THE ROLE OF ADMINISTRATIVE FACTORS IN STIMULATING TAX REFORMS IN KENYA

BY

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DECLARATION

This research is my original work and has not been submitted in this or any other university.

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This research project has been submitted for examination with my approval as the university supervisor.

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DEDICATION

This work is dedicated to my father Gerald Mutsotso and Kenya Revenue Authority who made it possible.

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To my wife Fidelis Wamalwa and daughter Tess Isendi, I say thank you so much for being there for me and for your understanding.

Finally, I thank God for the gift of life and blessings.

LIST OF ABBREVIATIONS

i. GDP-Gross Domestic products

ii. CBK-Central Bank of Kenya

iii. KRA-Kenya Revenue Authority

iv. VAT-Value Added Tax

v. NGO-Non Governmental organization

vi. PIN-Personal identification number

vii. PAYE-Pay As You Earn

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ABSTRACT

The Kenyan law as relates to tax has been deemed complex in terms of the understanding of what needs to be incorporated in the computation of tax to be paid and what should not be part of the tax bracket. As such, the complexity of the corporate tax system may be the reason for low compliance levels in Kenya. The compliance problem has meant that the Government collects far less than it needs to yet projects that are to be funded by the Government continue to escalate. The tax reforms therefore come in handy to remedy the situation for corporate tax payers. It is in this light that the study seeks to examine the role of tax complexity, enforcement and compliance in tax reforms in Kenya. The study sought to establish the role of tax complexity, compliance and enforcement in tax system reforms in Kenya.

This study used a descriptive survey. The population of interest in this study consisted of all the 350 tax managers within the Kenya revenue Authority who deal with or advice on tax reforms issues and the financial managers in the 55 companies listed. The financial managers deal with tax issues hence their consideration in this study. Three managers within Nairobi formed the sample size that filled in the questionnaire for the tax managers at KRA. A sample of 35 financial managers was selected for the study using simple random sampling. Primary data was collected from the respondents using two sets of questionnaires. The primary data collected was analyzed based on descriptive statistics such as percentages. Results were presented using tables and graphs, and pie charts for effective interpretation by users.

The study found that tax compliance, tax complexity, and enforcement play major roles in influencing tax system reform in a country. As the study found out, low levels of compliance earlier on led to more reforms to ensure that compliance percentages increase. Ever since the introduction of new measures at the KRA, compliance levels have been rising. These points to the fact that compliance levels significantly influence tax system reforms. Low levels of compliance earlier on led to more reforms to ensure that compliance percentages role. Further, the reforms that were earlier on carried out in the tax system were meant to make more taxpayers comply. The problem was due to lack of stringent enforcement procedures that saw many escape the traps. With the new political reality, enforcement has been beefed up and this has seen KRA surpass even its revenue collection targets. Thus, enforcement plays a major role in tax reforms. The study recommends that for any meaningful tax reforms to take place in Kenya, the role of administrative factors such as enforcement, compliance and tax complexity should be considered. The administrative factors are an important ingredient in realizing the objectives of tax reforms.

CHAPTER ONE

INTRODUCTION

1.1. Background to the Study

The best tax policy in the world is worth little if it cannot be implemented effectively. Tax policy design in developing and transitional countries must therefore take the administrative dimension of taxation carefully into account. What can be done to a considerable extent determines what is done in any country. In many developing countries, for example, there are many sectors that are not easily taxed. Often there is also a significant informal economy that is largely outside the formal tax structure. The tax base that is potentially reachable in such countries thus constitutes a smaller portion of total economic activity than in developed countries (Rajaman, 2003).

To some extent, the size of the 'untaxed' economy is itself a function of the design and implementation of the tax system. For example, the high social insurance tax rates levied in some countries create an incentive for a large informal economy by discouraging employers from reporting the extent of employment and encouraging the under-reporting of wage levels. The resulting lower tax revenues often lead.

Administrative factors raise a number of critical questions for tax policy and tax reform. How difficult is it for taxpayers to comply with and understand the current tax system? How much does operating the system cost? How well are taxes enforced? How would modifying the income tax or starting over with a new system affect the answers to these questions? These questions are difficult, but they are crucial aspects of the tax reform debate for several reasons (Rajaraman, 2003).

The perceived and actual complexity of the current tax system is a significant motivation for reform. This suggests that attention should be given to modifications of the existing system that emphasize administrative factors as well as to more fundamental changes. In addition, there are significant disagreements concerning the compliance and administrative costs of the existing system and the potential for tax reform to reduce those costs. Understanding the sources of those disagreements is critical to estimating the expected gains and losses from changes in policy. Moreover, because some of the newly proposed tax systems like a national retail sales tax or a flat tax have never been tried, or at least not tried on the scale that is being proposed, it is an open question whether they would be administrable and enforceable in the real world.

Policy makers face trade-offs among administrative goals of tax policy: a tax system can be quite simple, for example, with low costs of compliance, if it is not intended to be enforced well. Trade-offs also exists between administrative factors and other goals of tax policy; for example, policies that promote fairness may result in additional complexity.

1.2. Statement of the Problem

The best available measure of tax complexity is the sum of compliance and administrative costs. Complexity arises due to trade-offs with other policy goals and due to political factors, and, the key question is not how complex taxes are, but whether the tax achieves other policy goals that are worth the costs imposed by complexity. Huge differences in compliance cost estimates are caused by disagreements over two main assumptions, one regarding the value of taxpayers' time, and the other regarding how to calculate the number of hours that businesses spend on tax compliance.

Many modifications to the income tax emphasize simplification, enforcement, and reduced administrative costs. More than half of taxpayers could be moved to a return-free income tax system with minimal structural changes to the income tax. The administrative and simplification benefits of structural reforms broaden the tax base, reduce tax rates and broaden tax brackets. While it is probably possible to simplify many people's taxes, the overall reduction in compliance costs due to plausible income tax reforms will be a small fraction of current compliance costs.

Nevertheless, because the flat tax creates new distinctions in the tax law, it will create new pressure points for tax evasion and avoidance, many of which revolve around the business tax. In addition, transitional issues, social policy, distributional effects, and perceived inequities in the flat tax may well lead to a more complex system than has been proposed. There is significant potential for simplifying the existing system and for simplification in other tax systems as well. But it is not informative to compare tax systems that exist only on paper to those that exist in the real world. The latter have been forged through a combination of revenue requirements, political pressures, responses to taxpayer avoidance and evasion, and other processes that any system would eventually have to face.

The Kenyan law as relates to tax has been deemed complex in terms of the understanding of what needs to be incorporated in the computation of tax to be paid and what should not be part of the tax bracket. As such, the complexity of the corporate tax system may be the reason for low compliance levels in Kenya. The compliance problem has meant that the Government collects far less than it needs to yet projects that are to be funded by the Government continue to escalate. The tax reforms therefore come in handy to remedy the situation for corporate tax payers. It is in this light that the study seeks to examine the role of tax complexity, enforcement and compliance in tax reforms in Kenya.

There are a number of studies that have been done on taxation in Kenya. For instance, Ochumbo (1982) did an analysis of the changes in the Income Tax Act since 1973 using the tax efficiency criteria. Karun (1992) did a survey of income tax avoidance by organisations in Nairobi. Wang'ombe (2001) analyzed the productivity of the Kenyan tax system and some administrative factors. Migwi (2006) tackled the issue of taxpayers' attitude and tax compliance behaviour in Kenya but based his survey on small and medium size businesses in Kirinyaga District. In a more recent study, Kieleko (2007) studied the effects to tax reforms on tax productivity in Kenya. As can be observed from the foregoing, all these studies fail to capture the issue of the role of administrative factors in influencing tax reforms in Kenya. This is the gap the current study seeks to fill by focusing on the income tax in Kenya.

1.3. Objective of the Study

i. To determine the role of complexity of corporation tax system in tax reforms.
ii. To establish how compliance with corporation tax system influences reform.
iii. To investigate to what extent the level of enforcement of corporation tax policy dictates reform.

1.4. Research Hypothesis

The following are the hypothesis for the study;

H_0- The degree of complexity, compliance and enforcement of the corporation tax system influences reform.

H_1- Tax reform is not influence by the level of complexity, enforcement and compliance.

1.5. Justification of the Study

The perceived and actual complexity of the current tax system is a significant motivation for reform. This suggests that attention be given to modifications of the existing system that emphasize administrative factors as well as to more fundamental changes.

The significant disagreements concerning the compliance and administrative costs of the existing system and the potential for tax reform to reduce those costs. Understanding the sources of these disagreements is critical to estimating the expected gains and losses from changes in policy. Moreover, because some of the newly proposed tax system like a national retail sales tax or a flat tax has never been tried, or at least not been tried on the scale that is being proposed, it is an open question whether they would be administrable and enforceable in the real world.

Policy makers face trade-offs among administrative goals of tax policy. A tax system can be quite simple, for example, with low costs of compliance, if it is not intended to be enforced well. Trade-offs also exists between administrative factors and other goals of tax policy; for example, policies that promote fairness may result in additional complexity.

CHAPTER TWO
LITERATURE REVIEW

2.1. Tax Reforms in Kenya

An analysis of Kenya's fiscal structure reveals a number of important aspects. 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. 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). Although Kenya embarked on massive tax reforms in 1986, little is known about the performance of the reforms in terms of raising the revenue mobilization capacity of the tax system. It is not known how the reforms have affected each tax source.

