

**THE EFFECT OF TAX AMNESTY ON VALUE ADDED TAX  
COMPLIANCE IN KENYA**

**BY**

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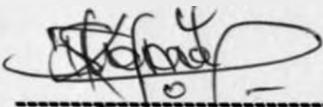
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## DECLARATION

This management research report is my original work and has not been submitted for a degree in any other university.

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## **DEDICATION**

**I dedicate this work to my beloved mother, Elizabeth Nkinoi Leseeto**

## **ACKNOWLEDGEMENTS**

I would like to express my deepest thanks to all the people, whom in their special ways supported me in search of knowledge which culminated in the completion of this management project.

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Equally, I would convey my appreciation to my parents, brothers and sisters for their sacrifices made for me. Last but not least, to all those I did not mention but were directly or indirectly involved in completing this study and most of all to God for the breath of life.

## **ABSTRACT**

Kenya has in the past implemented tax amnesties in its tax regimes in the years 1993, 1998 and 2004 to improve compliance among the taxpayers. The objective of this study was to examine the effect of the year 2004 tax amnesty on VAT compliance in Kenya. The key research question was: "Did tax amnesty of the year 2004 affect the VAT compliance?" The study utilised secondary data obtained from the KRA data base for the financial years 1995/6 to 2006/7 providing sufficient dataset for the use of an event study methodology for analysis.

The analysis result showed that VAT collections and taxpayer base have continuously grown in the past decade despite some observed seasonality in the data. The study indicated that tax amnesty has the following effects: First, the tax amnesty impacted positively on both short and long run compliance. This was evident by an upward trend after the amnesty event and further confirmed by high positive abnormal VAT collections. Secondly, the amnesty duration allowed the taxpayers to pay their overdue tax. This helped the government to manage its debt portfolio as shown by high collections during amnesty period associated with past transactions.

The empirical findings in this study support the proponents of tax amnesty. Studies have shown mixed results on the impact of amnesties on both short and long run compliance but all agree on its effect on debt management (Laborda and Rodrigo, 2003). This study confirms this scenario by showing collection of overdue tax as noted by Alm and Beck (1993). The study further supported Laborda and Rodrigo (2003) that amnesty improves short and long term compliance.

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## **LIST OF ABBREVIATIONS**

<b>CIA</b>	-	<b>Central Intelligence Agency</b>
<b>CSD</b>	-	<b>Customs Services Department</b>
<b>ETR</b>	-	<b>Electronic Tax Register</b>
<b>GDP</b>	-	<b>Gross Domestic Product</b>
<b>I&amp;E</b>	-	<b>Investigation and Enforcement</b>
<b>IMF</b>	-	<b>International Monetary Fund</b>
<b>IT</b>	-	<b>Income Tax</b>
<b>KAM</b>	-	<b>Kenya Association of Manufacturers</b>
<b>KRA</b>	-	<b>Kenya Revenue Authority</b>
<b>LTO</b>	-	<b>Large Taxpayers Office</b>
<b>OLS</b>	-	<b>Ordinary Least Squares</b>
<b>PAYE</b>	-	<b>Pay As You Earn</b>
<b>TAT</b>	-	<b>Tax Amnesty Team</b>
<b>USA</b>	-	<b>United States of America</b>
<b>UK</b>	-	<b>United Kingdom</b>
<b>UNDP</b>	-	<b>United Nations Development Program</b>
<b>VAT</b>	-	<b>Value Added Tax</b>
<b>WB</b>	-	<b>World Bank</b>

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 Background to the Study**

Amnesty programs have lately obtained growing attention in the tax compliance and evasion literature (Luitel and Sobel, 1991 Malik and Schwab, 1991). In situations where there is revenue shortfall, governments have resulted into offering tax amnesties to allow taxpayers to declare and pay their past undeclared taxes. Although many tax amnesties have been conducted all around the world, evidence about their long-term effects is largely lacking (Alm and Beck, 1993). This in essence shows that tax amnesties without other structural adjustments can not be used as a tool for improving tax compliance (Luitel and Sobel, 1991). Improving tax collection through enhanced compliance requires understanding of the impact of various structural and administrative measures put in place (KIPPRA, 2004).

The tax base in Kenya, as is most sub-Saharan African countries, is still sub-optimal (KIPPRA, 2004, Kiringi and Wanjala, 2005). Most developing countries with a comparative GDP like Kenya and other sub-Saharan Africa are showing higher tax compliance (KIPPRA, 2004). So far, attempts to increase tax revenue have focused on closing the 'taxation gap' and expanding the tax base. The main policies recommended by the International Monetary Fund (IMF) have led to trade liberalization, which have had mixed results in terms of enhancement of tax compliance (Njoroge, 1996). Agbeyegbe et al., 2004) argued that the reduction in tariffs has been successful as increased imports have so far more than compensated for the reduction in tariffs and resulted in an increase in import related revenues. On the other hand, the impact of

domestic tax reforms has been less impressive (Njoroge, 1996). Most importantly, revenue collected from VAT and direct taxation through income tax has not increased as hoped (KIPPRA, 2004).

Notable reforms in the recent past in Kenya include switching from sales tax to VAT system and the creation of Kenya Revenue Authority (KRA) to collect and account for taxes on behalf of the government. However, the expectations are far from being achieved and the issue of compliance is still a “thorn in the flesh” of KRA. It is argued that structural weaknesses in the Kenyan economy are strong constraints on the state’s ability to increase income tax revenue (KIPPRA, 2004). These constraints are identified to include placing revenue expansion limits caused by low levels of formal employment, poor wages and a high dependency ratio. Njoroge (1996) further added that taxpayers’ negative attitude towards paying taxes coupled with limited knowledge on relevant tax laws reduces voluntary compliance. There are tax delinquents who intentionally evade paying taxes due and payable so as to re-invest into their businesses (Cuccia, 1994, Torgler, 2002). Finally, demographic factors such as the age of the taxpayer; where newly registered taxpayers tend to evade paying their taxes more than the long time registered taxpayers. These among other factors led to the adoption of tax amnesty as an initiative to increase tax revenue collection in short-run and encourage long-term compliance (Alm and McKee, 1998)

Luitel and Sobel (1991) discussed two schools of thought on the effects of tax amnesty on tax compliance. First, the proponents of tax amnesty argue that it may increase tax revenues as taxpayers take advantage of the grace period offered by the tax authority. The

second school of thought consisting of the opponents of amnesty contend that the revenues from the more productive amnesties are relatively small (Malik and Schwab, 1991). They noted that amnesty outcome is overstated on the revenues it generates if known delinquents are allowed to participate and if the administrative costs of the amnesty are not accurately considered. They argue that not only is the revenue increase it generates is quite small, but also that amnesty may affect compliance level of the honest taxpayers as they may view tax amnesty as an unfair tax break for tax “cheats”. Luitel and Sobel (1991) argued that amnesties provide incentives for otherwise honest taxpayers to start evading taxes because they anticipate the offering of future amnesties. The outcome of such process is a weakened tax compliance and inefficient tax system.

VAT is a tax on consumer expenditure introduced in Kenya in January 1990 to replace sales tax, which has been in operation since 1973 (KIPPRA, 2004). The primary motive of its introduction was to increase government revenue through the expansion of the tax base, which hitherto was confined to sale of goods at manufacturing and importation level under the sales tax system. In Kenya, VAT switched the focus of taxation from direct taxes such as income tax to indirect taxes (KRA, 2007). It was thought that it would generate much more revenue even when the general economy is on its downturn. VAT is levied on consumption of taxable goods and services supplied or imported into Kenya and collected by registered person at designated points who then remit it to the commissioner. Registered persons only act as VAT agents in collection and paying the tax since tax is borne by the final consumer of goods and services.

Tax compliance in Kenya is still low due to various reasons some of which are structural while others relate to taxpayers' attitude towards taxation (Njoroge, 1996). It is estimated that tax compliance was rated at 65% and 66.9% for the fiscal years 2000/1 and 2001/2002 respectively with VAT being the least complied tax system (KIPPRA, 2004, KRA, 2006). Reforms aimed to improve compliance have been designed especially in the past ten years according to KIPPRA (2004). With the emerging trend of reduced donor funding, the government needs to improve on its internal financing in order to meet the repayment of loans and accrued interest at the same time bridging budget deficit that is ever increasing (KIPPRA, 2004, Agbeyegbe et al., 2004). The issue facing Kenya today in its pursuit of her fiscal policy is among others low revenues collections in the short run and the low level of tax compliance in the long run (KIPPRA, 2004). A sustained increase in reduced tax compliance fuels government borrowing from the financial sector. This crowd out private investment inhibiting sustained economic growth.

The Kenyan tax structure is less buoyant and possibly inelastic although indirect taxes, such as VAT, hold the capacity to improve flexibility of the tax system (Njoroge, 1996, Karingi et al., 2005). VAT revenue collection rank second after the income taxes and has continuously grown over the years as a response to the modernization programs put in place. VAT has responded very poorly to reforms yet it is the most important indirect tax (Karingi et al., 2005). That being the case, tax authorities directed substantial effort and resources to exploit the ability of this tax to raise more revenue for the Governments at a relatively lower cost of administration and compliance. This makes VAT an important area for study so as to examine the efficiency of reforms measures on compliance. The

major reforms undertaken in this area includes introduction of Electronic Tax Registers (ETRs) and online filing of VAT returns.

## **1.2 The Kenyan Experience**

Governments desperate for quick funds sometimes turn to amnesties (Agbeyegbe et al., 2004). The immediate revenue results may occasionally be impressive; although it is seldom clear what the real present value of any net revenue increment may be (Luitel and Sobel, 1991). Perhaps the most effective amnesty is one that is given to, so to mention, “wipe the slate clean” of old offenses in order to launch a new era of tough tax enforcement. Repeated amnesties generally signal that the government is unable to enforce taxes effectively. Such amnesties have effects during both the years preceding the amnesty and in the amnesty year (Alm, 1998). As compliance becomes further eroded, such limited positive effects become increasingly unlikely in the amnesty year.

According to KRA (2004), there are a number of tax amnesties offered in Kenya. The first tax amnesty offered in Kenya in 1993 was aimed at broadening the tax base and to discourage evasive tendencies. Two major compliance mechanisms implemented are Personal Identification Number (PIN) and self-assessments for the purposes of income tax. In order to provide a relief to individuals with introduction of the two powerful tools, the government set a date from which additional assessments could not be raised. The government provided amnesty to persons who voluntarily made a full disclosure of all income chargeable to tax for the year of income 1992 and refrained from assessing and recovering tax relating to years of income prior to 5<sup>th</sup> February 1993. This tax amnesty lasted for six months and covered the period from 5<sup>th</sup> February, 1993 to 31<sup>st</sup> July 1993.

