UNIVERSITY OF NAIROBI

SCHOOL OF LAW

"TOWARDS ACHIEVING THE CONSTITUTIONAL PRINCIPLES OF EQUITY AND FAIRNESS IN TAXATION: A CASE FOR TAXATION OF THE INFORMAL SECTOR IN KENYA"

BY:

Sheriffsam Mwangangi Mwendwa

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DECLARATION

I, **Sheriffsam Mwangangi Mwendwa,** declare that this thesis is my original work and has not been submitted for examination in any other University for the award of any Degree.

Submitted by:

Sheriffsam Mwangangi Mwendwa (G62/68608/2011)

4th November, 2014

Signature Date

This thesis has been submitted for examination with my approval as University Supervisor.

4th November 2014

Signature Date

Mr. Tim. O. A Mweseli,

Senior Lecturer, School of Law

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ABBREVIATIONS AND ACRONYMS

CDF	Constituency Development Fund
CIT	Corporate Income Tax
CMA	Capital Market Authority
COMESA	Common Market for East and Southern Africa
EAC	East African Community
ETR	Electronic Tax Register
GDP	Gross domestic product
GPRS	General Packet Radio Services
GPRS-ETR	Gprs-Integrated ETR
GPRTU	Ghana Passengers Road Transport Union
GSM	Global System for Mobile
IGT	Identifiable Grouping Taxation
ILC	International Labour Conference
ILO	International Labour Office
ILO	International Labour Organization
IMF	International Monetary Fund
KRA	Kenya Revenue Authority
MSMEs	Micro, small and medium enterprises
PAYE	Pay as You Earn

PIT	Personal Income Tax
PSV	Public Service Vehicles
SAPs	Structural Adjournment Plans
SMEs	small and medium enterprises
TIN	Tax Identification Number
TMP	Tax Modernization Programme
TOT	Turn Over Tax
TRA	Tanzania Revenue Authority
VAT	Value Added Tax
VIT	Vehicle Income Tax
WCO	World Customs Organisation
WHT	Withholding Tax
WIEGO	Women in Informal Employment: Globalizing and Organising
WTO	World Trade Organization

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Capital Market Act, Chapter 485A, Laws of Kenya, Revised Edition 2009(1990)

Constitution of Kenya, 2010

Finance Act, 2007

Income Tax Act, Cap 470, Laws of Kenya

Kenya Revenue Authority Act, Chapter 469, Laws of Kenya, Revised Edition 2012[1995]

The National Transport and Safety Authority Act No. 33 of 2012

The Value Added Tax Act, Chapter 476, the Laws of Kenya, Revised Edition 2013[1993] (repealed)

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ABSTRACT

The main source of revenue for the Kenya government is taxation. The purpose of government is to ensure the general peace, promote the general welfare, secure for each individual the inalienable rights to life, liberty, social justice and the rule of law. These are the proper ends of government, and are therefore the ends which in every scheme of taxation should be kept in mind. The taxation system in Kenya however is skewed. There is excessive taxation on the same income bracket while the informal sector is not taxed leaving the persons in the formal sector to shoulder the burden of taxation. It is important to bring the informal sector under the tax regime in order to lessen the burden on the formal sector.

The specific study objectives are to; discuss the current Constitutional, legal, institutional and policy framework on taxation in Kenya under the new Constitutional dispensation. It also intends to review and recommend the international best practices in achieving taxation equity which are relevant to Kenya and applicable to the rest of the East Africa Community generally. It further makes proposals towards an effective, efficient and equitable taxation of the informal sector.

The data utilized in this study is both qualitative and quantitative. It was obtained from both primary and secondary sources. The data from secondary sources was acquired from the internet, books and journals while the data from primary sources was obtained from interviews conducted on small business owners and specialists in the tax sector in Kenya.

From the analysis it was apparent that due to several institutional and policy obstacles, the informal sector in Kenya has not been fully netted into the income tax bracket and consequently the burden of taxation has not been equitably shared. This trend is not satisfactory considering that taxes underwrite the capacity of states to carry out their goals and that issues of tax and revenue collections are central in governance and state formation. Secondly, taxation of the informal sector should reduce the chronic inequity in the Kenya taxation regime which results in severe/acute financial deficits. Thirdly, taxation of the informal sector should ensure that the

government of Kenya complies with Article 201 (b) of the Constitution which demands fairness and equity in imposing the tax burden. This should enhance the provision of social and economic rights. Efficient taxation of the informal sector should also help lower the percentage of income taxation in Kenya and play a central role in building and sustaining the power of state and shaping its ties to the citizenry.

The study concludes that tax reforms should give priority to the following areas: taxation of the informal sector by designing simplified registration processes, establishing a comprehensive database of the informal sector and give the sector treatment other than that provided by the current methods and tax code. This study finally makes specific recommendations on the legislative and policy measures that should bring the informal sector into the tax regime.

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CHAPTER ONE

1.0 INTRODUCTION

1.1 Background

In functional democracies, governments need resources to carry out their responsibilities. Governments therefore come up with measures for raising these resources. There are two main categories of income sources for governments which are, firstly, taxes on income and wealth accumulated by individuals, businesses, goods and services produced, exported and imported from the country. Secondly, there are non-tax sources and or income from state-owned enterprises, the central bank's income and capital inflows in the form of loans and debts from the international financial institutions.

Generally, the main source of revenue for governments is taxation. In Kenya, taxes constitute a substantial percentage of its revenue. The current tax regimes are, Personal Income Tax (PIT), Pay as You Earn (PAYE), Corporate Income Tax (CIT), Withholding Tax (WHT), Value Added Tax (VAT) and Excise Duty and Custom Duty.[1]

The purposes of government are stated in the preamble to the Constitutions of many countries in the world. The preamble to the Constitution of the United States of America and the Constitution of Kenya 2010 stipulates that the purpose of the government is to ensure the general peace, to promote the general welfare, to secure to each individual the inalienable rights to life, liberty, social justice and the rule of law. These are the proper ends of government, and are therefore the ends which should be kept in mind in every scheme of taxation. If taxation is imposed for any other purpose, then the legitimacy requirement might not be met and the tax-payer will be justified in questioning why they should be paying the tax imposed.

[1] Waris A, et al: "Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare", Tax Justice Country Report Series, Kenya Report (2009) p.16.

Greater responsibility has also been imposed on the government of Kenya to generate more revenue and ensure proper utilization of the funds collected. Article 43 of the Constitution introduces Social and Economic rights as part of the Bill of Rights under Chapter Four. It provides that every person has the right to the highest attainable standard of health, which includes the right to health care services, besides appropriate social security to persons who are unable to support themselves and their dependants. Therefore, although this Constitutional provision is to be realized progressively, effective revenue generation mechanisms must be devised and executed.

On the contrary, this might translate in a greater tax burden to the citizenry. This paper therefore explores ways of fairer distribution of the tax-burden without further placing the tax load on the few who are already overburdened. Spreading the tax-burden fairly would impel the government to develop clear policies on taxation of the informal sector which forms the bulk of the Kenyan economy and will lead to increase in tax revenue and enhanced good governance.