2.1.1. Fiscal Operations in Kenya

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 show that for all years, expenditures exceeded revenues. Similarly, both government revenue and expenditure maintained consistent growth patterns. Government revenue increased by Ksh170.1 billion compared with an increase of Ksh174.4 billion in expenditure. In absolute terms, the growth in expenditure exceeded revenue. In relation to GDP, government revenue averaged 29.8%, while mean expenditure was 34.4%. This generated a resource gap of about 4.6% for the period 1986 to 1998.

On a year-to-year basis, the deficit–GDP ratio rose from 4.5% in 1988 to a high of 11.3% in 1993 and then fell to a low of 1.5% in 1996. The persistence and magnitude of this deficit have baffled the revenue authorities. 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. 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. 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.

2.1.2. Elements of Tax reform

The revenue structures of most developing countries have not been as productive as desired. Too often the growth in revenue has failed to catch up with government spending pressures, a situation that has occasioned huge imbalances between the demand and supply of public budgetary resources. These countries have then had to reform their tax structures, with the general objectives of revenue adequacy, economic efficiency, equity and fairness, and simplicity (Osoro, 1993). The main elements of the reform programmes include; imposing a small number of taxes with the broadest possible base and moderate rates (World Bank, 1990), using VAT to replace commodity taxes in order to minimize disincentives for investments and exports (Thirsk, 1991).

Tax reform may also involve not only avoiding raising taxes on the poor, but also reducing their tax burden. This is achieved by levying excise duties on luxury items and exempting foodstuffs to protect the low-income groups. In addition a reform may avoid tax incentives and shift to broader, simpler tax bases on which lower rates are applied, minimize corporate tax evasion by levying minimum taxes on a company's net worth and lower distortions that reduce economic welfare and growth. More often, policy advice directed towards countries desiring to reform their tax systems has emphasized the introduction of either new taxes or new rates on existing bases, more stringent administrative changes to seal loopholes that encourage tax evasion, and the need to widen tax bases and reduce exemptions. Other measures include the allocation of more budgetary resources to the revenue authorities, paying higher salaries to revenue officers and imposing relatively prohibitive penalties.

Generally, special attention is also directed to the simultaneous reduction of the tax rates and widening of the base as one of the most effective approaches for addressing the twin problems of the disincentive effects of high marginal tax rates and tax evasion. Tax reform measures are mainly undertaken in order to restore buoyancy to revenues, strengthen modern taxes, and drastically reduce the complexity and lack of transparency of the system (World Bank, 1990). The main factors contributing to an improved revenue performance are changes in tax legislation, tax administration and minimal tax evasion (Morrisset and Izquierdo, 1993).

Generally, tax reform in developing countries involves broad issues of economic policy as well as specific problems of tax structure design and administration (Musgrave, 1987). In this sense, tax reform has to grapple with complementarities between revenue structure and development policy including issues such as the impact of alternative taxes on saving and investment and the resultant challenges for macro balance of the economy. Reforms may also address the issue of equity in the distribution of the tax burden as well as composition of the tax structure. There is, as well, the question of the administrative adequacy of the tax system usually approached within the wider context of political structures and feasibilities.

2.2. Specific Tax Reforms in Kenya

Though the Kenyan tax structure had changed tremendously over the years, massive reforms commenced in 1986 following the publication of Sessional Paper No 1 of 1986. Since then, the implementation of major tax reforms introduced the following changes to the tax system. There has been a reduction in direct taxes through a widening of tax brackets and gradual lowering of income tax rates. Indirect taxes have been increased to cover the shortfall in revenue. Since indirect taxes are regressive and therefore impose a greater burden on the poor, this shift has been criticized as reducing the redistributive effect of the tax system.

Notably, there has also been a shift from taxes on international trade to taxes on domestic goods and services. Value added tax (VAT) has become the primary source of revenue, generating about two-thirds of domestic taxes on goods and services. It is argued that VAT is an indirect tax on consumption and therefore has less adverse impact on investment and exports. In the 1990–1994 periods, VAT was the most important tax, constituting 37% of total tax revenue. However, this fell to about 28% in fiscal year 2000/2001.Since VAT relies heavily on proper recording, the willingness of traders to avail their accounts to the scrutiny of the tax authorities is crucial. As such, transparency in the running of business concerns is inevitable. A limitation of VAT relative to the sales tax is that the compliance process is longer. Such a tax (requiring lengthy processes) is more open to graft since each stage of verification, approval and validation avails an opportunity to extort bribes. Sequencing is therefore a symptomatic problem with VAT. Similarly, corruption erodes its efficacy.

Wagacha (1999) argues that Kenya's tax reform programme, should seek to improve the efficiency and productivity of taxation, improve tax collection and administration while lowering the rates, and gain tax effectiveness through greater tax elasticity. On the basis of tax/GDP ratios for the period 1992/93–1996/97, this author observes that Kenya's tax burden (averaging 26.6%) is high by international standards and therefore the ultimate objective of a reform scheme should be to lower the excessive tax burden and efficiency costs of taxation.

2.2.1. Customs reform

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%.

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 exemptions 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.

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.

In order to achieve these reforms, the administrative capacity of the tax system had to be strengthened. 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 controls at Mombasa port (from 1996).

2.2.2. VAT and excise duty reform

VAT was introduced in Kenya in 1990 to replace sales tax. This shift was motivated by the argument that VAT had a higher revenue potential relative to sales tax 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.

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 Kshs 10,000 to Kshs 5, 00,000 and introducing stiff penalties for defaulters in areas such as 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 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.

2.2.3. Income tax reform

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 30% currently. Further, basic tax allowances 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 30% between 1989 and 2007. 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. 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 system 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.

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 Kshs 11,135.

2.2.4. Organizational reform

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, and 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.

2.3. Tax Compliance

Smith (1976) notes that, "by subjecting the people to the frequent visits and the odious examination of the tax gatherers, it may expose them to much unnecessary trouble, vexation, and oppression; and though vexation is not, strictly speaking, expense, it is certainly equivalent to expense at which every man would be willing to redeem himself from it." Smith's comment makes clear that compliance costs can have elements of time, mental anguish, and money.

According to Sandford, (1995) compliance costs are costs incurred by taxpayers in meeting the requirements laid on them by the tax law and the revenue authorities. They are the costs over and above the actual payment of tax and over and above any distortion costs inherent in the nature of the tax; costs which would disappear if the tax was abolished. This definition clearly includes costs associated with maintaining tax records, learning about tax law, preparing the return, and sending the return to the tax authorities. Almost all studies of compliance cost include, at a minimum, these four elements. A more comprehensive measure of compliance costs would include expenditures of time or money by the taxpayer solely to avoid or evade taxes. Tax avoidance is legal behavior that reduces taxes. Tax evasion is illegal behavior that involves not paying taxes legally or illegally.

Administrative costs generally refer to the expenses incurred directly by the government in collecting taxes. These costs are ultimately borne by individuals. Although Government costs appear explicitly in budgets, measuring the administrative costs of a tax system is not always simple. Relevant budgetary costs of the tax collection agency should be included as administrative costs. However, for some purposes, the question of interest is the cost of a particular set of taxes, rather than the entire tax system.

2.3.1. The Taxpayer as Client

Facilitating compliance involves such elements as improving services to taxpayers by providing them clear instructions, understandable forms, and assistance and information as necessary. Monitoring compliance requires the establishment and maintenance of taxpayer current accounts and management information systems covering both ultimate taxpayers and third-party agents, such as banks, involved in the tax system as well as appropriate and prompt procedures to detect and follow up on non-filers and delayed payments. Improving compliance requires a judicious mix of both these measures as well as additional measures to deter non-compliance such as establishing a reasonable risk of detection and the effective application of penalties. The ideal approach is to combine these measures so as to maximize their effect on compliance. For example, when introducing a new tax, emphasis should first be given to assisting taxpayers to comply with the new tax, then to detecting non-compliance, and finally to applying penalties. As a rule, successful reform strategies require an appropriate mix of all these approaches.

In this respect, it is important to emphasize that improving tax compliance is not the same as discouraging non-compliance. This perhaps paradoxical conclusion emerges from the numerous sociological and psychological studies of taxation that have been carried out in recent years, based largely on experimental and survey evidence (Slemrod, 1992). While most tax compliance in most countries most of the time can perhaps best be characterized as "quasi-voluntary compliance" (Levi, 1988), because taxpayers have little choice as to whether their income sources have tax withheld or not, there nonetheless appear to be two distinct groups of taxpayers in any country at any time: those who comply and those who do not - almost irrespective of whether they can get away with it or not.

Some compliers comply not just because they do not have the opportunity to evade or because they are exceedingly risk-averse but because they think it is the right thing to do, and, importantly, they think other "right-thinking" people are also complying. By definition, there are more such people in "high-compliance" countries than in "low-compliance" countries. Even in the latter, however, it is a gross oversimplification to pretend that every taxpayer views the decision as to whether to pay his taxes as a gamble to be decided independently of his membership in and loyalty to the community. Some always pay; some always cheat; and some cheat when they think they can get away with it. An important task of tax administration is to prevent the mix from “tipping” in the direction of pervasive non-compliance.