The second tax amnesty implemented in 1998 was designed as a way of further encouraging tax compliance. It was a limited tax amnesty on the income tax, penalties and interest accruing on undeclared income from prior years. It was subject to the respective taxpayer purchasing government bonds of at least two years duration of the equivalent value of previously undisclosed income. The amnesty also covered interest and penalties on any VAT undeclared and not charged on supplies of goods and services related to undeclared income qualifying for the income tax amnesty. The latest, and the one mostly perceived successful amnesty, was offered in the year 2004. It was announced by the Finance Minister during the budget speech on June 10<sup>th</sup> 2004 and allowed persons (individual, firm or corporate body) to pay previously undeclared taxes or duties without being subjected to additional penalties, fines, or interest if the declaration is voluntary. It came into effect on 11th June and ran through 31st December 2004. It applied to Income Tax, VAT, Customs & Excise duties as well as traffic fees.

*Dhyshul*

The 2004 tax amnesty has been widely hyped as successful in the history of KRA by recovering a huge sum of money. The procedures put in place by the Authority provided an environment to maximize on the amnesty window. The tax agency warned that with the ongoing public awareness campaign, those who do not take opportunity of the amnesty will have themselves to blame when legal action is taken on defaulters. This amnesty was widely advertised both on the television and the print media for the whole period covered by the amnesty, posters were erected along the main highways in the country and tax payers were educated through holding of tax clinics across the country.

In order to implement the tax amnesty, the Commissioner General constituted an inter-departmental Tax Amnesty Team (TAT) to coordinate the implementation of this initiative. This amnesty applied to those delinquents who were not known by the tax authority. All taxpayers whose liability have been established or those who are in the process of an audit or investigations were expected to pay taxes determined without any benefit of the amnesty other than the provisions of the VAT Act on remission and waiver.

Table 2.2: Tax Amnesty Revenue Collections

<b>Tax Initiative</b>	<b>Collection Status</b>	<b>Cases</b>	<b>Amount</b>
Customs & Excise	Fully accepted	388	163,487,359.00
	Partially accepted	-	-
	Total accepted	388	163,487,359.00
	Applications made	803	284,698,944.00
Income tax	Fully accepted	1,968	2,674,830,947.00
	Partially accepted	290	47,977,228.00
	Total accepted	2,258	2,722,808,175.00
	Applications made	2,617	3,051,263,179.00
Value Added Tax	Fully accepted	754	1,447,058,471.00
	Partially accepted	111	77,043,549.00
	Total accepted	865	1,524,102,020.00
	Applications made	872	1,709,187,331.00
Road Transport	Fully accepted	191	3,573,790.00
	Partially accepted	-	-
	Total accepted	191	3,573,790.00
	Applications made	191	3,573,790.00
<b>Grand Total</b>	Fully accepted	3,301	4,288,950,567.00
	Partially accepted	401	125,020,777.00
	Total accepted	3,702	4,413,971,344.00
	Applications made	4,483	5,048,723,244.00

Source: KRA statistical Bulletin, July 2004-June 2005.

The procedure for applying for a tax amnesty for VAT involved calling at any VAT office with an application for amnesty, submitting returns or amended returns on the undeclared tax and paying VAT on undeclared taxable goods/services to the

commissioner where tax was due before 11<sup>th</sup> June, 2004. No additional tax, Penalties or fines were imposed where VAT was paid in full on or before 31<sup>st</sup> December 2004 (see *appendix I*). No queries were raised on voluntary disclosure of tax and a letter confirming amnesty was issued. Table 2.2 provides the cases of various tax heads applications for the amnesty, the manner in which the cases were settled and the total amounts collected. The partially collected and the uncollected tax revenues resulted from either the inability of the taxpayers to settle the tax outstanding due to liquidity problems or due to some circumstances where the applicants had given post dated cheques running beyond 31<sup>st</sup> December which had not been taken into account on the tabled statistics.

### **1.3 Tax Compliance Reforms in Kenya**

VAT, which was introduced in 1990, has undergone major rationalization with the rate maximum being reduced from 105% to 15% and the tax bases from 15 bases to 3 (KRA, 2006). The current VAT bases are Zero rate, standard rate (currently at 16%) and exempt supplies. The VAT collections over the years have constantly grown over the 10 years (KRA, 2006). This indicates that VAT offers a very important avenue by the government to finance its recurrent and development budgets. However, tax evasion is still evident and its literature dates back at least to the classic paper of (Allingham and Sandmo, 1972). Table 2.3 below provides a snapshot of VAT collection in Kenya for financial year 1995/1996 through 2005/2006. The constant growth can be attributed to the continuous structural and procedural changes being implemented (KRA, 2006). There has also been an increased awareness created among the taxpayers which has greatly changed their attitude towards tax payment (KIPPRA, 2004).

**Table 2.3: VAT Collections 1995/96 to 2005/06 Fiscal Years**

Fiscal Year	VAT Amount		Percentage of Growth on Vat Collection. %
	Target (Kshs M.)	Actual (Kshs M)	
1995/96	-	14,750.00	
1996/97	15,606.00	14,845.00	0.67
1997/98	18,197.00	19,250.00	29.67
1998/99	23,841.00	21,075.00	9.48
1999/00	21,800.00	22,404.00	6.31
2000/01	26,447.00	26,575.00	18.62
2001/02	28,945.00	26,447.00	(0.48)
2002/03	29,184.00	27,586.00	4.31
2003/04	31,700.00	31,411.00	13.87
2004/05	34,859.00	40,183.00	27.93
2005/06	42,422.00	42,151.00	4.9

Source: KRA statistical Bulletin, July 2005-June 2006.

KRA's mission statement embraces the element of enhancing voluntary compliance through the implementation of the taxpayers' charter and other administrative policies (KRA, 2007). Over the past few years, the authority has made notable steps towards improving tax compliance by way of changes in the tax laws (KRA, 2006). The following are just but a few changes made on the main revenue Acts: First, Section 17 of the VAT Act was amended and a new section 19A was introduced to enable Commissioner of Domestic taxes to require registered persons to withhold and pay VAT directly. Second, the 7<sup>th</sup> schedule of the VAT Act was amended to provide for introduction of Electronic Tax Registers for specified VAT registered persons. Third, Income tax Act amended to provide for appropriate penalties on persons who defaults making payments to the Commissioner on specified incomes withheld. Finally, section 92A of the Income tax Act was amended to clarify that the due date for additional assessment will be the same as the date of self-assessment.

Other administrative reforms and modernization measures implemented in a bid to enhance compliance are: merging of the revenue departments and sections such as the

VAT and Income Tax department to form a single department and consolidation of debt and compliance sections for efficiency and effectiveness of revenue collection (KRA,2004;2006). Joint audits for VAT and Income taxes were introduced in order to enhance efficiency and effectiveness of the audit programme and reduce the cost of compliance to taxpayers. Secondly, there is enhancement and implementation of focused taxpayer recruitment and holding of public tax clinics in various parts of the country. Thirdly, specialized departments which are in a position to effectively and efficiently manage the affairs of specific tax payers were created. For instance, Large Taxpayers Office (LTO) and Prosecution Section within Investigations and Enforcement (I&E) department are some of the specialized sections which can improve compliance.

#### **1.4 Statement of the Problem**

Tax amnesty has been used by governments for two reasons; first, to enhance voluntary compliance (Luitel and Sobel, 2005). Taxpayers are introduced into tax bracket and are subsequently monitored to ensure compliance to the relevant tax laws. Guilfoyle (2003) argued that compliance is measured through the subsequent revenue collection following an offer for tax amnesty from individual taxpayers. His findings for Michigan tax amnesty showed a positive relationship between the two variables, that is amnesty and tax compliance.

Second, tax amnesty is offered to collect tax arrears by allowing taxpayers to declare and pay principal overdue taxes without interest and penalties. Laborda and Rodrigo (2003) in their studies found out that tax amnesty only collects taxes in arrears previously undeclared. This measure helps to boost short term revenue collection for the

governments but does not affect long term compliance. It therefore acts as debt management strategy in addition to helping the government collect the overdue taxes to finance budgets and reduce deficits.

Studies done on this subject in other countries is showing contrasting evidence on the effects of tax amnesty on voluntary compliance (Alm and Beck, 1993, Andreoni, 1991). Taxpayers' attitude towards tax payment is adversely affected by tax amnesty, hence lower voluntary compliance, especially when offered repeatedly (Alm and Beck, 1993; Leonard and Zeckhauser, 1986; Malik and Schwab 1991). However, Andreoni (1991), Alm and Beck (1990, 1991) argued that amnesties may sometimes increase compliance, hence tax collection, when it is backed by heightened enforcement. Whichever the direction, it is generally agreed that offering tax amnesty affects revenue collections. It is important for the policy makers to evaluate the specific direction and magnitude of tax amnesties for the adoption and implementation of appropriate strategies.

This study therefore examines the effect of tax amnesty on VAT compliance in Kenya. Although Kenya has offered three major tax amnesties in the recent past, 1993, 1998 and 2004, the study will particularly focus on the effect on the amnesty of 2004 on the VAT compliance. This amnesty was offered due the declining tax growth and was aimed at improving tax compliance (Kiringi and Wanjala, 2005), especially on the indirect taxes whose VAT. The later amnesty was also appropriate for our study due to sufficient and complete data for the period of observation prior and after the amnesty. This allows us to empirically determine the effect of the amnesty on VAT compliance both in short and long run.

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The study empirically examined whether offering tax amnesty in Kenya affected the voluntary compliance. This will help in the debate of the contrasting impact of amnesties on compliance. This study endeavoured to develop a constant growth trend (pre and post amnesty) and further examined the short and long run compliance. This study incorporates time series analysis and examines the impact of an event (amnesty) on subsequent VAT collections. In order to achieve this, the study aims to answer the following questions:-

- (a) What is the trend of import and domestic VAT collections for the period 1995/6 to 2003/4 financial years?
- (b) What was the short run effect on VAT collections immediately following the amnesty of June-December 2004?
- (c) What was the long term effect on VAT collections by the amnesty for the period 2004/5 to 2006/7 financial years?

### **1.5 Objective of the Study**

The objective of this study is to examine the short and long run effect of tax amnesty on VAT compliance in Kenya.

