shown that investors rate tax incentives rather low among the factors they consider in choosing between locations.

The project only covered five year period and dwelt with the actual data collected, it is recommended that a further research be undertaken to cover a longer period and which should also incorporate the effect of the reform policies on both nominal and actual tax.

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APPENDIX I: Raw Data

	Total Tax		Sales Tax		Income Tax		Excise Duties		Import Duties	
	Nominal	**Real**	**Nominal**	**Real**	**Nominal**	**Real**	**Nominal**	**Real**	**Nominal**	**Real**
1	127,030	127,030	29,850	29,850	48,375	48,375	23,687	23,687	22,594	22,594
2	147,893	132,997	34,468	30,996	55,578	49,980	28,382	25,523	27,167	24,431
3	155,524	131,244	39,205	33,084	55,235	46,612	28,733	24,247	28,444	24,003
4	156,966	125,272	40,944	32,677	53,317	42,551	28,493	22,740	28,605	22,829
5	164,112	119,094	50,221	36,445	53,429	38,773	28,318	20,550	28,804	20,903
6	162,464	111,430	50,872	34,891	55,862	38,314	32,077	22,001	21,584	14,804
7	190,297	125,443	57,185	37,696	67,529	44,515	42,671	28,129	19,895	13,115
8	203,169	122,023	58,983	35,425	70,862	42,560	47,590	28,583	21,907	13,157
9	211,957	113,955	62,967	33,853	78,777	42,353	45,304	24,357	21,392	11,501
10	298,901	145,806	78,603	38,343	115,601	56,390	55,557	27,101	25,732	12,552

APPENDIX II: Raw Output

Correlations

Correlations

		Totaltax	Salestax	Incometax	Exciseduties	Importduties
Totaltax	Pearson Correlation	1	.093	.930**	.448	.201
	Sig. (2-tailed)		.799	.000	.194	.578
	N	10	10	10	10	10
Salestax	Pearson Correlation	.093	1	-.029	.317	-.699*
	Sig. (2-tailed)	.799		.937	.372	.025
	N	10	10	10	10	10
Incometax	Pearson Correlation	.930**	-.029	1	.503	.068
	Sig. (2-tailed)	.000	.937		.138	.852
	N	10	10	10	10	10
Exciseduties	Pearson Correlation	.448	.317	.503	1	-.480
	Sig. (2-tailed)	.194	.372	.138		.160
	N	10	10	10	10	10
Importduties	Pearson Correlation	.201	-.699*	.068	-.480	1
	Sig. (2-tailed)	.578	.025	.852	.160	
	N	10	10	10	10	10

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Regression

Variables Entered/Removed[b]

Model	Variables Entered	Variables Removed	Method
1	Importduties, Incometax, Salestax, Exciseduties[a]	.	Enter

a. All requested variables entered.

b. Dependent Variable: Totaltax

Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.992[a]	.984	.972	1670.47329

a. Predictors: (Constant), Importduties, Incometax, Salestax, Exciseduties

ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	8.74E+08	4	218576088.8	78.329	.000[a]
	Residual	13952405	5	2790481.016		
	Total	8.88E+08	9			

a. Predictors: (Constant), Importduties, Incometax, Salestax, Exciseduties

b. Dependent Variable: Totaltax

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	-25193.4	13730.931		-1.835	.126
	Salestax	1.540	.282	.429	5.469	.003
	Incometax	1.524	.129	.842	11.831	.000
	Exciseduties	.497	.304	.132	1.634	.163
	Importduties	.938	.167	.507	5.606	.002

a. Dependent Variable: Totaltax

T-Test

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	Totaltax	125429.4	10	9934.54557	3141.579
	Salestax	34326.00	10	2771.26818	876.35195

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	Totaltax & Salestax	10	.093	.799

Paired Samples Test

		Paired Differences					t	df	S
					95% Confidence Interval of the Difference				
		Mean	Std. Deviation	Std. Error Mean	Lower	Upper			
Pair 1	Totaltax	91103.40	10063.86947	3182.475	83904.14	98302.66	-2.152	9	

T-Test

Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	Totaltax	125429.4	10	9934.54557	3141.579
	Salestax	34326.00	10	2771.26818	876.35195
Pair 2	Incometax	45042.50	10	5488.87625	1735.735
	Exciseduties	24691.80	10	2645.22454	836.49345
Pair 3	Totaltax	125429.4	10	9934.54557	3141.579
	Importduties	17988.90	10	5371.67488	1698.673

Paired Samples Correlations

		N	Correlation	Sig.
Pair 1	Totaltax & Salestax	10	.093	.799
Pair 2	Incometax & Exciseduties	10	.503	.138
Pair 3	Totaltax & Importduties	10	.201	.578

Paired Samples Test

		Paired Differences					t	df
					95% Confidence Interval of the Difference			
		Mean	Std. Deviation	Std. Error Mean	Lower	Upper		
Pair 1	Salestax	91103.40	10063.86947	3182.475	83904.14	98302.66	-1.018	
Pair 2	Incometax	20350.70	4744.87900	1500.462	16956.42	23744.98	-0.335	
Pair 3	Importduties	107440.5	10300.68449	3257.362	100071.8	114809.2	-0.638	