The very limited international comparisons that can be made on the basis of existing literature suggest that considerable care must be exercised in extrapolating results from one context to another. In particular, while non-compliers may be similar in some respects everywhere, both the size and the nature of the factors inducing compliers to comply may be quite different in different countries. Aspects that may differ from country to country include the value attached to "fairness" and its meaning, the degree of deference to authority and the legitimacy attached to that authority, and the extent to which contributing to the finance of government activities is seen as socially as opposed to privately, as in the economic model of tax evasion, discussed below desirable.

Increased enforcement actions (like amnesties - whether viewed separately or jointly from increased enforcement) may have quite different results on "compliers" than on "non-compliers." So may increased efforts at public education about taxpayer rights and obligations or increased efforts by tax authorities to provide improved service to taxpayers. Such policies may change attitudes, although not all changes for all groups will necessarily be in the desired direction. Nonetheless, a good case can generally be made that the "optimal" enforcement strategy is likely to include both rewards (support) for compliers and penalties for non-compliers.

In addition, while there are few studies of private compliance costs in developing countries, the evidence from studies in developed countries (Sandford, 1995) is that these costs are larger than public costs, that they are largely substituted for public costs, and that their incidence can be quite different from those of the taxes themselves. The complexity and cumbersome administrative methods employed with respect to some taxes found in some developing countries - for example, stamp taxes and the variety of minor excises - suggest that compliance costs may well be very high in such countries. Moreover, compliance costs have been found to be particularly sensitive to the stability of the tax legislation and to such changes in the external environment as inflation.

All these factors are more important in the "low compliance" environment of most Latin American and Caribbean countries than in the "high compliance" environment of the few developed countries where such costs have been studied. Low compliance may thus at least to some extent be a function of high compliance costs, as well as of such more basic problems as lack of state legitimacy, inadequate connection between taxes and benefits, and perceptions of tax fairness.

The taxpayer's decision to comply, or not comply, with his fiscal obligations is of course the subject of a large formal theoretical literature on the economics of tax evasion (Cowell, 1990; Slemrod and Yitzhaki, 2002). While some progress has been made both in incorporating the "strategic" aspects of the evasion decision in a game-theoretic framework and in modeling it in principal-agent terms, much remains to be done before the results of such analysis have much to say about the real world " tax game" in developing countries. For example, most literature on tax evasion assumes that tax officials are completely honest.

If not all officials are honest (and in the expected utility framework it is not clear why they should be expected to be), the game is very different than that usually modeled. "Leakage costs," as Shaw (1981) calls that portion of tax revenues that flows into the pockets of officials rather than into the coffers of government, may simply be transfers in economic terms, but they may nonetheless result in significant distortions as new taxes are invented and tax rates increased in an attempt to make up the revenue loss.

In addition to this serious gap in the existing formal analysis, the literature has not as yet managed to model very well either the long-term, repetitive nature of the tax game or the role of "norms" in determining how people play the game. Consideration of the temporal dimension of tax administration emphasizes the importance both of the interaction of officials and taxpayers and of changes in "tax technology" and taxpayer attitudes to government. The problem of tax administration reform is essentially how to alter the outcomes of administrative effort by appropriate investment in developing new legal and organizational frameworks, adopting new technology (computerization), and altering the allocation of administrative resources. Finally, in recent years virtually all attempts to reform tax administration have centered on some form of computer application. Certainly, it is difficult to conceive of a tax administration that can perform its tasks efficiently without using some form of computer technology, Musgrave, (1987).

2.4. Simplicity/Complexity of Tax System

Although tax systems are routinely described as "complex," there is no ideal definition of tax complexity. Slemrod (1984) proposes using the total resource cost, the sum of compliance costs, incurred directly by taxpayers or third-parties on their behalf, and administrative costs incurred by the government, as a measure of complexity. This approach provides a quantitative measure of complexity, a standard by which different tax systems can be compared and judged, and by which the administrative aspects of a particular tax system can be compared with its impacts on equity, efficiency, and revenue targets.

In addition, this measure can capture complexity that results from increased ambiguity or from increased specificity. A new provision that is vague and can be interpreted in different ways will spur taxpayers, preparers, and Kenya Revenue Authority officers to spend more time learning about the provision. Complexity, like pollution, may sometimes be unavoidable. Therefore, the fundamental conceptual question with regard to compliance costs is not the overall level of such costs, but whether society is getting good value for the complexity that exists. This depends on how large the costs are, who bears the costs, how much the complexity aids in achieving other goals, and how much those other goals are valued, Adari, (1997).

Views about the costs of complexity may well depend on which income groups or age groups bear the burden of complex tax calculations. The incidence of costs on particular sectors in the economy -individuals, businesses, or the government -may also be a relevant policy concern. All of these factors point to the importance and the difficulty of estimating the level, nature, and distribution of both the costs and benefits of tax complexity.

Analysis of administrative (and other) aspects of tax reform options should examine the proposals not only as they exist on paper but also as they are likely to exist or evolve if they were enacted. Generally, any tax system can be made to look cleaner and simpler on paper than it can be after being subjected to the political process and the need to raise revenues. More fundamentally, it may prove easier to repeal a particular tax system than it is to eliminate political factors from the tax code. Analysis should also focus on the compliance and administrative costs of government policies in general, rather than just the tax system. Government can impose policy via taxes, spending, regulations, or mandates. Any tax provision can be made simpler by eliminating it, but if it then is recreated as a spending program, the overall complexity of government may have risen, Levi, (1988).

Comparisons of the resource costs of alternative tax systems are most meaningful when holding constant other aspects of tax policy, the level of revenue, the level of evasion, or the distribution of tax burdens, for example, or certain characteristics of the taxpaying populations, particularly their educational levels and cognitive skills.

According to Bird & Casanegra, (1992), as a rule, an essential precondition for the reform of tax administration is to simplify the tax system to ensure that it can be applied effectively in the generally low compliance contexts of developing countries. The experience of Bolivia, which introduced a major simplification of its tax system in 1986, is instructive in this respect, for example. Much of the initial success achieved in reforming the tax administration in Bolivia was clearly attributable to the extensive simplifications made in the tax system. Das-Gupta & Mookherjee, (1998).

Bahl & Vazquez (1992) argue in the case of Jamaica, that it seldom makes sense to try to reform tax administration without simultaneously reforming the tax structure into something that is both sensible and administrable. As experience in both Chile (Harberger, 1989) and Colombia (Pardo and McLure, 1992) demonstrates, it is possible to achieve considerable improvement in administration with less drastic but nonetheless effective simplifications in tax policy. Reducing the number of income tax deductions, for instance, permitted these countries to eliminate filing requirements for most wage earners, thus greatly reducing the administrative burden, since withholding alone then sufficed to enable most income taxpayers to fulfill their obligations.

Developing countries exhibit a wide variety of tax compliance levels, reflecting not only the effectiveness of their tax administrations but also taxpayer attitudes toward taxation and toward government. For example, it is not possible to appraise the efficiency or effectiveness of tax administration without taking into account both the degree of complexity of the tax structure it is expected to administer and the extent to which that structure remains stable over time. Complexity and its implications for tax administration has long been a concern even in the most developed countries. Even the most sophisticated tax administration can easily be overloaded with impossible tasks, (Hood, 1976).

If additional specificity is added to eligibility criteria, benefits are phased-out over some income range, or are limited in some other fashion, taxes become more difficult to compute. In either case, measured and true total compliance costs could rise, and the increase would be appropriate. Suppose a particular tax provision is so complex that few taxpayers understand it. If the provision is clarified by subsequent regulation, more people will exploit the provision, so the resource cost of complying with the tax system could rise, even though the particular provision was made simpler. (Bird, 1989).

Sand ford (1995) reports that consideration of tax compliance costs has become an integral part of the tax policy-making process and that the compliance cost assessments do influence policy decisions. Steuerle, (1997) proposed that the treasury or other government agency publish an annual study that lists and quantifies the compliance cost savings of any number of potential tax simplification proposals. This would provide a ready-made list of off-the-shelf items to consider and help concentrate attention on these issues. One possibility would be for the Kenya Revenue Authority to subsidize electronic filing. Electronic filing may help reduce error rates because returns are often prepared using computer software programs with built-in accuracy checks, and it prevents key punch errors that could otherwise occur at the Revenue Authority.

Some such gimmicks - for example, lotteries in which tax invoices constitute lottery numbers - have long (and properly) been derided by experts as costly and of dubious effectiveness (Goode, 1981). Another popular device is to introduce widespread withholding, covering not only traditional items such as wages, interest and dividends but also extending to professional fees, rents, and in some instances to practically all business transactions. Some countries have even introduced what may be called reverse withholding, in which purchasers (government agencies or large enterprises) "withhold" tax from sellers (small enterprises). Such widespread withholding is no panacea (Soos, 1990). The tax administration must be able to control withholders to make sure they hand over to the Treasury the amounts withheld, and it must also be able to check whether the amounts taxpayers credit against their liabilities as taxes withheld have in fact been withheld. In short, the mere expansion of withholding will not improve compliance unless the administration is able to control both withholders and taxpayers subject to withholding.

As emphasized above, an important element in any successful administrative reform is simplicity. The earlier discussion emphasized giving the administration simpler, and hence potentially, enforceable laws to administer. In addition, it is equally important to simplify procedures for taxpayers, for example, by eliminating demands for superfluous information in tax returns and perhaps consolidating return and payment invoices. Once procedures are simplified, the tax administration can then concentrate on its main tasks: facilitating compliance, monitoring compliance, and dealing with non-compliance.