### **1.6 Significance of the Study**

This study will be of importance to; first, this study is important to the organization that administers tax laws in Kenya, the KRA Commissioners. These are the managers charged with the responsibility to ensure efficient and effective operation of the organization. They also advise the government on administrative and operational strategies to be implemented to enhance compliance. This therefore will enable them to understand the

effect of tax amnesty on VAT compliance hence forms organizational knowledge. The study gives the managers a basis for comparison in case of future amnesties.

The second category of the users are the researchers who offer a “pool” of knowledge for future researches, especially on such important areas of government policy. The findings of this study will form bedrock for future researches on effects of tax amnesties in Kenya and other knowledge on tax matters. The literature on tax amnesty and its relationship with compliance is still growing. This is further complicated by the intense debate on whether or not the amnesty improves compliance. This study therefore brings to fore the empirical evidence of the amnesty in Kenya and give insights to other studies to explore of areas identified for further study.

Thirdly, the study also benefits the general public. The public, comprised of taxpayers have a stake on the study since they are the subject of this study. To further enhance compliance, the findings of this study will improve their attitude towards tax amnesty. To some extent, it also allows them to make an informed decision in case of a future amnesty as they fully understand the processes involved and the consequences. The post amnesty trend may act as a motivation towards compliance and a document of taxation, the study offers awareness to the public.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Introduction**

This chapter discusses tax amnesty, compliance and reforms from different parts of the world. It broadly covers the theories of tax compliance and tax amnesties in sections 2.2 and 2.3. The chapter further discusses the existing empirical evidence on tax amnesties in section 2.4. Conclusion is then drawn from this review of literature which forms the bedrock of the study in section 2.5.

#### **2.2 Theories of Tax Compliance**

There are two broad classes of tax compliance theories; (a) the economics-based theory which emphasize incentives (Cuccia, 1994, Torgler, 2002) and (b) psychology based theory which emphasizes attitudes (Alm and McKee, 1998). The economic based theory suggests that the taxpayers try to maximize on the benefit associated with tax evasion, through “playing the audit lottery”. The probability of detection for audit, coupled with the consequences either encourages or deters taxpayers. The taxpayers finally make a choice of the alternative which maximizes their economic benefit, hereby discussed as after-tax return. For such taxpayers, Cuccia (1994) argues that increasing audit visits, interest and penalties would affect their compliance levels.

The psychological based theory on the other hand relies on moral and ethical concerns of the taxpayers. Regardless of the risk of being caught, the taxpayers’ attitude to voluntary compliance would still remain high (Alm and McKee, 1998). Increasing compliance

with such taxpayers requires a change of their attitude. Governments driven by the desire to increase compliance for psychology based taxpayers do so by increasing taxpayer education, reducing operational costs of return filing. Alm and McKee (1998) argue that amnesty offer and the subsequent participating is one way of educating the taxpayers on the procedures and legal implication of evasion.

However, the two theories are not completely independent and measures put in place to influence one may impact the other. Alm and McKee (1998) points out that amnesty creates an environment where both theories are understood and consequences addressed in a holistic manner. Taxpayers are made aware of their exposed risk of being caught and reduced chances of benefiting from evasion (Torgler, 2002). Testing the effectiveness of either theories require the examination of the variables underlying these theories and their effects on compliance.

### **2.3 Theories of Tax Amnesty**

Governments facing budget deficits take actions to close the deficit through spending cuts and/or tax increase (Agbeyegbe et al., 2004). With the pressure to raise additional revenue, many states have begun to offer, and in many cases repeatedly offer, periods of state tax amnesty (Luitel and Sobel, 2005). Malik and Schwab (1991) argue that some evaders would like to rejoin the tax system but are discouraged by high fines and possible embarrassment they might face should they reveal their evasion. Given an amnesty, these people can rejoin the tax system without facing fines and this embarrassment. Cases like these are clearly a *ceteris paribus* Pareto improvement as these individuals gain and

revenue increases, while no one else loses. Government raises more tax not only in the short run from collecting overdue taxes, but also by bringing former non-filers back into the tax system for the long run (Luitel and Sobel, 2005).

According to the researches done globally, the following have been found to be the common characteristics (Malik and Schwab, 1991, Alm and Beck, 1993). First, most amnesties are voluntary and have been found to be short lived in nature, generally lasting from two to three months. Individuals may decide not to participate; however, consequences of not participating could be such that if they are caught later, they could get a stiffer punishment than before (Luitel and Sobel, 2005). Thirdly, tax amnesties are also allowed to cover some tax heads and excluding others. For instance, an amnesty may be given to income tax alone without affecting the status of other taxes. Finally, incentives that waive the fines and penalties associated with evasion are granted but not on the principal amount of taxes that is due.

Tax amnesties vary widely across countries by content and period of coverage (Alm and Beck, 1993, Andreoni, 1991). Luitel and Sobel (2005) while discussing amnesty types noted that 1982-2004 in the USA, the shortest amnesty was conducted by Kentucky (15 days in 1988). The longest amnesty periods in the same study was offered by Oklahoma and Arkansas (183 days in 1984 and 2004 respectively). Empirical evidence on these theoretical effects of a tax amnesty is rare. Naturally, it is difficult to measure the real effects of tax amnesties due to the data availability problems. The reason to participate amnesties therefore becomes scanty unless it is established through evaluation of the evaded tax and the influence on the tax base (Cassone and Marchese 1995). On the other

hand, for taxpayers who found themselves in such a position by accident, the marginal cost of participation is low and an amnesty offers a new start into an honest life where personal guilt is reduced.

Most empirical results are reported from the United States since their database is well developed. Similarly, state amnesties are better comparable than amnesties between countries with very different backgrounds. In their empirical work with field data, Alm and Beck (1993) analyze the long run effects of the Colorado tax amnesty for the period January 1980 through December 1989. Their time series analysis indicates that the amnesty in Colorado had virtually no long-run effect on the level and the trend of tax collection, despite the fact that the Colorado Department of Revenue increased the post-amnesty enforcement efforts. In a cross-section analysis including 28 US states, Alm and Beck (1991) empirically analyze the effects of tax amnesties on the total amnesty revenues or the total revenues divided by state population. The results indicate that the participation of known delinquents and a reduction of interest payments on back taxes increase the amnesty revenues significantly. Furthermore, strict post-amnesty penalties and enforcement mechanism also increase amnesty revenues. Alm and Beck (1991) additionally stress the fact that a government can implement all these strategies without costs except the enforcement mechanism.

As field data on tax amnesties are rare, the possibilities for investigations are rather limited. Alm, McKee and Beck (1990) pointed out that there is lack of field data on the post-amnesty impact regarding taxpayers' expectations about future amnesties. Field data pose the problem that it is difficult to separate different effects e.g., enforcement efforts

and changes based on the tax amnesty (Alm and Beck 1993). Experiments offer the possibility to get own data and to check specific circumstances, which are difficult to control in field studies (Torgler, 2002). Tax amnesty experiments help to control this problem since they allow analysis of the effects of different tax amnesty structures in the long run. Alm, McKee and Beck (1990) found in an experiment that the average level of compliance falls after an amnesty. However, taxpayers who revealed a high compliance before an amnesty, continued to be compliant afterwards. On the other hand, subjects with a moderate tax compliance rate reduced their compliance in the post-amnesty phase. The authors found that a successful strategy to increase tax compliance after an amnesty is to intensify enforcement efforts. Enhancing the enforcement mechanism increases the cost of evasion and thus reduces the cost of participating in an amnesty. Short-term revenues support the transition to a new tax system (Graetz 1999).

It might be seen as a fair warning, especially for those taxpayers who were honest before the tax amnesty. It aims at convincing tax delinquents that the probability of getting caught increases signaling that tax evasion is morally wrong (Fisher, Goddeeris and Young, 1989). Alm, McKee and Beck (1990) also found that the anticipation of a further amnesty increases if individuals get the opportunity to participate in an amnesty although the government had stressed that no further amnesty will take place. The government loses credibility and makes evasion seemingly forgivable. Taxpayers get the incentive to wait for further grace periods to be reconsidered freely. In our experiment we will check for these effects. According to Alm (1999) experiments should be administered in a uniform and consistent manner to allow replication and ensure robustness of the research design.

## **2.4 Empirical Evidence on Tax Amnesty**

The understanding of tax amnesty in many countries is currently in vogue. However, cross-national experience shows that the financial success of such a tax amnesty is not granted (Luitel and Sobel, 2005). Furthermore, it is debated whether in the long run tax amnesties undermine tax compliance (Laborda and Rodrigo, 2003). This suggests that tax amnesties should not be viewed as any kind of fiscal panacea. Multiple amnesties are even less successful in generating additional revenues, and they have perverse effects on voluntary compliance as taxpayers incorporate the expectation that future grace periods will occur (Alm, 1998). A major controversy exists in the literature regarding evidence on the effect of tax amnesty on tax compliance. The existing literature on amnesty has created two different debate groups separating the supporters of compliance induced amnesty from those opposing it (Luitel and Sobel, 2005). One strand of literature argues that tax amnesty leads to improved short-term revenue collection and strengthen long-term tax compliance, Alm (1998). The other strand, however, proposes that tax amnesty leads to depressed short-term revenue collection and weakens long-term tax compliance, Alm and Beck (1993).

Tax amnesties are disputed in the tax compliance literature. On one hand, a tax amnesty in the short run can generate an increase in the tax revenue and reduce administration costs (Alm, 1998). Furthermore, it might get evaders “back to the route of honesty”. This is particularly important when correct declaration is difficult due to a complex tax system. Leonard and Zeckhauser (1986) point out that some people become tax delinquents only by mistake. Such individuals might be willing to correct their behaviour

to become honest citizens when they are not confronted with punishment mechanisms as prosecution and penalties. Thus, future non-compliance might be reduced integrating former tax delinquents into the taxation procedures.

On the other hand, there are also disadvantages of tax amnesties. Honest taxpayers get informed about the presence of tax evasion (Alm and Beck 1993). Thus, previously honest taxpayers often view an amnesty as unfair and feel less motivated to comply in the future. They interpret the amnesty as a signal that tax evasion is a forgivable and insignificant peccadillo (Leonard and Zeckhauser 1986). This might increase their belief to have paid too much in the past compared to other taxpayers. Therefore, the psychological costs of not complying are reduced when observing others' opportunistic behaviour, which results in a crowding out of the intrinsic motivation to comply. Furthermore, an amnesty may induce anticipatory behaviour of taxpayers. After an amnesty, previously honest taxpayers anticipate further amnesties by reducing their tax honesty (Luitel and Sobel, 2005). They argued that the success of an amnesty does not only depend on its short-run revenue effects but also on the long-term effects on tax compliance. Fisher, Goddeeris and Young (1989) point out that those individuals who were most involved in tax evasion getting the largest benefits do less likely participate in an amnesty. Furthermore, participants could fear that the government may use the new information for tax fraud detection activities after the amnesty (Alm and Beck, 1990; 1991).