As it were,

> *"taxpayers have no a priori duty to pay a portion of their incomes as taxes...'and that since "...there is no moral obligation to pay taxes, the state can expect its citizens to weigh only the law or purely legal consequences in deciding whether compliance with tax laws makes sense as a matter of personal choice. The state, as a result, is almost forced to enact just tax laws or face a public increasingly willing to risk what is almost purely a legal price of tax evasion without moral sanction."*[2]

Our government therefore ought to envision these possibilities and uphold the Constitutional principles of equity and fairness in order to enhance legitimacy and inspire in people, a moral choice to faithfully remit and report their taxes. On the contrary, the informal sector has been able to evade or avoid taxation partly due to systemic, logistical and attitudinal problems. The government ought to carefully engage the informal sector with a view to both formalizing it and widening the tax net. Indeed, people in the informal sector sometimes earn more than those in the

[2] Martinez P. Leo: '*Taxes, Morals and Legitimacy*', Brighan Young University Law Review, 1994 available at www.lawreview.byu.edu/archives/1994/3/mar.pdf last visited on 3rd June, 2013.

formal sector. Accordingly, failure to impose taxes on these individuals and entities perpetuates unfairness and inequalities that are unconstitutional. This should be addressed urgently.

Normally, each taxpayer desires to be freed from the tax burden but does not mind if it is borne by others. It is essential that a good tax system should be equitable to all taxpayers[3]. The current situation in Kenya is however abhorrent as regards equity and fairness in distribution of the taxation burden. There is over taxation of a few individuals engaged in the formal sector yet there exist an underground economy that is bigger than the formalised economy that could be brought into the tax bracket.

It is also important to tax the informal sectors who are also beneficiaries of public goods. Payment of tax would serve to reinforce social contract between citizens and state that is provision of public services and goods in return for payment of tax. As Waris et al, observe,[4] the motto of the Kenya Revenue Authority captures the essence of taxation when it states: '*Kulipa Ushuru ni Kujitegemea'* - Paying taxes is being independent. As observed in a study carried out in Europe, Asia and America[5], experience has shown that true development is only sustainable when it is dependent on the nation's own resources. While aid might, in the short term, contribute to solving some of the challenges facing Kenya, the country will only join the league of developed nations if it manages to free itself from dependence on external resources. So far, Kenya has made long strides to this end even with the skewed taxation system. The promulgation of the Constitution of Kenya on 27th August, 2013 ushered a new dispensation on the issue of taxation in Kenya. Chapter 12 of the Constitution addresses matters of public finance in Kenya and stipulates various principles and framework for public finance namely openness and accountability, equitable and fair share of the burden of taxation, equitable share of the revenue collected among national and county governments. This has been the turning point on the Kenyan taxation regime and hastened the enactment of the Value Added Tax Act[6] which has extended the taxation net widely and eliminated many discretionary tax reliefs.

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[3] Waris A: Taxation without Principles: A Historical Analysis of the Kenyan Taxation System, Kenya Law Review (2007) 272 available at *www.kenyalaw.org/Downloads.../waris_taxation.pdf* last visited on 25th September, 2013.

[4] Supra note 1 at p.17.
[5] Ibid.
[6] Value added Tax Act, Chapter 476, the Laws of Kenya, Revised Edition 2013 (1993)

A more equitable tax system will ensure that individuals with higher incomes bear a greater tax burden compared to individuals on low incomes. Most of those in the formal sector are already paying taxes heavily at the expense of others who should have been in the tax bracket. As clearly espoused by John Mutua:-

> *"Which of these cases is most equitable? The question has many answers, depending on which angle you look at it. ITEP (2011) gives some of the key reasons why tax fairness should be considered as an important goal by policy makers. These reasons are: firstly, fair taxes are essential to adequate funding of public services because they tax those who have the most to give, secondly, fair taxes help the government in its relations with its citizens, who are likely to support and tolerate tax reforms that will lead to fair tax systems and finally, a fair tax system is important on grounds of moral imperative."*[7]

From the foregoing, the following issues arise out of the current tax regime with regard to the informal sector. First, the narrow tax base has the effect of increasing the tax rates. Secondly, the inequities and the inefficiencies of the current taxation system have led to cycles of tax evasion and consequently, a deficit in the annual budget. Thirdly, the informal sector does not make an adequate contribution to the provision of public goods thereby overburdening the formal sector. Finally, the non-taxation or inefficient taxation of the informal sector serves as a disincentive to employment in the formal sector which further creates an inequitable society where the tax burden is not shared fairly and thus violating Article 201(b) (i) of the Constitution of Kenya, 2010.

It is against this background that a study of the informal sector is necessary with the goal of proposing an equitable taxation regime that ensures that a proportional share of the tax burden is borne by the informal sector so as to correct the current inequality. Further, lessons learned from the study will guide the tax collectors, the policy makers and legislatures in developing the necessary policy framework and legislation that would ensure effective taxation of the informal sector and thus enhancing equity in sharing tax burden and help lower the tax burden in Kenya. Effective policy framework and legislation aimed at netting the informal economy within the

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[7] Mutua M. John: "A Citizen's Handbook on Taxation in Kenya", Institute of Economic Affairs, Kenya, 2012.

taxation regime should also enhance the provision of social and economic rights by the government as provided for, in the Constitution of Kenya, 2010 and promote good governance.

The study carries out a comparative analysis of the various methods employed in taxing the informal sector in other selected jurisdictions in both developing and emerging economies and suggests the best practices on informal sector taxation from those jurisdictions.

1.2 Statement of the Problem

The law of taxation is said to be barely connected with the universe and with universal law as we understand it[8]. Waris submits that the reason tax law operates like the universal law is because the tax system in any economy goes to the root of the overall government policies.[9] The tax base in Kenya is extremely narrow as is in most of the Sub-Saharan African countries since the Kenyan economy largely comprises of the micro and small enterprises that are in the informal sector. The operations within the informal sector are also not well organized, use labour intensive technology and are mostly, unlicensed and unregistered businesses. Further, informal sector activities in Kenya are mainly carried out by persons operating in open air markets and stalls, residential houses, traders and artisans.[10] This informal sector includes a vast amount of perfectly legal activities. However, illegal activities may be found within the sector, just as there may be illegalities, though at a lower rate, in the formal sector. Waris et al., refers to this kind of economy as the 'underground economy', the 'second economy', 'the fourth Sector', 'popular economy', or the 'Jua Kali' sector. [11]

In 2007, the informal sector in Kenya was estimated to comprise approximately 38 percent of the Kenyan economy accounting for 77 percent of the total employment.[12] The Kenya Economic Survey of 2011 demonstrates that employment in the informal sector in Kenya expanded from

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[8] John Prebble, 'Why is Tax Law Incomprehensible' 4 (1994) *British Tax Review* 380 at 393.
[9]Supra Note 3 P.277.
[10] Oberai R., Small Business Taxation & Informality (2007) presentation made FIAS-Investment Climate Team for Africa Livingstone, Zambia p.7 .
[11] Supra note 1 p.17.
[12] Unlocking the Revenue Potential in Kenya Paper by the Parliamentary Budget Office, Policy Working Paper No. 2/2010 available at www.parliament.go.ke (accessed 22 November 2011).

8.3 million to 8.9 million jobs between 2009 and 2010 and currently accounts for 80 percent of the employment in Kenya.[13] This is a sizable proportion of the economy and a high potential area for revenue generation.