2.5 Enforcement of Tax Laws

The importance of good administration has long been as obvious to those concerned with tax policy in developing countries as has its absence. Experience suggests that it is not possible to ignore the administrative dimension of tax reform, to assume that whatever policy designers can think up can be done, or to assume that any administrative problems may easily and quickly be remedied. As a rule, the real tax system facing people and businesses in most developing countries is not what a quick reading of the tax law might suggest but rather results from how that system is actually implemented in practice. How a tax system is administered affects its yield, its incidence, and its efficiency. Tax administration is simply too important to policy outcomes to be neglected by tax policy reformers.

Despite its perhaps surprising complexity, it is important for those concerned with tax policy and its effects on the economy to understand tax administration. In a very real sense, "tax administration is tax policy" (Jantscher, 1990). Maximizing revenue for a given administrative outlay is only one dimension of the task of tax administration. Revenue outcomes may not always be the most appropriate basis for assessing administrative performance. How the revenue is raised - the effect of revenue-generation effort on equity, the political fortunes of the government, and the level of economic welfare - may be equally or more important in some contexts. Similarly, private as well as public costs of tax administration must be taken into account and due attention given to the extent to which revenue is attributable to "enforcement" (the active intervention of the administration) rather than compliance (the relatively passive role of the administration as the recipient of revenues generated by other features of the system).

Assessing the relation between administrative effort and revenue outcome is by no means a simple task. Increasing attention has been paid in the last few years to the importance of tax administration and its role in tax reform. As Tanzi (1991) points out that tax administration has a crucial role in determining the real (or effective) tax system, as opposed to the statutory tax system. There is a growing conviction among tax policy specialists in developing countries that "policy change without administrative change is nothing, (Bird, 1989) and that it is critical to ensure that changes in tax policy are compatible with administrative capacity (World Bank, 1991). But how much is actually known about the experience of countries that have reformed - or tried to reform - their tax administration.

2.5.1. Approaches to Tax Administration Reforms

In an ideal, law-abiding society, people would pay the taxes they owe, and tax administration would amount to little more than the provision of facilities for citizens to discharge this responsibility. No such country exists, or is likely ever to exist. Compliance with tax laws must be created, cultivated, monitored, and enforced in all countries. What induces compliance with tax laws has been the subject of extensive research in recent years. The conventional view in economic models of taxpayer behavior is that people comply with tax laws so long as they feel that non-compliance may cost more, that is, that the penalties likely to be suffered in case evasion is detected exceed the tax to be paid. Jenkins, (1995)

This view does not explain why people pay taxes even when enforcement is weak. A host of other factors such as social values, public morality, and people's perception about the fairness of the system also matter in shaping attitudes to tax laws. Nonetheless, although the role of societal and cultural factors cannot be denied, compliance is unlikely to be high if the belief prevails that evasion can be practiced with impunity. Tax administrations must foster, not simply enforce, tax compliance. How effectively they can do so depends ultimately upon their perceived ability to detect and bring tax offenders to book, Ziliak, (2001).

Resources are always limited; therefore, no tax administration can play the policeman for every potential taxpayer. Partly for this reason, tax systems all over the world have over the years tended to move toward a regime in which taxpayers themselves determine and report - in other words, "self-assess"-

their tax liability and pay the amounts due without any special prodding from tax authorities. But self-assessment will result in high levels of compliance only if accompanied by actions that lend credibility to the sanctions prescribed in the law against non-compliance. Heady, (1993),Gillis, (1989) states that effective tax administration requires establishing an environment in which citizens are induced to comply with tax laws voluntarily, while efficient tax administration requires that this task be performed at minimum cost to the community. This is not a simple task anywhere. The job is particularly difficult in developing countries with large informal sectors, low levels of literacy and public morality, poor salary structure for public servants, poor communications, malfunctioning judicial systems, and entrenched interests against radical reform. Despite such handicaps, the experience of several countries in recent years shows that substantial improvement can be achieved with determined effort and an appropriately designed strategy. What a tax administration can do, however, and how it can best be reformed depends largely upon the environment in which it operates.

2.5.2. The Environmental Context

Mahon,(1997) states that among the "cultural" factors that may matter are the extent of institutionalization of corruption, the extent of criminalization of politics, standards of public morality, and the attitude towards compliance of peers. Although none of these factors is immutable, and their effects on tax compliance are by no means always obvious, the extent and nature of feasible tax administration reform depends in part upon such important but largely intangible factors. Similarly, such political factors as the extent of public acceptance of government in general or of its expenditure or taxation measures may affect reform, as may the structure of intergovernmental fiscal arrangements.

According to Diaz, (1990), the legal environment is also crucial to tax administration. Enforcing a bad tax law well is usually not a good idea. For a law to be enforced properly, it should both be appropriate to the environment and enforceable: good enforcement requires good tax law. As noted previously, it is easy to attempt to incorporate too many objectives of social and economic policy in tax policy, thus resulting in complexities with which neither taxpayers nor tax administrations can easily cope. Voluntary compliance (self-assessment) cannot work where taxpayers find it hard to figure out their obligations correctly. Similarly, withholding (and its verification) also encounters problems when the tax base is ill-defined or when there are many exemptions and deductions.

Tax enforcement is also strongly influenced by administrative law - the public sector management rules that establish the incentives which motivate the performance of government officials. In addition to specifying salary scales, rewards for performance, and career paths, such rules also specify mechanisms for ensuring financial and management accountability.

With sophisticated payments systems income-generating transactions leave temporal traces, unlike the cash or barter transactions that dominate the so-called "irregular" or "informal" economy. On the other hand, sophisticated financial systems coupled with openness increase the ease with which funds may cross international borders to escape taxes. The possibility of international income shifting through various forms of transfer pricing and related financial transactions limits the scope of feasible administrative actions by national tax authorities, as may the growth of cross-border electronic commerce. Thirsk, (1991)

More generally, economic growth is closely related to the size of the base for most broad-based taxes and is usually accompanied by a rising share of the formal or organized sector. As the attractiveness of the formal sector grows, in principle voluntary compliance should also increase. The widespread adoption of modern systems of business accounting is a necessary prerequisite for the introduction of many modern taxes, particularly the income tax, the corporation tax and the value-added tax. Geddes, (1994)

CHAPTER THREE
RESEARCH METHODOLOGY

3.1. Research Design

This study used a descriptive survey. Descriptive research portrays an accurate profile of persons, events, or situations (Robson, 2002). Surveys allow the collection of large amount of data from a sizable population in a highly economical way. It allows one to collect quantitative data which can be analyzed quantitatively using descriptive and inferential statistics (Saunders et al., 2007). Therefore, the descriptive survey was deemed the best strategy to fulfill the objectives of this study.

3.2. Population of Study

The population of interest in this study consisted of all the 350 tax managers within the Kenya revenue Authority who deal with or advice on tax reforms issues. In addition the study targeted financial managers in the 55 companies listed in the Nairobi stock exchange. The tax managers were targeted given their sole role on tax issues. The financial managers deal with tax issues hence their consideration in this study.

3.3. Sample and Sampling Technique

Three managers within Nairobi formed the sample size that filled in the questionnaire for the tax managers at KRA. For the financial managers of the listed firms, a sample of 35 managers was selected for the study. These were drawn from the firms that have their head offices in Nairobi and are listed on the NSE. A simple random sampling was used to select the 35 financial managers (listed firms).

Table 1: Sample Selection

Category	Population	Sample	Percentage
Tax managers	350	3	0.86%
Financial managers	55	35	64%
Total	**405**	**38**	**9.4%**

3.4. Data Collection

This study was facilitated by the use of primary data. Primary data was collected from the managers using the questionnaires. Two questionnaires were designed. One was filled by the finance managers in the 55 listed firms while the other one was filled in by the tax managers at KRA. This structure ensured that all the responses obtained were useful in answering the research questions.

3.5. Data Analysis and Presentation

The primary data collected was analysed based on descriptive statistics such as percentages. The influence of complexity, compliance and enforcement on tax reforms will be analysed using percentages. Data was presented using tables and graphs, and pie charts for effective interpretation by users. Graphs, tables and pie charts are powerful presentation tools that adequately present the results of the study in a way that is easily understandable.

CHAPTER FOUR

DATA ANALYSIS AND FINDINGS

4.1 Introduction

This chapter presents the results of the analysis. All the 35 questionnaires administered to the finance managers were collected and used in the analysis. All the three tax administrators also filled in the questionnaires which were subsequently collected and used for analysis.

4.2 Sample Characteristics

4.2.1 Profile of Listed Firms Surveyed

The study found that of the 35 firms that were surveyed, 43% were in the industrial and allied sector while 29% were in the finance and investment sector. 23% were in the commercial and services sector while the remaining 6% were in the agricultural sector. These results are summarised in Figure 1.