Alm and Beck (1990; 1991) and Andreoni (1991) have theoretical analysed the impact of tax amnesties from a different perspective. Alm and Beck (1990; 1991) show that amnesties may sometimes increase compliance and tax collection, especially if individuals perceived paying tax is the social norm and the amnesty is accompanied by heightened enforcement efforts. However, amnesty revenues may come at the expense of reduced long long-run tax revenue because of the reduction in tax compliance. They argue that although tax amnesties generate short-term revenues, their ability to generates revenues in the long run is ambiguous. Andreoni (1991) on the other hand, examines fully anticipated tax amnesties and finds that evasion rises only to the extent that people expected. This is because evasion rises only to the extent that people expect to participate in the amnesty and if they participate in the amnesty, then the government is able to recapture not only the new evasion but also the pre-existing evasion.

During the last few decades, the governments of numerous countries, both developed and less developed, have established tax amnesty measures (Andreoni, 1991, Luitel and Sobel, 2005). Nevertheless, the typology of these programmes has been extremely varied on implementation. The time for implementation could be temporary or permanent amnesties. Luitel and Sobel (2005) also noted that on some occasions tax evaders who have already been detected by way of inspection and audits have been allowed to participate in the amnesty. Some countries have however restricted participation to only those whose past records are not subject to any fraudulent investigation (Lopez-Laborda and Rodrigo, 2003). In terms of contents various types of taxes have been offers for some period of time while others restrict time and the type of the tax head eligible (Luitel and Sobel, 2005). Some countries have offered amnesties for very specific type of fraud while

others legislating for the totality of the tax regimes currently in force (Lopez-Laborda and Rodrigo, 2003).

The empirical results indicate that tax compliance increases in income and audit rates and decreases in tax rates. Compliance is also greater when the individuals perceive some benefits from a public good funded by their tax payments (Malik and Schwab, 1991, Luitel and Sobel, 2005). Malik and Schwab (1991) in the adaptive utility framework and Alm and Beck (1990) in prospect theory have discussed in details the causes of taxpayer compliance. Alm and Beck (1990) offered alternative explanations for individual's behaviour in situations of uncertainty and for the specific patterns of conduct observed in amnesties granted in a variety of countries. This puzzle has been addressed by Malik and Schwab (1991) by showing that an adaptive utility framework, where a tax payer learns about his or her utility function through experience and the decision to evade could be affected by offering a tax amnesty. They argue that amnesty internally updated and revises individuals' calculated risks. Furthermore, amnesties in practice are offered in conjunction with an announcement of increased enforcement effort. This works as an additional incentive for an evader to participate in an amnesty program (Luitel and Sobel, 2005).

Fisher, Goddeeris and Young (1989) noted that most non-filers were out of compliance only for a single year prior to the amnesty implying their expectation for impending amnesty. Further, only a small number of tax payers evaded large amounts of taxes over long periods of time and that most tax payers used the amnesty as an opportunity to pay a relatively small amount of overdue taxes. Similarly using 1983, Massachusetts amnesty

data, Joulfaian (1988) finds that habitual evaders, or evaders who pays taxes but under report them, generally did not participate in the amnesty program. This conclusion is at odds with the claim that amnesties bring habitual evaders back into the system, providing substantial long-run revenue gain. In a recent study of the 1986 Michigan amnesty, in sharp contrast the previous findings, Christian, Gupta and Young (2002) found that a substantial portion of amnesty program participants subsequently continued to file tax returns. They conclude that the 1986 Michigan amnesty was successful in attracting many participants and in retaining many of them in the system; however its impact on revenue was negligible.

Measuring the effect of tax amnesty has been focused on both short and long run. Using cross country experiments in Switzerland and Costa Rica, Torgler and Schaltegger (2003) and Torgler, Schaltegger and Schanffine (2003) noted that long run tax compliance rises if the possible tax amnesty is subjected to a popular vote, regardless of whether the amnesty is passed or rejected. They also observed that the anticipation of a future tax amnesty has a negative effect on tax compliance. Alm and Beck (1991) indicated that heightened post-amnesty enforcement encourages greater participation in an amnesty. Also Alm and Beck (1993) examined the 1985 Colorado tax amnesty using monthly individual income tax revenue data from January 1980 to December 1989 and concluded that the amnesty had no long run impact on the level or the trend of tax collections. Torgler and Schaltegger (2003) report the result of much tax amnesty that has been implemented in different countries, arguing that revenues have been largely less than expected. Tax amnesties are often less profitable than expected. It is interesting to note that one of the most successful tax amnesties on income tax, enacted in India in 1997.

These amnesties allowed Indian government to recover an amount of taxes as big as half of the fiscal revenue originated from income tax (Alm, 1998).

Amnesty widens the tax base since it may encourage those not previously registered for tax purposes to register and provides future voluntary compliance. Alm, (1998) points out that important source of increased compliance stems from getting individuals who previously had not paid taxes for one or more years back into the system and onto the tax roles. A wider tax base provides a long-run revenue source for governments to finance its activities for the general development of a country. Compliance will also increase if the amnesty is followed by greater enforcement efforts and by stronger civil and criminal penalties. In fact, for a government that wants to increase enforcement activities and do so in a manner that taxpayers perceive as fair, a one-time grace period before the enforcement increases may be an effective transition mechanism. Alm (1998) further argued that amnesty helps the tax authority in debt management and reduction of its administrative backlog of paperwork and arrears, thereby saving some administrative costs. This improves post-amnesty voluntary compliance through better post-amnesty record keeping and monitoring of taxpayers who previously were not on the tax net. The tax authority will follow up the newly registered taxpayers to ensure sustained compliance. Table 2.1 highlights the arguments for and against tax amnesty as adopted by Torgler and Schaltegger (2003).

**Table 2.1: Arguments for and against a Tax Amnesty**

<b>Arguments in Favour</b>	<b>Arguments Against</b>
Pareto improving because nobody loses and government increases revenue.	Undermines tax morale, as honest tax payers may get upset because tax moral costs to behave dishonestly decreases.
Brings people back to the path of honesty that became tax delinquents or evades by mistake.	Too soft on action to be taken against law breaker.
Remove the guilty feeling of otherwise ordinary citizens.	Guilty feeling is removed such that honest taxpayers may actually start evading taxes.
Most appropriate before increasing penalties and enforcement and to the transition to a new tax regime.	Individual become aware of the presence of rampant non-compliance in the tax system.
Sends a signal that the government is committed to tackle the problem of tax evasion.	Send a wrong signal of a weak government, which is unable to enforce the tax law.
Enlarges the tax base as many taxpayers brought back into the tax system.	Tax payers would anticipate future tax amnesties, which will have a negative effect on tax compliance and erodes the tax base.
Generates both short run and long-run revenues for the government.	Experience indicates that amnesties produce little and/or overstated revenues.
Reduces administrative costs of tax collection (Debt management)	The revenues could have been collected with the normal enforcement procedure anyway it waited a little longer.
Enhances tax compliance by keeping and monitoring taxpayers not previously on the tax rolls.	Simply not possible. If it were true, then the amnesty is not required in the first place.

Source: Torgler and Schaltegger (2003) pp. 6.

Although there is conflicting evidence in the two schools of thought on the effect of tax amnesty on compliance, it is generally argued that amnesty can be fruitful if it is accompanied by administrative changes, such as strengthened enforcement procedures and an increase in taxpayer education (Luitel and Sobel, 2005). They argued that aggregate impact of an effective amnesty is that it encourages previous non-compliant taxpayers to be brought into the tax bracket. Empirical evidence indicates that amnesty programs most effective in generating revenues are those that reduce rates, interest and penalties on the items reported in the amnesty, that allow known delinquents to participate, and especially those that increase post-amnesty enforcement. Based on the findings, Luitel (1998) concluded that if a state is considering offering a tax amnesty to

raise total tax revenue, the impact will depend on whether the state has previously offered an amnesty and that it will probably never be a good idea to all. The public choice literature, however, is filled with examples of short sighted political behaviour that could be consistent in explaining why states still adopt an amnesty.

## **2.5 Summary from Literature Review**

From the review of literature on tax amnesty and compliance, the following conclusions can be derived; First, offering tax amnesty does not affect compliance. Instead, the government only collects previously evaded taxes in form of tax debts (Alm, McKee and Beck, 1990). Offers for amnesty therefore only boost the tax collection during the amnesty period only from the amnesty participants only but do not affect the compliance of other taxpayers.

Second, other empirical studies on tax amnesties are showing negative effects in tax compliance (Malik and Schwab, 1991). Offering tax amnesties to delinquent taxpayers reduces voluntary compliance as the previously compliant adopt a wait and see strategy. For instance, Alm and Beck (1993) argued that tax amnesty undermines the willingness of a taxpayer to fulfil his obligations with the State in the long term. The anticipatory behaviour of taxpayers for future amnesties makes them to evade tax payments during the current period with the hope that a similar blanket “forgiveness” will be offered.

Third, similar studies in other countries, on indirect taxes, indicate a positive effect of tax amnesty on compliance (Luitel and Sobel, 2005). Further, Fisher, Goddeeris and Young (1989) pointed out that amnesty brings both short and long term success in compliance

resulting from pooling of taxpayers into the tax bracket. The taxpayers, due to the publicity and sometimes enhanced enforcement voluntarily comply with the tax laws. The taxpayers get to understand the consequences of failure to comply hence more new taxpayers are registered while the existing ones tend to declare proper taxes due and pay.

This study however examines the effect of tax amnesty on compliance in the local context, Kenya. The methodology employed on data collection involves the use of KRA's data base for the periods before and after the year 2004 tax amnesty. Analysis is then done using the event study methodology to examine whether offering tax amnesty affects short and long run compliance. Further, the study focuses only on VAT as opposed to the other studies which deal with taxes in general. The reason for focusing the study on VAT was because it was the main reason for the amnesty as was proposed from the KRA reform agenda to enhance compliance from indirect taxes and reduce high dependencies on direct taxation (Kiringi and Wanjala, 2005; KRA,2006).