The Kenya government has attempted to net the informal sector into the tax regime. Through the Finance Act of 2007, the government introduced a presumptive tax known as Turn Over Tax (the TOT).[14] The TOT is applicable to any resident person whose turnover from business does not exceed Kshs.5 million during any year of income. The TOT is charged at the rate of 3percent on gross sales per annum. All taxpayers whose gross business income is below Kshs. 5 million and above Kshs. 0.5 million per year are registrable for purposes of the TOT.[15]

Since its operationalisation, the performance of the TOT has been dismal. According to the Kenya Revenue Authority (the KRA), the target for the TOT in the financial year 2000 was 442 million shillings but it raised a paltry 136 million shillings translating to 30 percent performance. Similarly, in 2010, the performance was also below 50 percent.[16] This clearly indicates that there is need to review the taxation system touching on the informal sector for maximum revenue generation.[17]

1.3 Justification of the Study

Anuradha Joshi and Joseph Ayee observe,[18] in many poor and developing countries like Kenya, economic activities are increasingly located within the informal sector, whereby tax administration has not been prioritized making it challenging to tax authorities. Lack of enacted policies on tax remittance on the informal sector additionally impedes legislated tax collection institutions in carrying out their mandate. Besides, tax administration employees avoid this

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[13] Kenya National Bureau of Statistics; Kenya Economic Survey,2011 P.44, presented on 17th May, 2011.

[14] Finance Act 2007 through the provision of the Income Tax Act, Cap 470, under section 12c as read with section 34.

[15] Circular by the Kenya Revenue Authority (KRA) on Turn Over Tax available at www.kra.go.ke (accessed 22 November 2011).

[16] Supra note 8.

[17] Waweru, M.G., Addressing The Different Tax Policy And Tax Administrative Challenges Of Micro, Small And Medium Businesses, A presentation at the International Tax Dialogue Global Conference From 17th -19th October 2007 At Buenos Aires, Argentina. P.13.

[18] Brautigam D. A et al, Taxation and State – Building in Developing Countries, Cambridge University Press, 2008 at P.1.

sector, because they perceive it as unrewarding in terms of income supplementation, and not lucrative.[19] Nevertheless, there are good public policy reasons for paying more attention to taxation of the informal urban economic activity, both in terms of governance concerns on the spread of the tax net and in order to explore alternative ways of building the capacity to tax the sector more effectively in the long term.[20]

The principles and framework of the Constitution provide that the tax burden should be fairly and equitably distributed. Both sectors of the economy- the formal and the informal sector need to be equitably taxed to ensure compliance with the Constitution and accord to the principles of a just society. The informal sector, being a beneficiary of public goods also ought to pay for its fair share towards the establishment and the maintenance of these goods. Further, if government has a duty for example under Article 43, to provide social and economic rights, then all the citizens have a corresponding duty to pay taxes. It is therefore important to tighten reigns on all sectors of the economy in order to ease the tax burden on the formal sector and erase the consequent desire to evade such taxes. This would also have the effect of lowering the tax rates currently imposed on persons in the formal sector due to the limited and shallow tax base.

This research is timely. It comes at a time when the people of Kenya have ushered in a new Constitution and are implementing the devolution agenda. It also comes immediately after the enactment of the VAT Act[21] which seeks to review and update the law relating to the Value Added Tax providing for the imposition of value added tax on supplies of goods and services, made in, or imported into Kenya.[22] Consequently, as the business community attempts to come into terms with the new VAT Act, caution should be exercised to avoid escalation of the cost of living fuelled by scrupulous merchants taking advantage of the situation. The VAT Act as we will demonstrate in the succeeding discussion is the best way the government can extend indirect taxation and eventually penetrate the informal sector. This should broaden the tax base, as the

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[19] Ibid P.186.

[20] Joshi, A et al, "Associational Taxation: A Pathway into the Informal Sector?", in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (eds.) Capacity and Consent: Taxation and State-Building in Developing Countries (Cambridge: Cambridge University Press), 2006a, forthcoming.

[21] The Value Added Tax Act, 2013, No.35 of 2013 was enacted by the 11th Parliament and assented to by His Excellency the President on 14th August, 2013. The effective date of the Act was published as 2nd September, 2013.

[22] The short title of the Act is very elaborate and indicates that unless goods and services (referred in the Act as supplies) are exempted or zero rated, then they are subject to VAT payment.

VAT Act has greatly reduced exemptions and attempted to close many loopholes through the expansion of the scope of the VAT goods.

Further, the financial system has been greatly impacted by the new Constitution which introduces new dimensions such as devolution, the Commission on Revenue Allocation and the bicameral Parliament all of which increase the cost of running government. Accordingly, there is need for greater prudence in revenue collection and administration. As stated earlier, it will be unconstitutional for the entire taxation burden to be laden on one group in the society. Bringing the informal sector into the tax bracket will effectively enlarge the tax base and raise revenue collection in our country to unprecedented heights thereby spearheading economic growth.

This research is novel in that it not only argues for taxation of the informal sector but it also juxtaposes it against the requirements of the new Constitution and the new structures of governance. By focusing on the informal sector, this study seeks to identify the weaknesses in government policy and also identify the lacuna in the law which contribute to non-taxation of the informal sector. The study also examines whether the non-taxation of the informal sector contributes to tax evasion and avoidance in the sector and as a consequence, poor governance. Further, it analyses and identifies the best practices in other jurisdictions in and advances that some of those policies could be adapted into the Kenyan situation to solve the now age-old problem of non-taxation of the informal sector. Finally, the study identifies and proposes policy, legislative and institutional reforms to be put in place so as to address the existing challenges in taxing the informal sector.

1.4 Research Methodology

A research methodology must be systematic, rigorous, conventional and unbiased if research is to be considered scientific.[23] This section therefore outlines the techniques and methods used in collecting and analyzing data for this research.

[23] Marshall, C., & Rossman, G. B. (1999). Designing Qualitative Research (3rd ed.). London: Sage Publications P.33.

The target area of this study was Machakos County's informal sector operators. The preliminary survey conducted by the researcher showed that every form of an informal sector enterprise and activity in Kenya could be found in the area selected for the study. Consequently, the selected area was the most convenient as the researcher and the research assistants were located in the County -which ensured effective and efficient administration of the questionnaires and interviews. This facilitated speedy collection of the primary data from the respondents within the stipulated time.

The sample frame was further stratified into categories of the informal enterprises with common characteristics. The sample size for this study was 200 informal sector entrepreneurs or operators. A sample of 20 respondents was drawn from each strata.

The study was a qualitative inquiry as it assessed the attitudes of persons both in the formal and informal sector in Kenya with respect to their perception on the existing tax regime. This was achieved through self-administered questionnaires with the aid of a research assistant to entrepreneurs in the formal sector and respondents in the informal sector so as to assess their awareness and or attitude on tax issues. The study also included interviews to labour union representatives and specialists in the tax field so as to gather their views on the challenges of taxing the informal sector.

The study was also quantitative as it considered the trends in revenue collection in the informal sector, the percentage of the economy occupied by the informal sector and other numerical data necessary to demonstrate key thematic trends. It also involved detailed analysis of the informal taxation practices in Kenya in comparison to the informal taxation regimes in other jurisdictions as well existing international best practices. The data utilized in this study was both qualitative and quantitative which was obtained from both primary and secondary sources.