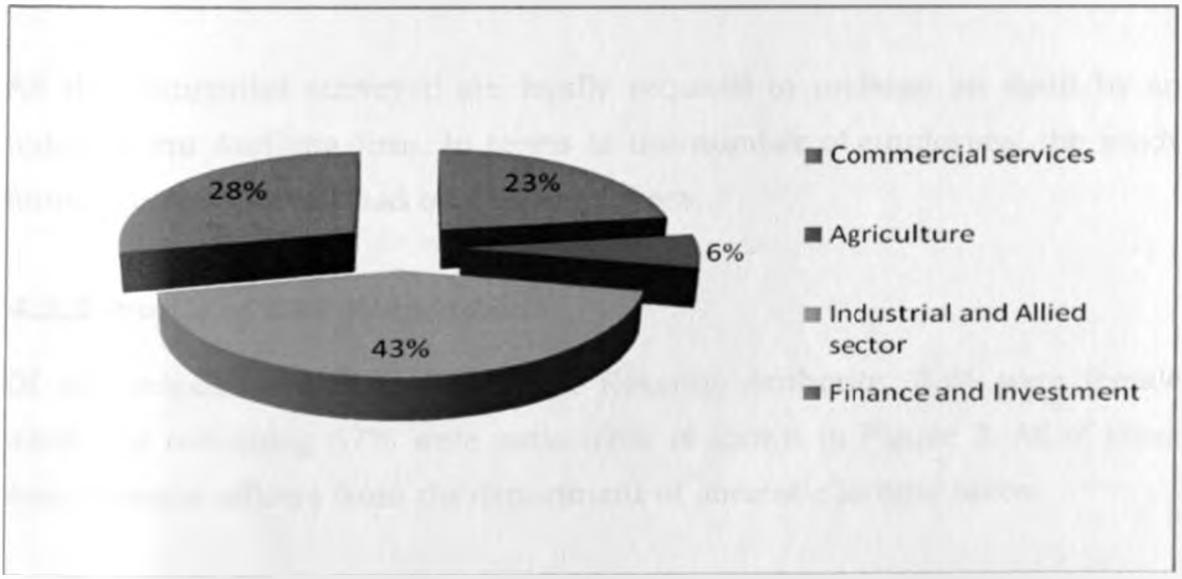

Figure 1: Activities of the Firms Surveyed

On the source of funding, the study found that most of the firms received their funding from issue of shares (46%). Debt financing is used by 26% of the firms while the remaining firms either use government grants, ploughed back profits or reserves as indicated in Figure 2.

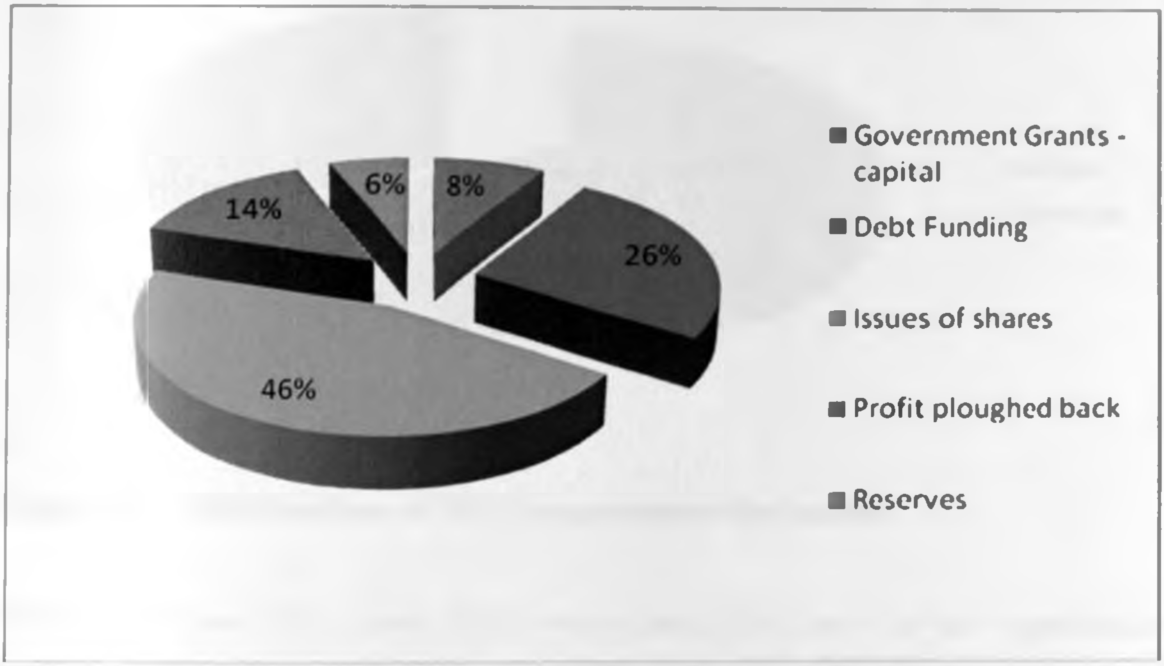

Figure 2: Source of Funding

All the companies surveyed are legally required to undergo an audit by an independent Auditing firm. In terms of the number of employees, the study found that all of them had over 51 employees.

4.2.2 Profile of KRA Respondents

Of the respondents from the Kenya Revenue Authority, 33% were female while the remaining 67% were male. This is shown in Figure 3. All of them were revenue officers from the department of domestic income taxes.

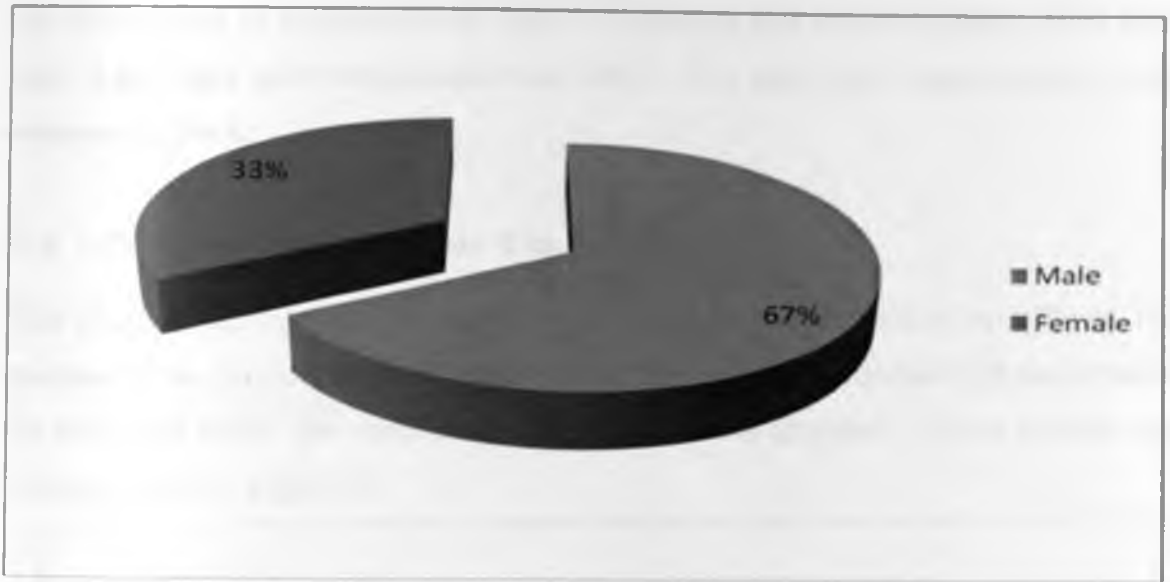

Figure 3: Distribution of KRA Respondents by Gender

The study found that most of the respondents had been in the organisation for a period between 3 and 5 years (67%). The rest of the respondents had been working in KRA for over 5 years. This is shown in Figure 4.

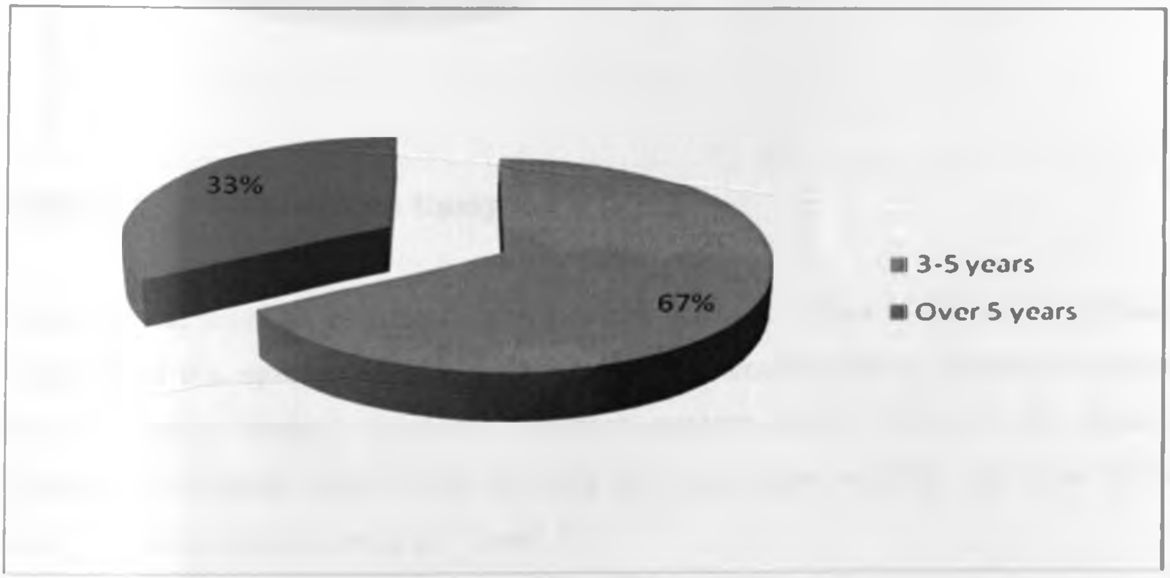

Figure 4: Period of Service in KRA

On their level of responsibility held in advising tax reform issues, 33% said they had high level responsibilities while 66% said they had average level responsibilities.