## **CHAPTER THREE**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

This chapter describes the research design, target population and sample adopted in the study in sections 3.2 and 3.3. The methods of data collection, analysis and model testing are further discussed in sections 3.4, 3.5 and 3.6 respectively.

#### **3.2 Research Design**

The research design adopted in this study is descriptive in nature. This study identifies the effect of tax amnesty on taxpayers' compliance by estimating the past trends and compare with post amnesty period (Jankowicz, 2006). It involves quantitative analysis of VAT collections declared and paid by the taxpayers. The study adopted an event study methodology to investigate whether tax amnesty affected tax compliance proxy by the VAT collections.

The event study measures the magnitude of the effect that an unanticipated event has on the expected collections. This method has been used to measure the effects of intervention actions in various disciplines (Agrawal and Kamakura, 1995, Binder, 1998). The Event study examines the effect of an event on the normal trend of returns (MacKinlay, 1997), in this case VAT collections. The estimation window comprised of 18 biannual VAT collections which is used to estimate the trend prior to the amnesty period. This signifies the taxpayers' compliance behaviour and payment trends. The trend model is important in determining the taxpayers' reaction towards the amnesty as

reported in the other empirical studies (Malik and Schwab, 1991). It measures the deviation of VAT collection in the post amnesty period as compared with the expected normal VAT collections.

This study follows an event-study framework by focusing on the period surrounding the June-December 2004 tax amnesty. The study considers the VAT collection trends over the study period and evaluates the effect of the amnesty intervention on subsequent revenue performance. It involves summing up of monthly VAT collection to a semi-annual value ( $t_i$ ) to match the observation window of 6 months. The period comprises of 24 biannual collections, represented as  $t_{24}$  for the total period under review. However amnesty event occurred in the bi-annual  $t_{19}$  providing the focus point to determine the impact of the amnesty on compliance.

### **3.3 Population and Sample of the Study**

The population of interest comprises of businesses registered with the commissioner of domestic taxes. Currently, there are 77,419 registered VAT businesses in the country actively filing monthly returns and will be considered as target for the analysis. The amnesty event of 2004 (June to December) is the centre of this study and examines its effects on VAT compliance proxy by the monthly collections. The choice of the year 2004 was particularly due to the available complete data to enable trend model development and testing for short and long term effects. The amnesty was also offered mainly as a response to the low compliance levels observed from VAT taxpayers. VAT collections were used as proxy for compliance as used by many studies in other countries.

The study therefore utilised all the available data on VAT registered taxpayers making both domestic and import contributions to KRA. The sampling design adopted by this study involves the purposive, non-probabilistic, choice of the amnesty event of 2004 over the previous amnesties. This was facilitated by the fact that access to a complete and accurate data is possible for this amnesty as opposed to the previous amnesties. The second level sample decision involved the choice of VAT over the other tax regimes. VAT was the major reason for the 2004 amnesty and the study endeavoured to empirically test whether the policy expectation was significantly achieved.

### **3.4 Data and Data Collection**

The study made use of secondary data available from the KRA database for the period under review. Data on VAT monthly collections and taxpayers monthly registration for the financial year 1995/1996 to 2006/2007 was used providing a window relevant to measure both short and long run effect of the 2004 tax amnesty (MacKinlay, 1997). This comprises of pre and post amnesty period and the amnesty event period of 6 months. Information on taxpayers registration and deregistration was not readily available and the end year active VAT taxpayers were used to represent those making payments in those respective years. On the other hand, KRA database provides accurate and reliable source.

### **3.5 Data Analysis**

Descriptive data analysis is conducted to examine the general performance of VAT over the study period and results presented on tables and graphs. The effect of tax amnesty on VAT compliance was then determined using the event analysis where the deviation, positive, neutral or negative is examined. The analysis of the event was reinforced by

incorporating a trend analysis model which allows determination of abnormal VAT collections.

The effect of the amnesty on VAT is measured by determining pre and post amnesty VAT collections. This is compared against the expected and actual collections to compute abnormal collections which represent the effect of the amnesty on compliance. The growth in post-amnesty trend represented by positive abnormal collections indicates positive effect. However, a negative post-amnesty abnormal collection means reduced compliance otherwise no effect. The study period which comprised of 9 year (18 biannual) pre-amnesty and 3 year (6 biannual) post-amnesty was used to develop the model and test the effect respectively. Average growth in VAT collections was determined and the same projected over post amnesty period under review. The short and long run effect is then examined by observing any abnormal changes in VAT collections following the amnesty event.

The period under investigation comprise of 12 years monthly collections (1995/6 to 2006/7 financial years). This period is subdivided into 24 biannual VAT collections to allow the study to determine the effect of amnesty that took 6 months on both short and long run. The amnesty period was annexed as  $\tau$  representing the barrier between pre and post amnesty collection. The abnormal collections, hence the effect of the amnesty, was derived by subtracting the trended model for the 6 post amnesty period. The study adopted a constant growth VAT collection model, which assumes a steady growth in

VAT over time. The normal VAT collection model was developed from the estimation period comprised of 18 semi-annual collections in the years preceding the amnesty.

The event period (6 months from June 2004 to December 2004) represented as  $\tau_0$  the estimation window represented by the distance between  $T_1$  to  $\tau_0$ . Minitab analysis software is used to determine the trends of the estimation window. The software was also used to develop both short term and long term trend models. In addition the software provided the measure of accuracy, hence the validity of the model. The estimation window was used to generate the following equation model that is used to compute normal collections;

$$Y_t = \alpha + \beta * t + \varepsilon \dots \dots \dots \text{Equation 3.1}$$

Where  $Y_t$  represent the normal collection in time  $t$ ,  $\alpha$  represent the intercept at the beginning of the modelling,  $\beta$  represent the slope measuring the growth of collection over time and  $\varepsilon$  measure the white noise caused by seasonal variability in collections.

	$T_1$	$\tau_0$	$T_2$
	<i>Estimation Window</i>	<i>Event</i>	<i>Post event</i>
<i>Period:</i>	Dec 1995-June 2004	July-Dec 2004	June 2005-June 2007
<i>Aim:</i>	Model development	Amnesty event	Estimate abnormal returns

### 3.6 Diagnostic Tests

To test the effect of tax amnesty on short and long run compliance, the study is subdivided into three data sets and estimation error examined (Mean Absolute percentage Error, MAPE). The estimation data set is used as the exploratory data to develop the trend model. The short run effect is tested from the post amnesty model fitting using the collections immediately after the amnesty. The long run effect on the other hand is

examined from the equation fit developed from the total data set. The effect was determined by comparing the slopes ( $\beta$ ) of the three models and their accuracy.

## **CHAPTER FOUR**

### **DATA ANALYSIS, RESULTS AND DISCUSSIONS**

#### **4.1 Introduction**

This chapter provides descriptive and analytical results and discussion from the study. It describes the performance of VAT collections over the past thirteen years, which also coincides with the establishment of the KRA as an agent to collect and account for taxes in Kenya. The chapter also discusses the trend model of VAT collections and further evaluates the effect of tax amnesty on both domestic and import related VAT collections. Finally, conclusion is drawn from the results to summarise the empirical effect of the amnesty on compliance in Kenya.

#### **4.2 Descriptive statistics of VAT Collection**

Tables 4.1 (a) and (b) shows that domestic VAT, despite its high variability dominates the total collection during the 24 bi-annual periods from July 1995 to July 2007 over import VAT. The mean VAT collection from import related transactions is lower during the period of study with approximately Ksh 12.4 billion and a standard deviation of 4.6 billion. Domestic collection accounts for slightly more than half the average total collections of Kshs. 26.5 billion although it has a higher standard deviation as shown on table 4.1(a) above. Table 4.1(b) further confirms this explanation with relatively higher correlation between the total VAT and the domestic VAT. The Pearson correlation shows that VAT collection sources (import and domestic) are highly correlated at 97%. Increased in importation enhances volumes of trade hence increased domestic VAT (Agbeyegbe et. al 2004). An enhanced volume of trade, indicated by large imports into the country is likely to facilitate more domestic VAT collections.

**Table 4.1 (a) Analysis of Means**

	Mean	Std. Deviation	N
Import VAT	12,369.25	4,602.11	24
Domestic VAT	14,180.58	5,807.53	24
Total VAT	26,549.87	10,333.35	24

Source: Author from the KRA database

**Table 4.1 (b) Analysis of Correlation**

		Import VAT	Domestic VAT	Total VAT
Import VAT	Pearson Correlation	1.000	.970**	.991**
	Sig. (2-tailed)		.000	.000
Domestic VAT	Pearson Correlation	.970**	1.000	.994**
	Sig. (2-tailed)	.000		.000
Total VAT	Pearson Correlation	.991**	.994**	1.000
	Sig. (2-tailed)	.000	.000	

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

Source: Author from the KRA database

Table 4.1(c) and figure 4.1 indicate a very strong correlation between the number of taxpayers and VAT collections, with a 97.2% Pearson's correlation value. The implication of this is that the analysis can base compliance on the VAT collections over the period of consideration. The data available on VAT collections is highly documented and complete from the records kept by KRA in the databases.