Structured survey questionnaires with unambiguous questions were used to ease the analysis of respondents and variation among interviewees. Closed and open-ended questions and multiple choice questions were used to limit the interviewee to choices to be selected from. Closed-ended questions were used to ease the response rate amongst the respondents so as to ensure comprehension of the asked questions. This enabled the researcher and his assistants to read out the questions and explain the questions to those who did not understand the English language. Several open-ended questions were used to elicit information on opinions, attitudes and beliefs of the interviewees towards taxation of the informal sector. Those who were able to write completed such questions on their own while those who could not write were assisted to do so as they talked to the researcher.

To validate the research findings, the researcher used both structured and unstructured face-to-face interview to elicit more information on the taxpaying behaviour of the respondents. Anonymity of the respondents was guaranteed by virtue of the fact that tax concerns are sensitive. The data collected was analyzed using Statistical Package for the Social Sciences (now known as IBM SPSS Statistics) Version 20[24] and presented using tables to divulge respondents' views, opinions and attitudes towards tax remission.

Secondary data was acquired from the internet, books, local and international journals, articles, research papers, case law, newspapers and magazines relevant to the study. The University of Nairobi Law Library, the Jomo Kenyatta Memorial Library, the Kenya Revenue Authority Library and the Kenya National Assembly Law Library are the main places where the research was undertaken.

1.5 Research Objectives

The specific objectives for the study were:

1. To assess the extent to which the informal sector in Kenya is taxed and is aware of the taxation obligations.
2. To establish the challenges facing the government of Kenya in including the informal sector in the taxation bracket and enforcing taxation legislations on the sector.
3. To ascertain Kenya's tax policy, legislative and institutional gaps which have hindered an effective, efficient and equitable taxation of the informal sector in Kenya.

[24] IBM SPSS Statistics is a very popular statistical package with an intuitive Graphical User Interface. It is widely used in Universities social science departments and among social scientists in government and private organisations as it helps in analyzing data.

1.6 Research Questions

The research questions for the study were:

1. What is the current taxation regime in Kenya and how does it affect the informal sector?
2. What are the challenges in taxing the informal sector in Kenya currently?
3. What would be the impact of a tax system that effectively taxes both the informal and the formal sector?

1.7 Hypotheses

The study was premised on the following assumptions:

(a) That the informal sector in Kenya had not been efficiently and effectively netted into the income tax bracket.

(b) That the burden of taxation in Kenya has not been equitably and fairly shared in compliance with the international best practices and the Constitution of Kenya, 2010.

(c) That there is poor governance in Kenya because of the inefficiency by the government to tax the informal sector.

(d) That state building and development in Kenya is premised on how efficient and effective, the government reforms taxation of the informal sector.

1.8 Research Scope and Limitations

This study focused on the challenges faced by the Kenyan government in taxing the informal sector and did not analyse and address all the issues affecting the entire taxation system in Kenya. Other studies have shown that the informal sector is not the only area where the taxation system could be more efficient and effective.[25] Further, a study conducted in 2009[26] demonstrates that the principal areas where taxes are not being paid are in the corporate sector, where an additional Kshs. 106 billion could be collected and therefore, it would be prudent to

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[25] Supra Note 1p.17

[26] Supra Note 8

study the entire taxation regime in Kenya so as to make compressive analysis and recommendations on the various reforms required in making the whole taxation regime in Kenya effecient. This is however not possible because of time constraints and hence the focus on taxation was in the informal sector.

The study also focused on determining whether efficient taxation of the informal sector would enhance the provision of social and economic rights by the government, good governance and development and thus help to lower the percentage of income taxation in Kenya borne by the formal sector. However, this study appreciated that research on the taxation law in the informal sector and its effect on development in developing countries like Kenya has been carried out in other countries as may be applicable to this study.

The major limitation on the study was the sensitivity of the tax information that made the respondents reluctant in giving their opinion on the subject matter. However, through informed consent and guaranteed anonymity of the interviewees, several business persons were interviewed. Thus, the findings of the study are generalised and are not a representative position of the entire informal sector in Kenya on tax laws.[27]

In addition, whereas this study suggests the best practices on informal sector taxation from other jurisdictions, research has shown that the Kenyan situation is unique because of the new Constitutional dispensation which has specific Constitutional provisions on taxation. Accordingly, conclusions from these jurisdictions may not be of general application into the Kenyan economy without modifications.

1.9 Theoretical Framework

Traditionally, equity has been the standard applied by the tax experts to the structural details in addressing taxation matters.[28] Equity theorists ask whether existing laws treats individuals the same, equally when addressing tax issues (horizontal equity) and whether the existing law differentiates appropriately among unequal individuals when addressing same tax issues (vertical

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[27] Emmanuel G. Ofori, A Dissertation presented to the Institute of Distance Learning, Kwame Nkrumah University of Science and Technology, Kumasi Taxation Of The Informal Sector In Ghana: A Critical Examination May, 2009.
[28] Bittker Boris . I,, Equity, Efficiency, and Income Tax Theory: Do Misallocations Drive Out Inequities ; Yale Law School Legal Scholarship Respository, July 1979, Vol. 16 No. 4.P.734.

equity).[29] The principle of horizontal equity demands that similarly situated individuals face similar tax burdens.[30] The equity principle is universally accepted as one of the more significant criteria of a "good tax". In determining whether taxpayers or groups of taxpayers are equal or unequal, equity theorist compare their pretax economic incomes. This is the foundation of Article 201 (d) of the Constitution that there should be equity in taxation. In this research, the researcher demonstrates that equitable taxation of the formal and informal sectors is not only a Constitutional obligation, but also, has social, economic, political and development advantages.

Studies on the informal sector show that the informal sector is growing, absolutely and relatively. While the exact figures are debated, there is no controversy that the informal economy in poorer countries like Kenya forms the backbone of the economy. For example, in 2007, the informal sector in Kenya was estimated to comprise approximately 38% of the economy of Kenya and accounting for 77% of the employment statistics.[31] Studies have also estimated that the informal economy in Malawi has grown from about 7 per cent of GDP in 1972 to 39 per cent in 1990.[32] Further, recent calculations for developing countries suggest that the informal sector varies from between about 20 per cent of GDP in Indonesia to around 67 per cent in Bolivia; and that it accounts for over 40 per cent of GDP in twenty-four of the fifty-five countries for which we have estimates.[33] Considering the great role played by the electorate in the informal sector who according to studies form the bulk of the voters during the electioneering process in Kenya, this study theorizes that the business persons in the informal sector can shape and determine the leadership of the country. It also appears that the informal sector is an exceptionally important force in Kenya and if brought within the taxation bracket, it could affect governance in direct and unexpected ways.

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[29] Ibid P.735

[30] David Elkins, Horizontal Equity as a Principle of Tax Theory, Yale Law & Policy Review Vol. 24 No. 1 (Winter, 2006).

[31] Supra Note 8.

[32] Chipeta, C. 2002; The Second Economy and Tax Yield in Malawi. Nairobi: African Economic Research Consortium.

[33] Alm, J. and Martinez-Vazquez, J. 2003. 'Institutions, Paradigms, and Tax Evasion in Developing and Transition Countries', in J. Alm and J. Martinez-Vazquez (eds.) Public Finance in Developing and Transition Countries: Essays in Honour of Richard Bird. Papers presented at a conference at Andrew Young School of Policy Studies, Georgia State University. Cheltenham, UK: Edward Elgar: 146–78.