4.3 Complexity and Income Tax Reform

The income tax system in Kenya was ranked as appropriate by 43% of the respondents. On the other hand, 42% of the respondents find the tax system as complex while the remaining 14% find it less complex. These results are summarised in Figure 5.

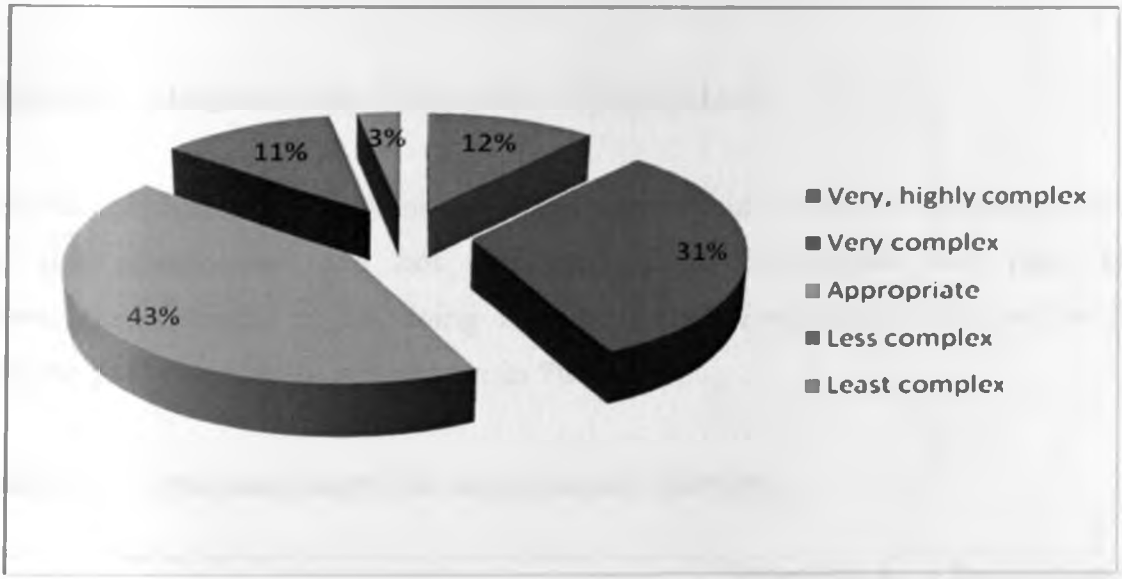

Figure 5: Level of Tax Complexity

Most of the finance managers in the firms surveyed were of the opinion that a simplified tax system with a smaller tax rate could lead to greater revenues for the state budget than the current system (51%). 23% of the finance managers did not think so while 26% did not know whether the case would hold. This is summarised in Figure 6.

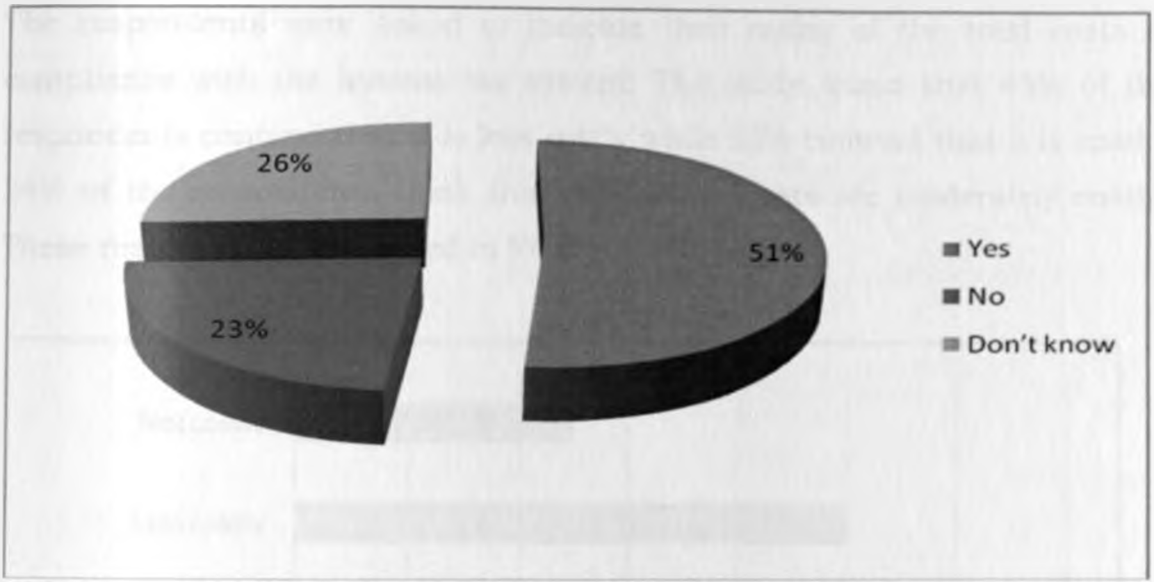

Figure 6: Implication of Simplified Tax System

The study found that 63% of the respondents think that the services offered by the government are not consumerate to the taxes they pay. The Government seems to be doing less with the taxes paid. 37% are so far satisfied. These results are shown in Table 2.

Table 2: Satisfaction with Government Services

	Frequency	Percentage
Satisfied	4	11
Partially satisfied	9	26
Partially dissatisfied	10	29
Dissatisfied	12	34
Total	**35**	**100**

On the estimation of tax liability related costs of the firms in percent of total earnings before taxes, the study found that tax liability in all the firms was above 15%.

The respondents were asked to indicate their rating of the total costs of compliance with the income tax system. The study found that 43% of the respondents contend that it is less costly while 23% contend that it is costly. 34% of the respondents think that compliance costs are moderately costly. These results are summarised in Figure 7.

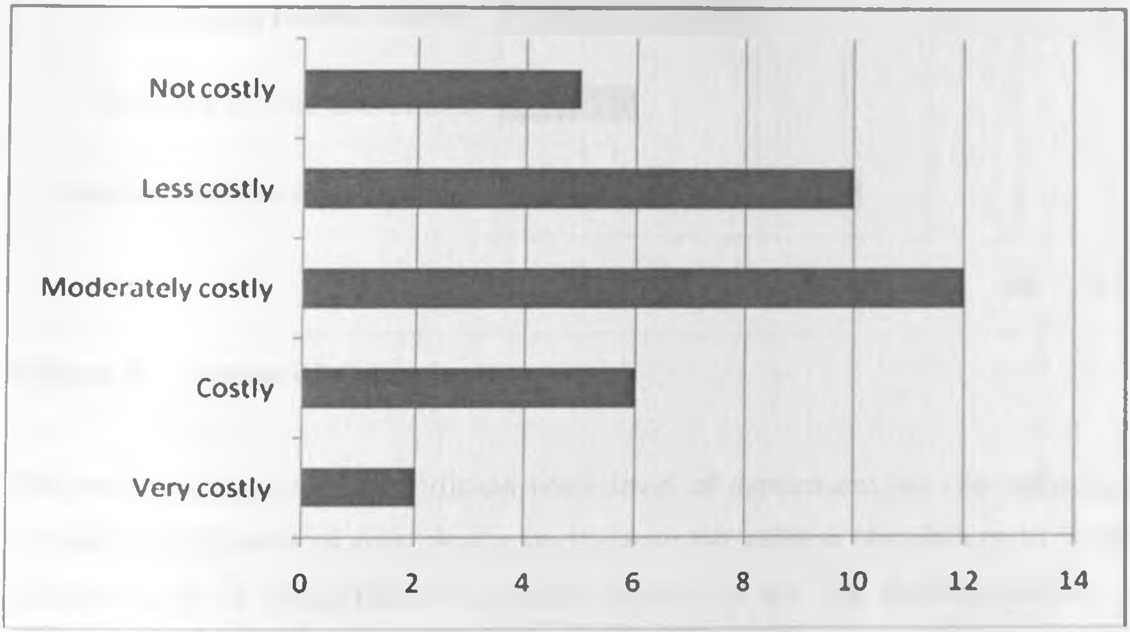

Figure 7: Costs of Compliance

On the areas the respondents considered to be more complex in the current Income Tax system, the study found that accessing refunds is the most complex area in income tax as agreed by 94% of the respondents. 69% of the respondents found paying penalties to be another complex issue while 60% said that evaluating allowable deductions is another complex area in income tax system.

Filling of income tax returns, meeting deadlines and computing taxable income were not found to be major complex issues. This is summarised in Figure 8.