**Table 4.1 (c) Tax base correlation with VAT**

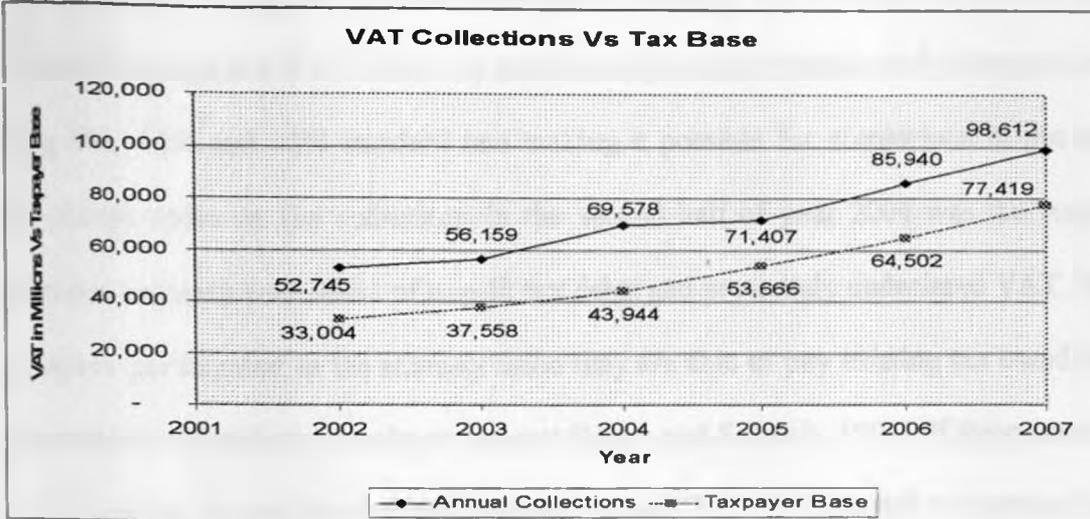
		VAT collections	Tax payers
VAT collections	Pearson Correlation	1.000	.972**
	Sig. (2-tailed)		.006
Tax payers	Pearson Correlation	.972**	1.000
	Sig. (2-tailed)	0.006	

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

Source: Author from the KRA database

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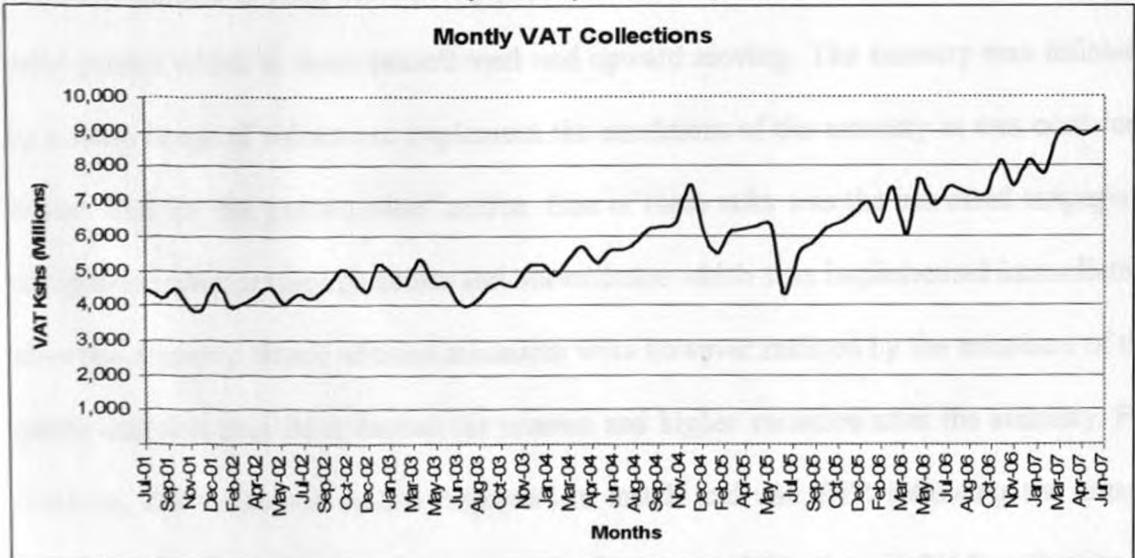
**Figure 4.1 Tax base correlations with VAT collections**



Source: Author

The two factors, tax base and collection, move in the same direction in somewhat parallel lines indicating a strong correlation. The only major deviations existed in the year 2004 due to the extra collections made from amnesty participating taxpayers from their previous undeclared taxes. It is important to note that the tax base refers only to the active taxpayers registered under the VAT Act and liable for monthly filing of VAT returns.

**Figure 4.2 Total VAT Collections for the years July 2001 to July 2007**



Source: Author

The figure above (fig. 4.2) shows the trend of monthly VAT collection for six years. Within this range, the VAT rates have considerably remained stable with three main rates being 0%, 10% and 16% standard rate making it possible for comparison of the trend. The abrupt spike on the collections in the second half of year 2004 was the result of increased amnesty collections of unpaid tax debts and previously undeclared VAT. Many taxpayers participated in the amnesty since they are able to pay existing tax owed to the government without any penalty or interest (Malik and Schwab, 1991). If these taxpayers remain within the tax bracket and continue to pay, VAT is expected to increase hence compliance in the long run (Alm, 1998; Luitel and Sobel, 2005). The expected VAT collections, safe for the impact of the “natural” growth by the economy should actually improve for a positive effect of amnesty.

The collections, however, maintained an upward trend for the period under examination. Although the general trend of collections is upward moving, there seems to be high variation especially after the amnesty period of June to December 2004 as opposed to the prior period which is more smoothed and upward moving. The amnesty was followed by a wide range of reforms to implement the conditions of the amnesty as was contained in the “call for the participation” notice. One of these reforms was the increased taxpayers’ compliance checks through audits and surveillance which was implemented immediately after the amnesty. Some of these measures were however resisted by the members of the public and this may have caused the uneven and higher variation after the amnesty. For instance, the resistance by the taxpayers to install and use ETR following the annual government budget in 2005 could possibly have caused the drop in VAT collection in

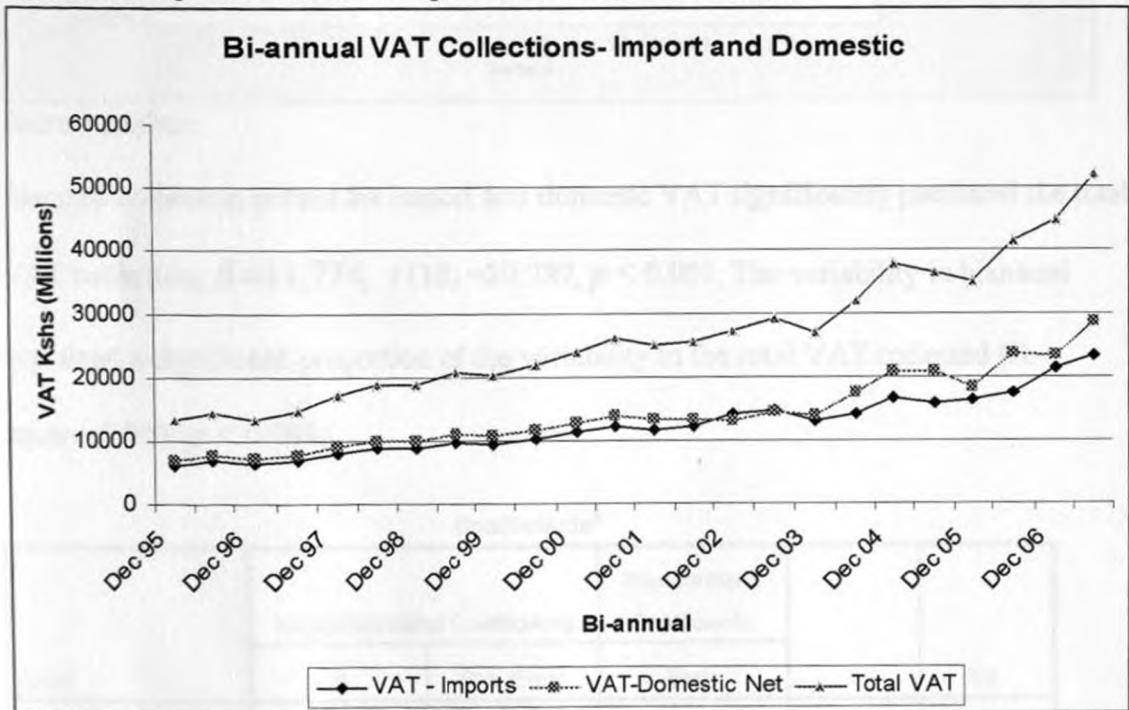
July of the same year and the subsequent lower bi-annual collection for December 2005. Compliance is said to be enhanced by increased tax administration and implementation of terms and conditions of the amnesty (Luitel, 2005, Luitel and Sobel, 1991). The impact of these tax administration conditions, whether positive or negative can be attributed to the amnesty itself which paved way for their implementation.

The analysis of biannual VAT collections indicates the role played by domestic VAT on boosting the total collection. Figure 4.3 plots the biannual VAT collections showing a sharper increase of total VAT collection as a result of a more comparative domestic collection than the import related VAT collection. This is so despite a consistent increase in both domestic and import VAT over the past decade. Post-amnesty period in this study shows a proportionate increase in domestic VAT revenues. This increase may be due to increased voluntary compliance following the amnesty offer by the government. Domestic VAT collection highly depend on the taxpayers voluntary level as opposed to a highly structured import VAT payment which is declared at the port of entry before cargo is released (Luitel, 2005, Lopez-Laborda and Rodrigo, 2003).

Similar observations are also evident where the spikes of VAT collections becomes less stable after the amnesty than it was before, caused by unstable domestic VAT collections. Import based VAT remained stable and grew at a more smoothed pattern but remained proportionately lower than the domestic collections. High VAT growth, as high as 29% in June 2006, is experienced after the amnesty for the domestic sources. Similar growth is also observed for import VAT, although lower than the domestic. For instance, import

VAT maintained a 5-6% biannual growth gaining its peak of 22% in December 2006. These years have experienced a major reforms and modernization in both domestic and import taxes with the introduction of computerized cargo declaration system. There was also an increase in annual audits and compliance workforce through the graduate training program. Measures such as tightened tax administration regime coupled with increased economic growth have continuously influenced the attitude of the taxpayers. This may have impacted positively causing an upward trend in tax collections over the years (Njoroge, 1996).

**Figure 4.3: Comparative Bi-annual import and domestic VAT collection**



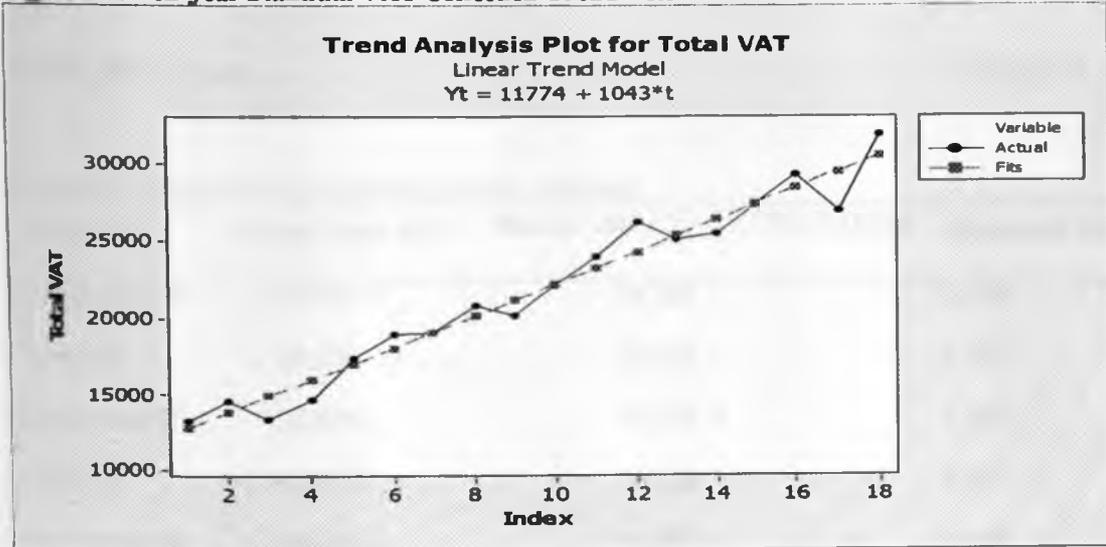
Source: Author

### 4.3 Results of the Event Study

The trend equation was used to compute bi-annual abnormal VAT collections for the whole period under review. These expected VAT is therefore derived from modelling the

past trends and patterns so as to extrapolate to measure the future behaviour of VAT compliance.