Owing to the unregulated nature of the informal sector, studies carried during this research reveal that the informal sector in Kenya forms the foundation of the country's economy comprising of businesses spread in construction, finance, manufacturing industry and transport services amongst others.

Studies further confirm that an increase in the tax burden, and the consequent desire to evade such taxes, is one of the main motivating factors behind participation in the informal sector. It is shown that as long as the possibility of detection is low, then people are more likely to engage in the informal economic activities notwithstanding any prohibitive penalties for tax evasion.[34] It is important to point out that studies have also shown that businesses are reluctant to join the tax system and hence prefer being in the informal sector. They argue that there are numerous taxes and administrative costs, that they do not know how to comply with often complex requirements, that they fear the consequences of bringing themselves to attention of tax officials, that they do not believe they will receive services in return and that they fear being caught for non-compliance due to rules not understood or opaque and the low detection due to weak enforcement.[35]

Again, the informal sector does not pay taxes for the public goods that it consumes. This means that the tax burden on the formal sector is larger than it would otherwise be. As a result, the formal sector becomes less attractive as an employer and supplier of goods and services. As more businesses move to the informal sector, taxes for the formal sector have to rise to bring the automatic gap. This is likely to create a danger of a vicious circle, which may end in most or all of the economic activity being carried out in the "underground".[36] Tax evasion also comes at the additional cost of not being able to use or offer all public goods. In such an economy, the government only redistributes income (it does not provide public goods) and has a fixed revenue requirement.[37]

[34] Sookram, S and Watson, P. K., '*Small-Business Participation in the Informal Sector of an Emerging Economy,*' *Journal of Development Studies,* Vol. 44, Issue. 10, Nov 2008.
[35] Supra note 15 p.6.
[36] Dijkstra, B. R.: '*Good and Bad Equilibria with Informal Sector*', University of Nottingham, School of Economics, Discussion paper 06/01, January 2006, ISSN 1360-2438.
[37] Supra Note 18 at p.4.

Taxation is however the new frontier for state-building in developing countries.[38] Brautigam D. A et al, define "state-building" as the process of increasing the administrative, fiscal and institutional capacity of governments to interact constructively with their societies so as to pursue goals more effectively.[39] They hypothesize that in Europe, taxes not only helped create the state, but also they helped to form it, and therefore, the origins of representative government are intimately bound with the evolution of taxes.[40] Brautigam et al., further advances the theory of taxation and state-building in the developing countries that;

> *"...taxation stimulates demands for representation, and an effective revenue authority is the central pillar of state capacity and hence tax and revenue are central to good governance and state formation. Taxes underwrite the capacity of states to carry out their goals; they form one of the central arenas for the conduct of state-society relations, and they shape the balance between accumulation and redistribution that give state their social character. Without the ability to raise revenues effectively, states are limited in the extent to which they can provide security, meet basic needs or foster economic development. Yet the political importance of taxation extends beyond the raising of revenue. We argue in this book that taxation may play the central role in building and sustaining the power of states, shaping their ties to society. The state-building role of taxation can be seen in two principal areas: the rise of a social contract based on bargaining around tax, and the institution-building stimulus provided by the revenue imperative. Progress in the first area may foster representative democracy. Progress in the second area strengthens state capacity. Both have the potential to bolster the legitimacy of the state and enhance accountability between the state and its citizens.*[41]

Therefore, authority, effectiveness, accountability and responsiveness in governance are closely related to the ways in which governments are financed. It is argued in this research that it is prudent for governments to tax their citizens fairly and equitably rather than depend on foreign aid. John Brewer[42] observes that in the late seventeenth century, the Legislatures in Britain used their power of the purse to hold governments accountable for the use of citizens' tax revenues. This resulted into demand for capacity to document the legislative proposals and as a result, government departments became more skilled and sophisticated in collecting information they needed to respond to legislative demands for accountability. Ultimately, the dependence of

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[38] Supra note 9.
[39] Ibid.
[40] Ibid note 22 .
[41] Supra Note 22 p.1.
[42] Brewer, J 1989, The Sinews of Power: War, Money and the English State 1688-1783, London Unwin Hyman; New York: Alfred A. Knopf

governments on tax revenue encourages bargaining with taxpayers and an exchange of (quasi-) voluntarily compliance over the tax payments for institutionalised influence over public policy.[43] This approach would work very well in raising revenue by the devolved governments where tax compliance would depend on openness and public participation in decisions of financial nature. Societal equity through a fair taxation system, equitable distribution of public finances and equitable development through measures that address historical marginalization and under development would foster governance and development in the county government.

Studies have further shown that the populace is likely to revolt against leaders who are perceived to misuse their money. Therefore, taxation of the informal sector would enhance good leadership by motivating the electorate to demand accountability from their elected leaders. Such demands for accountability will ensure that they discharge their constitutional mandate to the required standards. For example, in Kenya, the introduction of the Constituency Development Fund (CDF) in 2003, has led to a high "casualty" on incumbent members of Parliament who do not deliver projects using the CDF funds. Gutierrez Romero, R observes;

> *"Despite the weak institutional framework supporting the CDF, MPs are still accountable to residents in general elections, when residents have the opportunity to assess the performance of their MPs and reward or punish MPs with their vote. In Kenya's last general election of December 2007, only 40% of the incumbent MPs were re-elected despite the fact that the great majority (80%) of them were contending for re-election."*[44]

This clearly demonstrates that changes made by the constituents enhance governance and result to prudent use of the CDF monies as the newly elected Members exercise caution in the implementation of the CDF projects. Accordingly, considering the informal sector has the potential to achieve high levels of productivity through the dynamic, entrepreneurial character of the micro-enterprises which comprise this sector, then if the sector is efficiently and effectively taxed, it has the potential of enhancing the quality of elected leaders as the taxpayers compete to elect development oriented leaders. Associated with this view are the studies that suggest that the

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[43] Supra Note 26 b

[44] Gutierrez Romero, R., (2009) "Decentralization, Accountability and the MPs Elections: The Case of the Constituency Development Fund in Kenya", iiG Briefing paper, available at www.iig.ox.ac.uk/.../iiG-briefingpaper-02-kenya-cdf. accessed on 26th September, 2013.

informal sector is not just a survival mechanism for the poor, but a means by which educated and skilled individuals evade income taxes.[45]

Finally, as the citizenry in the informal economies start to appreciate the pressure brought about by taxation, they will demand good and effective leadership that is central to good governance and state formation. This could shape the balance between accumulation and redistribution and thus sharing the taxation burden equally. Progress in equitable taxation would foster representative democracy while collection of enough revenues would strengthen the state capacity to deliver services. All this has the potential to enhance accountability between the state and its citizens and bringing about good governance and development.

1.10 Literature Review

Waris, Kohonen, Mosioma and Martin[46] give a comprehensive report which touches on diverse tax justice issues. They analyze a number of structures, including the national tax systems, distribution of tax burden and incentive structures, while exploring emerging national or regional themes. They however do not make specific recommendations on how to address the issues that have been identified. This study will therefore come with specific recommendations on how to address the challenges making it hard to address the taxation of the informal sector.