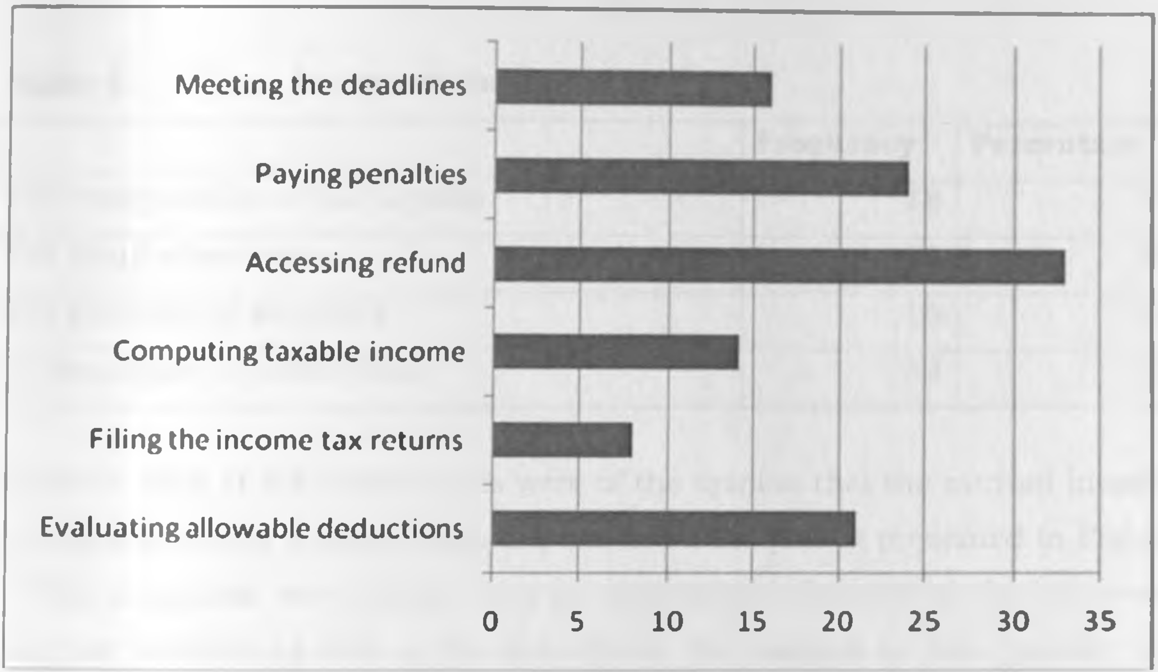

Figure 8: Areas of Complexity

The respondents were to indicate their level of agreement on the influence of the various aspects of complexity on income tax reform. As shown in Table 3, computation of deductions has more influence on tax reforms (91%) and followed by filing of tax returns (60%). These and the rest of the results are shown in Table 3.

Table 3: Complexity and Tax Reform

	Frequency	Percentage
The computation of tax payable	18	51
The filing of returns	21	60
The payment of penalties	16	46
Computation of deductions	32	91

The respondents were then asked to cite those aspects of complexity that require reforms. As shown in table 4, the area that needs most of attention of computation of deduction and payment of penalties.

Table 4: Areas for Tax Reforms

	Frequency	Percentage
The computation of tax payable	18	51
The filing of returns	21	46
The payment of penalties	16	91
Computation of deductions	32	60

Further, 80% of the respondents were of the opinion that the current income tax system needs reforms. 20% did not think so. This is presented in Figure 9. The areas that were mostly cited as warranting reforms were the tax rates, the tax brackets as well as the deductions. The reasons for this include the fact that the current income tax rates are considered very high hence making other people look for means of evading payment of taxes. The current tax brackets are also seen to be talking into account those who should be considered not to pay taxes as their earnings are very low.

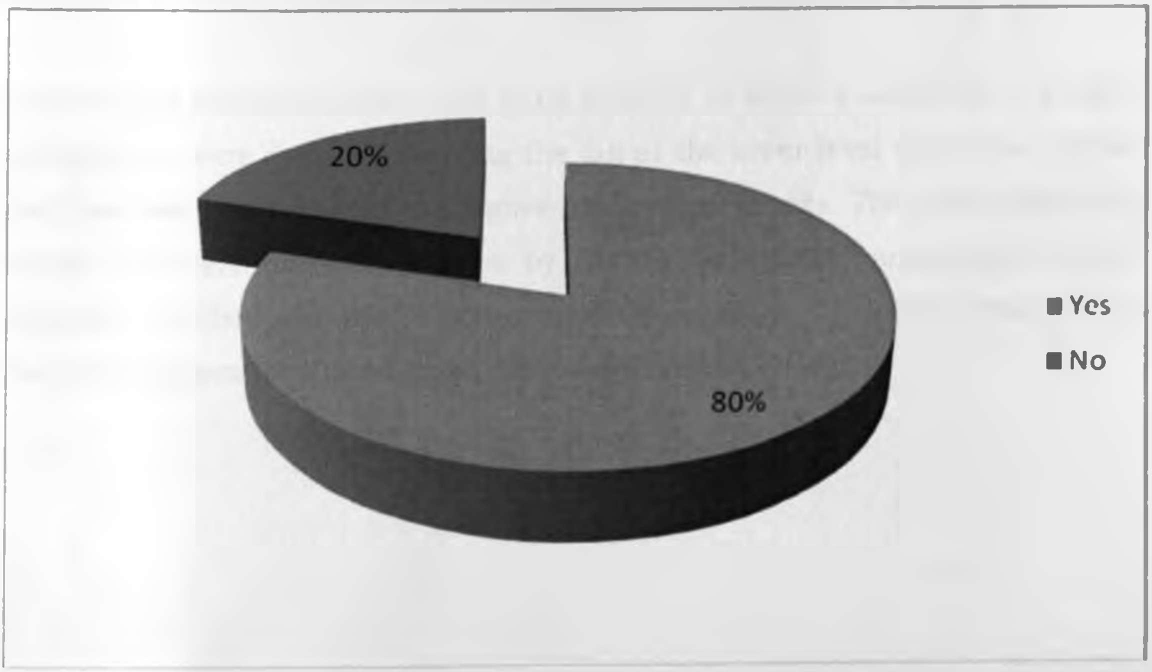

Figure 9: Need for Income Tax Reforms

4.4 Compliance and Tax Reforms

The respondents from KRA were asked to estimate what percentage of firms that does not comply with income tax requirements annually in their department. As the study found out, on average, about 30% of the firms do not comply with the income tax. The study further found that there has been some improvement in tax compliance by the firms under the department over the years.

In terms of the percentage increase in compliance in income tax over the last five years, the study found that this has ranged within 10% and 15%. Thus, for the last five years, there has been a rise in compliance in income tax.

The respondents cited that they were satisfied with the level of compliance exhibited in the department of domestic taxes but explained that a lot needs to be done to ensure that all those who are supposed to pay taxes pay their part of tax without delay so as to avoid the issues of penalties.

Some of the measures that need to be adopted to achieve satisfactory levels of compliance were cited as lowering the tax at the lower level of the tax bracket and increasing the tax for the higher bracket tax payers. The government also needs to create more awareness by having awareness campaigns to make taxpayers understand the importance of paying taxes. The other measure was that strong penalties need to be levied on tax defaulters.

4.5 Enforcement of Tax Reforms

The study found that the department of income tax was able to adequately undertake administrative responsibilities as all the respondents agreed to this fact. It was further established that to a greater extent, the reforms are dictated by enforcement efficiency of the current tax system.

All the respondents were also of the opinion that the current enforcement rules of the income tax system require reforms. The areas that need reform were found to be use of consultative approach between tax payers and tax assessors as opposed to strong criminal approach like taking tax payers to courts of law. The other suggestion was that the revenue officers be empowered in administering the tax laws. Introduction of stringent rules and hefty penalties were also suggested as ways that would reform the income tax in Kenya. But consultative approach was suggested as the best strategy to bring on board these reforms.

On whether there has been any previous reform on income tax system, the study found out that this was true. The reforms included widening of tax base, enhancement of compliance, education of tax payers on their role as tax payers, introduction of information management system, and more staff training. The forces that have influenced these reforms in the past include the Government through the Ministry of Finance, the complaints from tax payers, expanded service provision such as free primary education and an enabling political environment.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary of Findings

The income tax system in Kenya was ranked as complex by 42% of the companies surveyed. Most of the finance managers in the firms surveyed were of the opinion that a simplified tax system with a smaller tax rate could lead to greater revenues for the state budget than the current system (51%). The study found that 63% of the respondents think that the services offered by the government are not consumerate to the taxes they pay.

On the estimation of tax liability related costs of the firms in percent of total earnings before taxes, the study found that tax liability in all the firms was above 15%. The study found that 43% of the respondents contend that the costs of compliance are low while 23% contend that they are costly.

On the areas the respondents considered to be more complex in the current Income Tax system, the study found that accessing refunds is the most complex area in income tax as agreed by 94% of the respondents. 69% of the respondents found paying penalties to be another complex issue while 60% said that evaluating allowable deductions is another complex area in income tax system.

The study found that computation of deductions has more influence on tax reforms (91%) and followed by filing of tax reforms (60%). The area that needs most of attention in terms of reforms was found to be that of computation of deduction and payment of penalties. Further, 80% of the respondents were of the opinion that the current income tax system needs reforms. The areas that were mostly cited as warranting reforms were the tax rates, the tax brackets as well as the deductions. The reasons for this include the fact that the current income tax rates are considered very high hence making other people look for means of evading payment of taxes. The current tax brackets are also seen to be talking into account those who should be considered not to pay taxes as their earnings are very low.

The respondents from KRA were asked to estimate what percentage of firms does not comply with income tax requirements annually in their department. As the study found out, on average, about 30% of the firms do not comply with the income tax. The study further found that there has been some improvement of tax compliance by the firms under the department over the years.