**Figure 4.4: Ten-year Biannual VAT Collection Trend Determination.**



Source: Author

Biannual collection period for import and domestic VAT significantly predicted the total VAT collection,  $\beta = 11,774$ ,  $t(18) = 20.787$ ,  $p < 0.001$ . The variability in biannual explained a significant proportion of the variability in the total VAT collected (R-square=0.961,  $p < 0.001$ ).

**Coefficients<sup>a</sup>**

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	11773.506	566.398		20.787	.000
Biannual	1042.817	52.326	.980	19.929	.000

a. Dependent Variable: Total VAT

Source: Author

The trend analysis from the study of VAT collections yielded the equation 3.2 below; Where  $Y_t$  represents bi-annual VAT collections and  $t$  is the bi-annual index representing 6-months cumulative collections making the analysis points of reference.

$$Y_t = 11,774 + 1,043t \dots \dots \dots \text{Equation 3.2}$$

**Table 4.2: Abnormal VAT Collections (Kshs. Millions)**

<i>Biannual</i>	<i>Actual Total VAT</i>	<i>Normal VAT (<math>Y_t = 11,774 + 1,043t</math>)</i>	<i>Abnormal VAT</i>
December 04	37,705	31,591	6,114
June 05	36,491	32,634	3,857
December 05	34,916	33,677	1,239
June 06	41,271	34,720	6,551
December 06	44,669	35,763	8,906
June 07	51,901	36,806	15,095

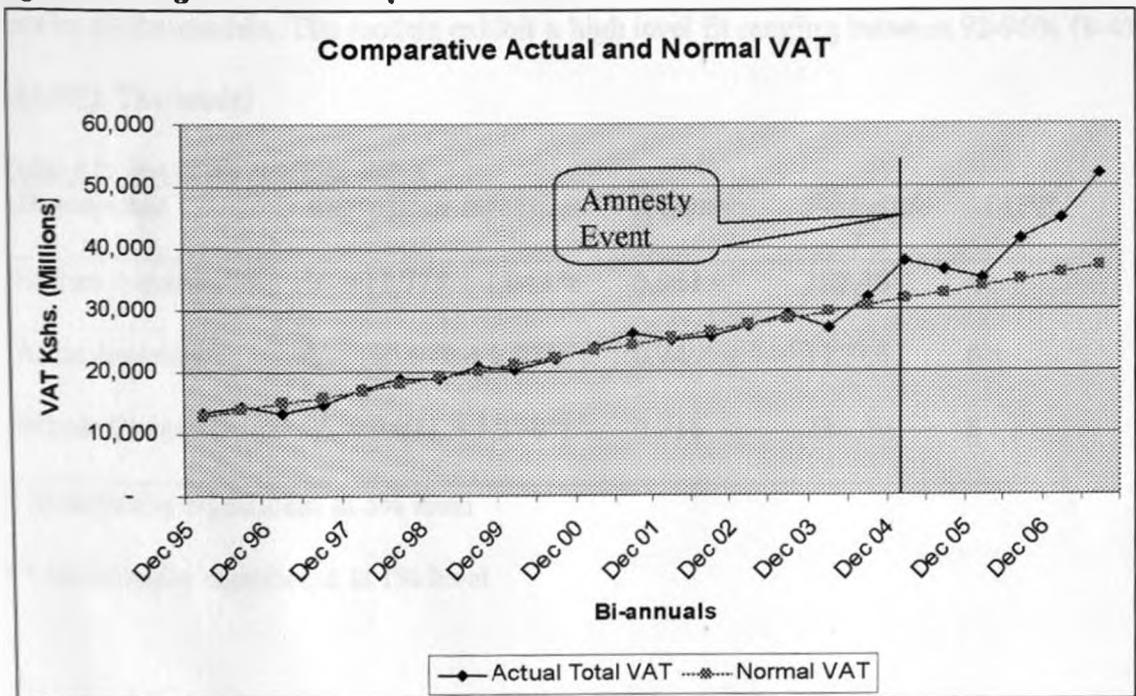
Source: Author

Table 4.2 compares the computed normal VAT with actual collections after the amnesty. The results indicate that the actual collections exceeded the computed normal and continuously grew in the long run. High value abnormal VAT in December 2004 can be explained by the huge collections of undeclared debts which may not mean long term compliance of the taxpayers (Alm, 1998). This abnormal VAT includes the amount, approximately Ksh 2 Billion, collected from previously undeclared sources as indicated in table 2.2 (chapter 2).

Although the period under consideration after the amnesty is relatively short, there is indication that the growth is going beyond short term. Figure 4.5 shows a persistent growth of actual VAT evidenced by the large positive abnormal collections. Table 4.2

also confirms that post amnesty resulted into marginally higher collections except the low positive increase for December 2005. The long run compliance tends to be positively influenced by the fact that stringent measures usually follow amnesty and taxpayer awareness is improved. The taxpayers changed their compliance behaviour after the amnesty in anticipation of future amnesties (Alm, McKee and Beck, 1990). This positive response by the taxpayers could be associated with the fact that the new government was taking over. There was also tightened administrative measures and tagline during the amnesty that it was the last amnesty for the past tax delinquents to abide to the law.

**Figure 4.5: Long run Post Amnesty VAT Collection**



Source: Author

The performance of the Ordinary least square method trend technique is done by considering the Mean Absolute Percentage Error (MAPE) from the fitted equation. The MAPE for the trend model is 4% which reliably satisfy the dependence of the equation to

compute normal VAT collection (Tayman and Swanson, 1999). The model was at least 96% representing the VAT collection growth in the short run and therefore suitable to compare pre and post amnesty collections to determine the effect of the amnesty event on voluntary compliance.

VAT compliance in the long run is further tested by examining smoothened normal VAT collection model over the whole period of study. The regression equations for the periods under review are shown on the Table 4.3 below. The results indicate an increased slope in the post amnesty period and on the combined period suggesting an upward boost on the long run collections. The percentage errors (MAPE) in all the fitted models are relatively low in all the models. The models exhibit a high level fit ranging between 92-96% (8-4% MAPE). The model

**Table 4.3: Test of the Amnesty Effect**

<i>Description</i>	<i>Regression Equation</i>	<i>R-Square</i>	<i>F-statistic</i>	<i>MAPE</i>
Before Amnesty**	$Y_t = 11,774 + 1,043*t$	0.961	397.16	4
After Amnesty*	$Y_t = 30,972 + 2,910*t$	0.74	11.366	6
Whole Period**	$Y_t = 9,071 + 1,398*t$	0.916	238.49	8

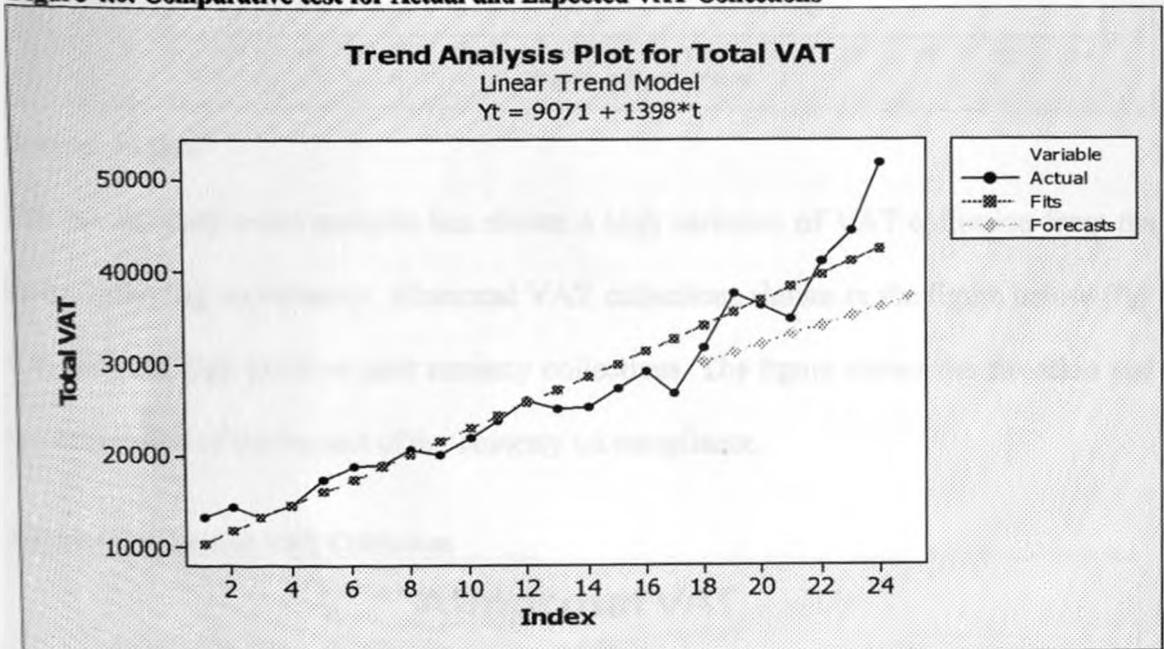
\* Statistically significant at 5% level

\*\* Statistically significant at 1% level.