Sookram and Watson[47] investigate the characteristics of the proprietors of small businesses that participate in the informal sector in the emerging economy and their perception of the risk of detection by tax authorities. They note that small-business owners are motivated to participate in the informal sector since the risk of detection by the tax authorities is low. Their perception of the risk of detection by the tax authority is determined largely by the longevity of their business operations and the income earned in the formal sector. Sookram and Watson base their argument on their study in Trinidad and Tobago informal sector which may not reflect the situation in

[45] Supra note 3 p.1
[46] Waris A, et al, Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare (2009).
[47] Supra note 31

Kenya while this study relied on data collected at Machakos County which may reflect the position of the business practices within the informal sector in other counties in Kenya.

The study on unlocking revenue in Kenya conducted by the Parliamentary Budget Office[48] considers the entire taxation regime and identifies some of the challenges leading to low revenue collection namely: administrative and cost challenges, lack of information such as informal wage and capital income and lack of proper accounting records among others. It therefore also considers taxation in the informal sector. The study however, due to its general exposition on other areas of taxation, does not give an in depth analysis of the informal sector nor propose ways of ensuring the sector is brought to an effective and efficient taxation regime. This study is however limited to the taxation in the informal economy and recommends specifics ways of taxing the sector.

Moyi and Ronge[49] review tax revenue performance in Kenya as well as tax design and administration changes during the period between 1996 - 2005 in order to identify priorities for further tax reform. Their empirical analysis reveal *inter alia* that taxation of the informal sector is one of the challenges facing the tax authorities and that Kenya's tax system is burdensome in terms of the time taken to prepare and submit tax returns. The study concludes that further tax reforms should give priority to the following areas: first, taxation of the informal sector by designing simplified registration processes and second, giving the sector treatment other than that provided by the current methods and tax code. They however do not address the areas of reform in the sector or further, recommend specific legislative proposals. This study however considers various options of taxing the informal sector in Kenya and make specific recommendations on the areas for reform both in legislations and policy framework.

Finally, Brautigam, Fjeldstad and Moore[50] explore an old idea that has returned to prominence: that authority, effectiveness, accountability and responsiveness is closely related to the ways in which governments are financed. Using case studies from Africa, Asia, Eastern Europe and Latin

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[48] Unlocking the Revenue Potential in Kenya Paper by the Parliamentary Budget Office, Policy Working Paper No. 2/2010 available at www.parliament.go.ke (accessed 22 November 2011).
[49] Moyi E. & Ronge E., Taxation and Tax Modernisation in Kenya: A Diagnosis of Performance and Options for Further Reform (2006), Institute of Economic Affairs.
[50] Supra Note 22.

America, they argue that it matters that governments tax their citizens rather than live from oil revenues and foreign aid, and that it matters how they tax them. They conclude that taxation stimulates demands for representation, and an effective revenue authority is the pillar of state capacity.[51] Theirs however is a case that relies on data collected in 1990s, which may not necessarily reflect the dynamisms of the economic trends as well as the situation in Kenya following the promulgation of the Constitution in 2010. Further, their study relies on data collected from many African countries including Kenya, which had by the time, not enacted the VAT legislation. This study considers the effects of the Constitutional provisions advocating for a fair and equitable sharing of the burden of taxation and how the same affect governance.

1.11 Chapter Breakdown

(a) Chapter One

This chapter introduced the research topic and gave a comprehensive overview of the statement of the problem, the theoretical framework within which the study was carried out. The chapter also set out the methodology used in the study as well as provided the data sources and their types. It also highlighted the objectives, justifications as to why the study was necessary and finally provided breakdown of the chapters in this thesis. It also discussed the scope and limitations of the study and further, gave the conceptual and theoretical framework, putting forward, a theory of development and good governance in support of the argument for effective and efficient taxation of the informal sector.

(b) Chapter Two

The chapter provided a detailed synopsis on taxation in Kenya from 1800 to 1986. The chapter also introduced the informal sector, examined the various factors behind the emergence of the informal economy in Kenya and the effect the same has on the entire taxation system.

(c) Chapter Three

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[51] ibid

This chapter critically examined and analysed the constitutional provisions relating to equitable and fair share of the taxation burden and identified the various gaps and weaknesses in realising a fair and equitable tax system in Kenya. The chapter also reviewed the challenges encountered in including the sector into the taxation regime and the various opportunities available in the informal sector for the tax authorities.

(d) Chapter Four

This chapter discussed the various options to be explored in sealing the gaps and weakness in taxing the informal sector in Kenya. The chapter also considered the options taken in other developing and emerging economies in taxing the informal sector.

(e) Chapter Five

This chapter provided the conclusions and recommendations for reform. The proposed recommendations should be considered by the policy makers and legislators in designing effective and efficient policy reforms and legislative amendments geared towards inclusion of the informal sector in the taxation regime.

CHAPTER TWO

2.0 TAXATION IN KENYA: A SYNOPSIS

2.1 Taxation during the Pre-Colonial Period in Kenya

In Pre-colonial Kenya, little is documented regarding the taxation system. This can be attributed to the lack of a central governance structure and existence of ethnic communities whose administration differed from one community to another. These communities were ruled by chiefs and councils of elders who were respected members of the community. Any required resources were collected using *ad hoc* measures. The mechanisms differed from people volunteering to collate their resource to the leaders asking members of the community to contribute towards meeting the need. As soon as the need was satisfied, then the resource raising efforts were terminated.

Regarding the taxes payable in this era, the taxpayers and the mode of collection of such taxes, Waris Attiya observes that Kenya was divided up into a myriad of tribal based societies all with their own fixed ethnic geographical territory before colonisation.[52] African society in pre-colonial times was termed as acommunist/socialist society where almost all the properties were communally owned with all members sharing in community wealth. However, in most if not all tribes, whatever production took place required that a part of it be remitted to the house of the chief of the tribe and community. This included parts of any harvest whether it was agricultural produce, trading profits or gifts. Both foreign and local traders, especially in ivory and slaves were all required to pay tithes in order to be allowed passage through the territory of a particular tribe. Thus, there was generally no taxation in the form as such.[53] It appears that these diverse tribal based tax systems were at best extremely rudimentary, simple and operated at small scale but it suited the economy of the time and was fairly successful in its time frame and the state of the economy at that point in time.[54]

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[52] Supra Note 3 p. 279.
[53] Supra Note 3 P. 277.
[54] Ibid, P. 279.

On the other hand, the Coastline had a different experience with taxation. In 1458, Vasco Da Gama landed in the East Coast of Africa and claimed it as part of the Portuguese Empire and the Kenyan coastline was recognized as the State of East Africa.[55] During this period, Portugal did not have any real political control of the East African Coast as their main interest was to control the Indian Ocean Trade. There was however an attempt to impose duties on the small part of the Kenyan Coast by granting land titles (Prazos) to mostly Portuguese landlords.[56] However, the fall of the Mombasa and Fort Jesus to the Omani Arabs in 1698 wrestled all control the Portuguese had on the Kenyan Coast.[57]

The Omani Arabs came with the intention of trade in ivory and slaves and intermingled but without any apparent clear cut need to conquer. Thus, they remained along the coastline of East Africa for business expediency to facilitate trade between the hinterland and the Arab traders who mainly came from the Sultanate of Oman.[58] However, as a result of intermarriage and continued interest in the East African Coast, people formed themselves into Sultanates as city states resulting in the creation of the Sultanates of Zanzibar, Mombasa, Malindi, Pate, Pemba, Mafia, Kilwa and Witu.[59] These Sultanates were allowed semi-autonomy from the Sultan of Oman who allowed them to run their own affairs and to collect taxes on his behalf. As between the sultanates there was complete independence fiercely guarded.