The study found that increase in compliance in income tax over the last five years has ranged within 10% and 15%. The respondents cited that they were satisfied with the level of compliance exhibited in the department of domestic taxes but explained that a lot needs to be done to ensure that all those who are supposed to pay taxes pay their part of tax without delay so as to avoid the issues of penalties.

Some of the measures that need to be adopted to achieve satisfactory levels of compliance were cited as lowering the tax at the lower level of the tax bracket and increasing the tax for the higher bracket tax payers. The government also needs to create more awareness by having awareness campaigns to make taxpayers understand the importance of paying taxes. The other measure was that strong penalties need to be levied on tax defaulters.

The study found that the department of income tax was able to adequately undertake administrative responsibilities as all the respondents agreed to this

fact. It was further established that to a greater extent, the reforms are dictated by enforcement efficiency of the current tax system.
All the respondents were also of the opinion that the current enforcement rules of the income tax system require reforms. The areas that need reform were found to be use of consultative approach between tax payers and tax assessors as opposed to strong criminal approach like taking tax payers to courts of law. The other suggestion was that the revenue officers be empowered in administering the tax laws. Introduction of stringent rules and hefty penalties were also suggested as ways that would reform the income tax in Kenya. But consultative approach was suggested as the best strategy to bring on board these reforms.

On whether there has been any previous reform on income tax system, the study found out that this was true. The reforms included widening of tax base, enhancement of compliance, education of tax payers on their role as tax payers, introduction of information management system, and more staff training. The forces that have influenced these reforms in the past include the complaints from tax payers, expanded service provision such as free primary education and an enabling political environment.

5.2 Conclusions

Given that issues, most of the income tax payers still find the income tax system as complex and that most of the firms contend that reforms are warranted are regards to the complexity of tax system, the study concludes that the degree of complexity influences reforms in tax system.

The study also concludes that tax compliance plays a very big role in influencing tax system reform in a country. As the study found out, low levels of compliance earlier on led to more reforms to ensure that compliance percentages increase. Ever since the introduction of new measures at the

KRA, compliance levels have been rising. These points to the fact that compliance levels significantly influence tax system reforms.

Further, the study concludes that enforcement issues also influence, to a larger extent, tax reforms in a country. As was shown, the reforms that were earlier on carried out in the tax system were meant to make more taxpayers comply. The problem was due to lack of stringent enforcement procedures that saw many escape the traps. With the new political reality, enforcement has been beefed up and this has seen KRA surpass even its revenue collection targets. Thus, enforcement plays a major role in tax reforms.

5.3 Recommendations

The study recommends that for any meaningful tax reforms to take place in Kenya, the role of administrative factors such as enforcement, compliance and tax complexity should be considered. The administrative factors are an important ingredient in realizing the objectives of tax reforms.

5.4 Areas for Further Research

The study recommends that a study be done to establish other factors, other than administrative factors that influence tax reforms. This will shed more light in identifying what combination of factors need to be taken into account in order for the tax reforms to be effectively implemented.

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APPENDICES

Appendix I: Questionnaire to Financial Managers

Introduction

The questionnaire is designed so as to facilitate effective answering and accuracy of responses. Absolute confidentiality is assured.

The information provided will not be distributed to any party and will be used, on a no names basis.

Please take the time to read the **guidance notes** prior to completion of the questionnaire. It is important that the information is accurate and included at the most appropriate location.

This questionnaire is designed to quantify the strength of administrative factors in influencing Income tax reform in Kenya. Thus, if you have been charged income tax by an authority outside Kenya this Income Tax must be excluded from the questionnaire.

The questionnaire has been divided into three sections. The section I establishes basic information regarding the company, the rest of the sections relate to each of the administrative factors and their possible strengths in influencing reform. It is hoped to quantify the strength in each of the specific areas.

The purpose of this is twofold. Firstly, it will enable us to identify the areas where the administrative factors have greatest influence. Secondly, having so identified the degree of influence, planning strategy to reform will be made easier.

SECTION I

THE PURPOSE OF THIS SECTION IS TO ESTABLISH THE PROFILE OF THE RESPONDENT COMPANY.

1. Insert a √ beside one of the following which best describes your Company.

ACTIVITY:	**Tick**
Alternative investment Market Segment	
Consulting	
Commercial services	
Agriculture	
Industrial and Allied sector	
Finance and Investment	
Others (specify)	

2. Indicate below the percentage of your funding which is derived from each source listed

SOURCE OF FUNDING:	**Tick**
Government Grants – capital	
Debt Funding	
Issues of shares	
Profit ploughed back	
Reserves	
Donations	
Amalgamations and Acquisitions	
Others (specify)	

3. Is the firm legally required to undergo an audit by an independent Auditing firm?

Yes ( ) No ( )

4. Number of employees?

Less than 10 ( ) 11-25 ( )

26-50 ( ) 51 or above ( )

SECTION II

COMPLEXITY AND INCOME TAX REFORM

1. Rank the current Income Tax System in terms of Complexity

LEVEL OFCOMPLEXITY	Tick
Very, highly complex	
Very complex	
Appropriate	
Less complex	
Least complex	

2. Do you think that a simplified tax system with a smaller tax rate could lead to greater revenues for the state budget than the current system?

Yes ( ) No ( )

Don't know ( )

3. Are you satisfied with the services provided by the state, considering the Taxes paid?

Satisfied ( )

Partially satisfied ( )

Partially dissatisfied ( )

Dissatisfied ( )

4. Estimate the tax liability related costs of your firm (tax advisor, special tax B0ook-keeping etc.) In percent of total earnings before taxes

   Below 5% ( )

   Up to 10% ( )

   Up to 15% ( )

   Above 15% ( )

5. Indicate your rating of the total costs of compliance with the income tax system

COSTS OF COMPEXITY	Tick
Very costly	
Costly	
Moderately costly	
Less costly	
Not costly	

6. What areas do you consider more complex in the current Income Tax system

Tick appropriately as below

AREAS OF COMPLEXITY	Tick
Evaluating allowable deductions	
Filing the income tax returns	
Computing taxable income	
Accessing refund	
Paying penalties	
Meeting the deadlines	

7. Indicate your level of agreement on the influence of the following aspects o
Complexity on income tax reform?

Tick appropriately the aspects of complexity that require reform

COMPLEXITY AND TAX REFORM	Tick
The computation of tax payable	
The filing of returns	
The payment of penalties	
Computation of deductions	

8. Do you think the current income tax system needs reform?

Yes ( )

No ( )

9. If Yes above, briefly list the areas that require tax reforms

....

....

....

....

10. In the areas listed above, what reasons make it necessary for reform?

....

....

....

....

Appendix II: Questionnaire to the Tax Administrators

Introduction

The questionnaire is designed so as to facilitate effective answering and accuracy of responses. Absolute confidentiality is assured.

The information provided will not be distributed to any party and will be used, on a no names basis.

Please take the time to read the **guidance notes** prior to completion of the questionnaire. It is important that the information is accurate and included at the most appropriate location.

This questionnaire is designed to quantify the strength of administrative factors in influencing Income tax reform in Kenya.

The questionnaire has been divided into three sections. The section I establish basic information regarding the tax administrators, the rest of the sections relate to each of the administrative factors and their possible strengths in influencing reform. It is hoped to quantify the strength in each of the specific areas.

SECTION I

1. Gender

   Female ( ) Male ( )

2. Indicate your position below

....

3. How long have you been in your position?

   Below one year ( )

   1-3 years ( )

   3-5 years ( )

   Over 5 years ( )

4. Indicate the level of responsibility held in advising tax reform issues?

   Tick appropriately as below

   High ( )

   Average ( )

   Low ( )

SECTION II

COMPLIANCE AND TAX REFORM

1. Estimate what percentage of firms does not comply with tax requirements annually in your department?

....

....

2. Has there been any improvement of tax compliance by the firms under your department?

   Yes ( ) No ( )

3. What has been the percentage increase in compliance in income tax over the last five years?

5% ( )

10% ( )

15% ( )

20% ( )

Over 20% [ ]

4. Are you satisfied with the level of compliance exhibited in your department?

Yes ( ) No ( )

5. If NO above, what are the possible causes of the unsatisfactory levels of compliance?

....

....

....

6. In your opinion, what measures are radically necessary to help in achieving satisfactory levels of compliance?

....

....

....

....

SECTION III

ENFORCEMENT AND TAX REFORM

1. Rate department's ability to adequately undertake administrative responsibilities?

   Tick appropriately using the 5- point scale Likert scale.

   Very able ( )

   Able ( )

   Moderate ( )

   Less able ( )

   Unable ( )

2. To what extent do you think reform is dictated by enforcement efficiency of the current tax system?

   Very Greater extent ( )

   Greater extent ( )

   Moderate extent ( )

   Less extent ( )

   Not at all ( )

3. Do you think the current enforcement rules of the income tax system Require reform?

   Yes ( ) No ( )

4. If yes in 3 above, briefly indicate what areas need reform?

....

....

....

5. Indicate the appropriate strategies of undertaking these reform processes?

....

....

....

6. Have there been any previous reforms on income tax system?

Yes ( ) No ( )

7. If yes above, what areas have the reforms focused?

....

....

....

8. What forces have influenced these reforms in the past?

....

....

....