The table also indicate that MAPE is below 10% described by Chang et al (2007) as excellent for any regression model to be reliably representative. The slope of the models ( $\beta$ ), which represent growth over time, shows that the post amnesty period recorded highest semi-annual growth of Kshs. 2,910 compared to Kshs. 1,043 prior to amnesty

effectively indicating a positive effect on compliance. The long run effect also shows a positive growth in excess of the pre-amnesty period at Kshs. 1,398. Figure 4.6 below further confirms the long run effect by exhibiting more than the expected normal collections. Both short run (shown by the 8-point forecasts) and long run (shown by the straight line of fits) indicate that the amnesty positively affected the total VAT collections.

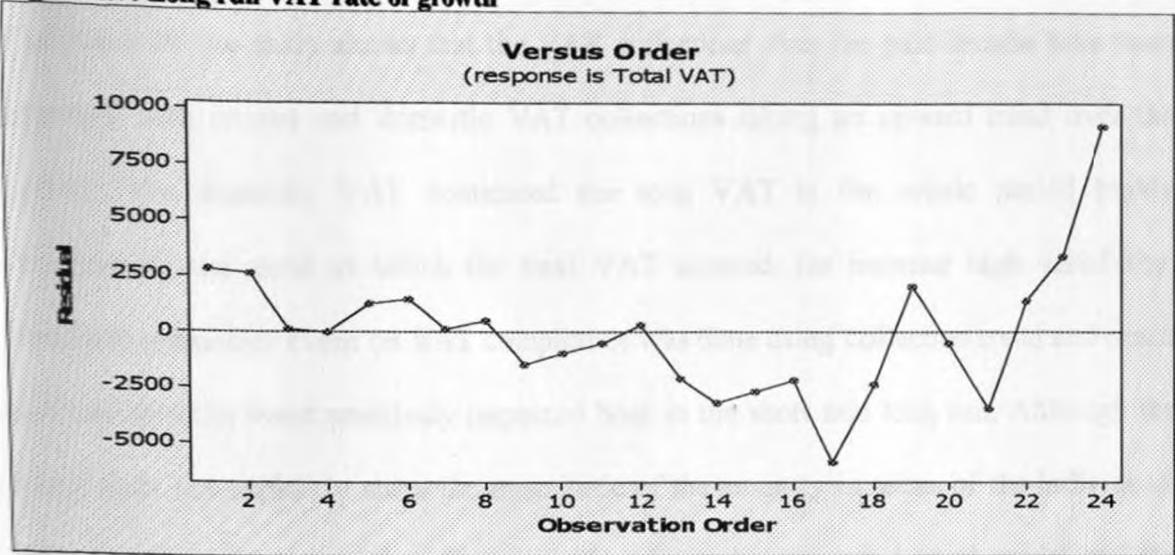
**Figure 4.6: Comparative test for Actual and Expected VAT Collections**



Source: Author

The rate of long term growth was tested by observing the residuals between the normal VAT collections with the long run model. Figure 4.7 indicate positive growth over the period of study. However, spread of residuals consistently increased negatively and as a result lowers growth between June 2001 and June 2004. Implementation of amnesty in the period July to December pushed the collections high as shown by the subsequent residuals except December 2005. The outcome of VAT growth is consistent with the findings by Kiringi and Wanjala (2005).

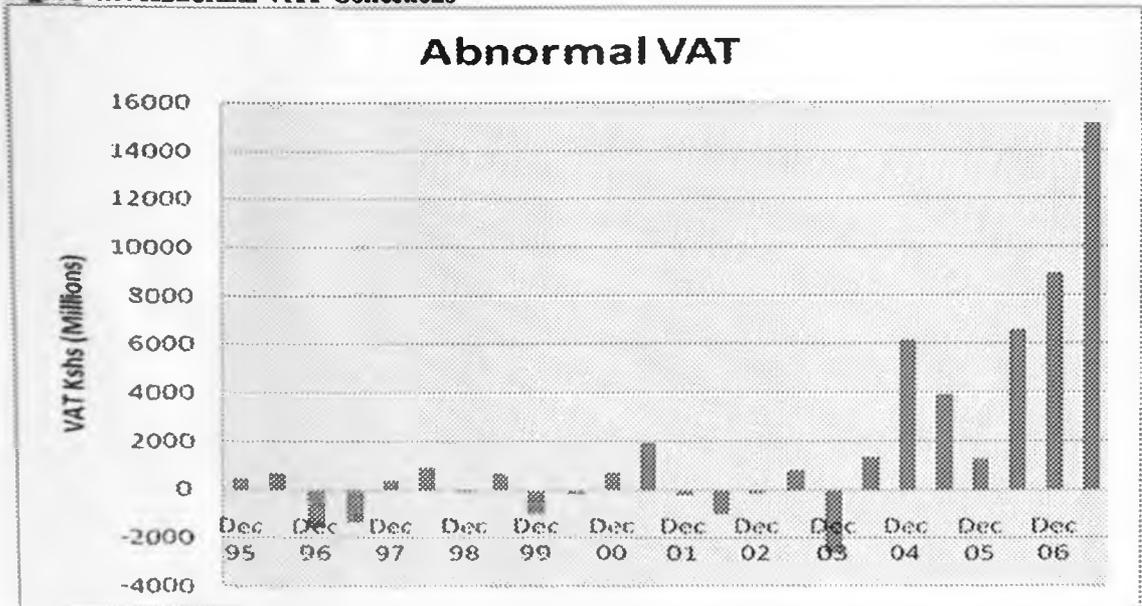
**Figure 4.7: Long run VAT rate of growth**



Source: Author

The tax amnesty event analysis has shown a high variation of VAT collection from the mean following an amnesty. Abnormal VAT collections shown in the figure below (fig. 4.8) indicate high positive post amnesty collections. The figure shows the direction and the magnitude of the impact of the amnesty on compliance.

**Figure 4.8: Abnormal VAT Collections**



Source: Author

#### 4.4 Summary

The result of the study shows that the VAT collections over the past decade have been growing with import and domestic VAT collections taking an upward trend over the period. The domestic VAT dominated the total VAT in the whole period highly determining the trend in which the total VAT adapted, for instance high variability. Evaluating amnesty event on VAT compliance was done using collection trend and result indicate that the event positively impacted both in the short and long run. Although the result does not explicitly show the magnitude of the amnesty in terms of the individuals affected, the direction of the effect is evident from the computed trend model and the resulting abnormal VAT collections. In general, the offer of amnesty in 2004 had a positive effect on the VAT compliance in Kenya measured by the collections.

## **CHAPTER FIVE**

### **SUMMARY AND CONCLUSION**

#### **5.1 Introduction**

This chapter provides summary of the key findings in section 5.2 and the derived conclusions from the study discussed in section 5.3. It further highlights the limitations of the study and recommendation for further research in section 5.4 and 5.5 respectively.

#### **5.2 Summary of the Key Findings**

Kenya offered its third amnesty in 2004 in the last 10 years and its first major one since the new government came into power. This study examined the revenue effect of tax amnesty on VAT. The study distinguished short and long run effect of the amnesty by focusing on the period immediately after the amnesty and the subsequent months respectively. The findings indicated that VAT collections have consistently improved over the study period. Both domestic and import related VAT has improved over time with domestic element being higher for much of the period under review. The increase in domestic VAT collection is consistent with the rise in the number of registered VAT taxpayers. The study further shows that offering tax amnesty to taxpayers enhances VAT compliance. The year 2004 tax amnesty not only allowed the government to recover tax debts but also improve future compliance. Participation in the amnesty cleared longstanding debt portfolio of approximately Ksh 2 billion on VAT alone and Ksh 4.5 billion in totals with other taxes. The response towards amnesty is evident from the results since the actual collections exceeded the normal (expected) VAT after the amnesty period.

### 5.3 Conclusion

This study concludes that the offer of the 2004 tax amnesty may have directly or indirectly influenced VAT collections. This was observed from the spike in the upward trend over the study period following the amnesty. The growth registered its high in the post-amnesty period than it was before the amnesty. The result of the study is consistent with similar studies in other countries. For instance, the amnesty helped to reduce KRA debt portfolio for VAT by allowing taxpayers to pay debt without interest and penalties (Alm, McKee and Beck, 1990). The analysis further indicated an increased compliance after the amnesty as proxy by the growth in collection (Luitel and Sobel, 1991; Fisher, Goddeeris and Young, 1989). The growth is dominant on the domestic VAT much more than the import VAT suggesting that voluntary compliance associated with monthly filing increased. Amnesty has generally driven up VAT total collection for both short and long run.

### 5.4 Limitations of the Study

The results of this study clearly showed that there was a positive effect on VAT collections following the amnesty period. What is less clear is the effect arising from other confounding factors such as the GDP growth rate, change in the education level and the awareness of taxpayers. The study further assumed that compliance is singly measured by VAT contribution. Although it is reasonable to attribute increase in collection to amnesty, it is somehow limited in interpretation. The growth may not be solely generated by the amnesty but may have been supported by other confounding factors.

## 5.5 Recommendation for Further Research

This study only begins to reveal the effect of amnesty on VAT revenue collection. In this endeavour, some unanswered questions were exposed such as the impact of the same amnesty on the other tax heads and whether repeated amnesties affect long term compliance. VAT collection has also exhibited an upward growth over the study period and various drivers could be behind the growth. It is therefore prudent to investigate other confounding factors on compliance for appropriate policy formulation. Results and conclusions were also limited to the year 2004 amnesty for convenience and reliability of available data. There were other two prior amnesties in the years 1993 and 1998; both may be good measure of repeated amnesties.

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## APPENDICES

### *Appendix I*

## TAX AMNESTY

Minister for Finance, Hon David Mwiraria has announced a Tax Amnesty, during the 2004/2005 Budget Speech. The amnesty will lapse on 31st December 2004.

The amnesty covers penalties or fines under the Customs & Excise Act (Cap 472) additional tax, penalties or fines under the Value Added Tax Act (Cap 476); penalties and interest under the Income Tax Act (Cap 470).

In a public notice issued by KRA, members of the public have been urged to take advantage of the Amnesty to declare voluntarily taxes owed over a period not exceeding seven years. All that a taxpayer would be required to is to make an application at the nearest KRA office where officers will be able to advise them on the guidelines. In addition Taxpayers seeking

amnesty would be required to:

- Submit any relevant documents or returns in respect of the dutiable goods or services.
- Pay to the relevant Commissioner tax due before 11th June, 2004.
- Submit returns or amended returns containing previously undisclosed income for any year of income ending on or before 31st December 2003.

Taxpayers have been assured that no Penalty or Fines shall be imposed where duty is paid in full on or before 31st December 2004. No queries either, will be raised on voluntary disclosure of duty and a letter confirming grant of amnesty will be issued.