Waris Attiya further observes that traders were taxed by the application of a capitation tax, as well as customs.[60] Studies also show that capitation tax was first applied in 1722 by the then ruler of Oman on every slave exported by the French from his African dominions and between 1809 and 1814, it is reported that the Sultan derived 75,000 dollars' worth of revenue from this tax.[61] By 1820, it is reported that this revenue increased to between 40,000 and 50,000 dollars per annum.[62] Other studies also indicate that customs tax was also imposed on all goods leaving

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[55] Supra Note 51.
[56] Ibid.
[57] Supra Note 51
[58] Ibid.
[59] Supra Note 3 p. 279
[60] Supra Note 57.
[61] Gray, Sir John (1957), *The British in Mombasa 1824-1826* (Macmillan & Company, New York) 23.
[62] Supra Note 57.

the Sultanate.[63] It is therefore clear, that at the Kenyan coastline, there was an elaborate and strictly enforced tax system before the coming of the Colonial power. These taxes mostly followed the Islamic law system from which they got their legitimacy and since some were voluntary, there was therefore compliance and in case of non-compliance the Sultan used force and military means to ensure compliance.

2.2 Taxation during the Colonial Period in Kenya

The history of colonialism in Africa was heralded with the Bismarck declaration of German protectorates over Togoland[64], Cameroon and Southwest Africa[65] in 1884, and by claiming that he was protecting the interests of German missionaries and traders.[66] The Germans applied trickery with intention of wining the trust and loyalty of the Africans and told Africans that German rule meant freedom from taxes and custom duties. British propagandists noted that Germany had military conscription and Britain did not, and they countered that German rule in Africa would lead to conscription for local people.[67]

Following the Berlin Conference in 1886, Britain and Germany settled the boundaries between German East Africa and the British territory to be known as Rhodesia and Germany recognized Britain's claim to Zanzibar.[68] A German company was in charge of the administration of German East Africa, and its demand for taxes and labour obligations provoked rebellion among local Arabs and from the Hehe and Yao tribes—the Abushiri revolt. Germans were therefore evicted from the coast except for strongholds at Bagamoyo and Dar es Salaam.[69] The Germans returned with an elite force under the German command General von Wissman, and they captured and hanged the leader of the revolt—the half- Arab half-African trader, Abushiri.[70] The

[63] Leonard J.H. Beighton, 'Simplification of Tax Legislation: How Are We Getting On' 1996 (6) British Tax Review 601-608.
[64] Now Togo.
[65] Now Namibia.
[66] Supra Note 3 p.282-283.
[67] See www.fsmitha.com/h2/map02af.htm quoted by Waris Attiya at Note 3 p.282.
[68] Ibid.
[69] Supra Note 65.
[70] Ibid.

British originally ruled all of what is today Kenya and Uganda together forming the East African protectorate and later the East African Colony.[71]

However, in 1890, Germany signed a treaty with the British exchanging Heligoland for British recognition of protection of Zanzibar.[72] On 14th December 1895, the Sultan signed over administrative responsibility of the areas formerly under the responsibility of the Imperial British East African Company to the British Government for the continued undertaking that the Sultan would be paid an annuity of £11,000.[73] In 1913, Zanzibar was transferred from the Foreign Office to the Colonial Office and the Governor of the East African Protectorate which 7 years later came to be known as the Kenya Protectorate

In British East Africa, the British East African Company's hopes for substantial revenue from mining ended when the gold rush in Kakamega was unfruitful.[74] Thus, British colonial tax policy developed in its rule in East Africa on the grounds of the need firstly, to prop up its own economy by creating foreign markets and sources of raw materials for its industries and thus obtain maximum gains with minimum input.[75] This was done initially, through the Chartered company concept. Therefore, in 1897, the Charter issued in 1888 was cancelled and the administration of the protectorate fell directly under the British government and Kenya became a British Colony in 1920.[76]

In order to secure the resources needed for the administration of the Protectorate following the collapse of the Imperial British East Africa Company and also ensure that the Kenya Colony was self-supporting, the Colonial government opted into imposition of heavy taxation system in Kenya colony. Therefore, all measures were employed to ensure that the requisite taxes were collected by the Chiefs. Matthew Forstater observes that the British officials, with African submission to their authority after pacification, were pressed by the reluctant metropolitan

[71] Supra Note 65.
[72] Ibid.
[73] Supra Note 65.
[74] Ibid.
[75] Supra Note 3.
[76] Portal to Lady Alice Portal, 3 Feb. 1893 in *Portal Papers* quoted in *History of East Africa, Volume 1* ed. Roland Oliver, p. 417.

taxpayers to find means of making the colonial territories self-financing.[77] They achieved this through the creation of the Office of the Chief as agents of local administration and tasked them with the responsibility for tax collection, maintenance of law and order and more importantly to supply cheap labour for public and settler requirements. It was the assignment of these tasks which put the colonial chiefs at the forefront in the abuse of human rights.[78]

In fact Matthew Forstater documents that although taxation was often imposed in the name of securing revenue for the colonial coffers, and the tax was justified in the name of Africans bearing some of the financial burden of running the colonial state, in fact the colonial government did not need the colonial currency held by Africans.[79]

The main taxes imposed in Kenya by the British colonial administration were the Hut Tax which was first imposed through the Hut Tax Regulations 1901. It required that an annual fee of one rupee be paid for every hut present in the colony by the owner or occupier of the hut. This could be paid in kind through unpaid labour in specified settler farms. However, through the Native Hut and Poll Tax Ordinance[80] the Hut Tax was supplemented by a Poll Tax payable by every able bodied adult within the colonial territory. There was also a non-native poll tax which was also a flat rate.[81]

Secondly, there was the Land Tax which was an indirect tax collected through issue of leases.[82] This was made possible through the Crown Lands Ordinance of 1915. It also allowed land leases to be granted for 99 years, and rent reassessments at one percent and two percent of the unimproved value of the land during the 33rd and the 66th year respectively. The Ordinance allowed the colonial government to promote the systematic registration of urban lands and the

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[77] Forstater Matthew: "Taxation: a Secret of Colonial Capitalist (So - Called) Primitive Accumulation", University of Kansas, Working Paper No. 25 available on http://www.cfeps.org/pubs/wp-pdf/wp25-forstater.pdf last accessed on 14/06/2013.
[78] Ibid.
[79] Note 74 at para. 30.
[80] Kenya Ordinance No. 2 of 1910.
[81] Supra Note 1 p. 286 and Gardner Leigh: 'Colonial Origins of Government Corruption? Evidence from Tax Collection in Kenya and Zambia', available at http://www.lse.ac.uk/economichistory/seminars/gardner.pdf last visited 14/06/2013.
[82] Supra Note 3 p. 287.

privatization of land rights throughout East Africa.[83] However, efforts to impose direct taxes on idle land were futile.

Besides, the Graduated Personal Tax was imposed through the Income Tax Ordinance of 1933. This was imposed on Non-Native Kenyans and it graduated according to the income of the individual. This form of tax led to the holding in abeyance the Non-Native Poll Tax.[84] Additionally, the Income Tax was imposed through the Income Tax Ordinance in 1940, the War Taxation (Income Tax) Ordinance in 1940 and the War Taxation (Income Tax) (amendment) Ordinance in 1941.

