

## **The effect of capital gains tax on total tax revenue in Kenya**

Kasingiu, Michael Mutisya

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### **Abstract:**

In Kenya, taxation is the single largest source of government budgetary resources. The current tax structure comprises of two main direct taxes: Individual Income Tax and Corporate Tax, and three main indirect taxes: Value Added Tax (VAT), Excise Tax, and Customs Duties. Capital gains tax (a direct tax) was introduced in Kenya in 1975 and suspended in year 1985. The effect of suspending CGT in 1985 has never before been quantitatively analysed. This paper investigated the effect of capital gains tax on total tax revenue using secondary time series data collected from 1965 to 1994. First, the study estimated buoyancies for three distinct periods, that is, 10 years pre-CGT, 10 years during CGT and 10 years post-CGT within the scope of 1965 to 1994. Total tax revenue was regressed against GDP base for each of the three periods. It was found that pre-CGT period buoyancy was the highest at 1.28 followed by post-CGT buoyancy at 1.11. In the period CGT was in operation, buoyancy fell to 0.95, which was less than unit and thus implying low buoyancy. The overall insight due to these findings is that CGT introduction led to loss of buoyancy of the tax system. Second, the study estimated a log linear model to explain the determinants of total tax revenue in Kenya, with CGT being investigated in detail to determine its significance. The study found that while average GDP and inflation were significant determinants of total tax revenue, CGT, agricultural, manufacturing and external sectors were insignificant determinants. The study concluded that CGT would have a negative and insignificant contribution to total tax revenue. However, pursuing a policy of zero capital gains tax may go against the main canon of equity in taxation.