In 1952, these taxes were consolidated in the East African Tax (Management) Act and administered by the East African Tax Department. The rates were set at 20 shillings for a an individual earning 60 pounds or below, 40 shillings for one earning between 60 – 120 pounds and for earnings above 120 pounds were charged at 60 shillings.[85] Lastly, through the Customs and Excise Duty, the Colonial administration imposed a requirement to have a pass which cost one dollar and 'the customs tariff was fixed at 5% *ad valorem* tax on all items imported or exported by the people of Mombasa and double that amount for all other traders.[86] There was also excise duties imposed on certain goods.

The Colonial administration generally assessed the following matters in considering when to extend the tax into new areas; the ability of the people to pay the Hut Tax on account of their proximity to labour-employing centres and their geographical position from the point of view of economic administration.[87] This explains why in 1902, the Hut Tax rate was increased to a maximum of three rupees. Further, over the time and owing to the changing social structures of the Kenyan democracy, the Colonial administration came up with tax regimes to reflect changes and to achieve particular aims. However, it was difficult to come up with a structured and equitable taxation system.

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[83] Ibid.
[84] Supra Note 76.
[85] Ibid.
[86] Supra Note 3 at p. 289.
[87] See Gardner p.6 & 7 in Portal to Lady Alice Portal, 3 Feb. 1893 in *Portal Papers* quoted in *History of East Africa, Volume 1* ed. Roland Oliver, p. 417.

Waris Attiya observes that the 1932 Moyne report looked into the call by many urging the replacement of both the Hut and Poll Tax by a universal poll tax abolishing all payments because of extra huts.[88] However, to obtain the same yield as from the existing taxes, the new tax had to be at a higher rate. The extra tax was to be spread over the Poll Tax payers so reducing the general average increase while on the other hand, a proportion of the Hut Tax payers were women who were to be exempted from the Poll Tax. A variant of the system proposed by Lord Moyne adapted to Kenyan conditions and consisted of a uniform adult male Poll Tax of 6 shillings plus a Cultivation and/or Cattle tax. This system was however seen to involve a great deal of extra work and expense in the collection of two taxes of different amounts and differently accrued from the same individual. Again, it involved a double burden on the owner of a hut in a reserve who occupied himself in cultivation as compared with the man who went abroad to work. Another issue that bedevilled this system was whether the taxation policy should be used to force the Africans out from their resources to the employment market. The question whether taxation should be utilised in order to stimulate the supply of native labour force at one period also formed a prominent issue of local politics. In the case of Kenya however, the administration did not impose the demand for taxation as strongly as the Government of Tanganyika, and for some years, the policy was acted upon by pressure from the Crown government.

In 1936, many official reports on taxation in Kenya despite being critical of the Hut Tax failed to suggest a viable solution. As late, as 1946, there were still discussions in government on the inequitable nature of the income tax and alternatives such as Land Tax and Cattle Tax were discarded under the argument "too many novelties to the East African native to be acceptable to him".[89]

This historical background demonstrates the attempts made in several parts of Africa in the period between 1800 and 1950s, to tax both the formal and the informal economy (including slaves). For example the Capitation Tax otherwise known as the Head Tax, was applied on each individual including slaves and on traders taking slaves out of the sultanate. This was similar to

[88] Supra Note 3 P.291
[89] Supra Note 3 P. 191-292.

the Poll Tax applied in Tanzania, Kenya and Uganda by the British Colony as personal tax. The challenge with the application of a blanket tax like the Poll Tax and the Hut Tax was that it violated the principle of horizontal equity in taxation and that it targeted taxpayers not necessarily earning wage or income. This resulted to an inequitable taxation.

2.3 Post-Colonial Kenya: From 1963 – 1995

The informal sector is a crucial sector of most of the developing countries.[90] Independent Kenya ushered in increased rural-urban migration especially of the school leavers who believed that the cities offered better income than in the rural areas. With increased unemployment and retrenchment of the formal workers, the increasing unemployed population turned into the informal sector to fend for themselves and their families. This economic stratification resulted in unequal distribution of wealth and facilitated development of an impoverished and economically deprived modern informal economy.[91] This gave birth into the *Jua Kali* economy, originally applied in the 1970s in Kenya, to artisans who produced wares out in the open sun. The term '*Jua Kali'* has since expanded to include all micro and small enterprises. Whereas the formal sector is closely linked to the government and has access to credit facilities, the informal sector has limited government regulation and is therefore associated with risk and uncertainty which creates a conducive environment for tax evasion and avoidance.

On the other hand, independent Kenya inherited the taxation regimes of the British colonial administration. Between 1963–1969, there was hardly any change in the tax law as inherited. The tax was administered by the East African Tax Department under the East African Commission created in 1948. The Sessional Paper No. 10 of 1965 on 'African Socialism and its Application to Planning in Kenya was the government's blueprint for the fiscal policy and development planning. Its main goal was to Africanize the public service and to focus development in areas where maximum returns would be guaranteed. These returns would then be redistributed to the other parts of the country.[92]

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[90] Amenya Nabuteya Gibson: "The Informal Sector in Kenya" available at http://www.nayd.org (last visited on 18/11/2013).
[91] Ibid.
[92] Supra Note 1 p. 21.

In order to raise taxes in the period following in independence, the government increased the number of people paying the Income Tax of PAYE. Further, in 1973, the Kenyan government introduced new taxes. The Sales Tax and 20 per cent withholding tax on non-resident entrepreneurs; capital allowance restricted to rural investment; a new tax on the sale of property; taxes on shares; the sale of land and a custom tariff of 10 per cent on a range of previously duty free goods.[93] These taxes were specific to Kenya and were not applicable to the rest of the East African Community (the EAC) member states and were administered by the Income Tax Department in Kenya. However, after the collapse of the EAC in 1977, the Income Tax Department had to be disbanded and each EAC member state took over the administration of its taxes. The collapse of the EAC also led to the need to raise money to fund the government functions and buy out some of the assets of the EAC. Moreover, the oil crisis of 1980s led to increasing the rates of the taxes already levied. This necessitated comprehensive tax reforms and further, gave birth to the Kenya Revenue Authority (the KRA or the Authority) established by the Kenya Revenue Authority Act,[94] as a central body for the assessment and collection of revenue and for the administration and enforcement of the laws relating to revenue in Kenya.

2.4 Emergence of the Informal Economy in Kenya and its effects.

Over the years, the government of Kenya has made conceited efforts to increase the tax bracket and the informal sector in such campaigns is the main target. However, the efforts seem not to be bearing fruit because although the economy has income generating businesses, the sector operates on a small scale using simple skills. Further, the sector encompasses economic activities not regulated by law such as environmental, labour or taxation, but is subject to the regulations of the local authorities for orderly business operation. The economic activities carried out in the sector range from market vendors to road side stalls and shoe-shining among others. The absence of government regulation in the small scale economy creates a gap which enables the sector to continuously slip from the taxman's noose.

[93]Supra Note 1 p. 22.
[94] Chapter 469 of the Laws of Kenya.

The informal sector however contributes to about 35-50% of GDP in many developing countries.[95] The importance of the informal sector cannot therefore be overlooked or wished away. In Kenya, the trend depicts that the employment creation interventions implemented in the country have facilitated growth in the informal sector employment more than it did to the formal sector and over time, as job creation in the informal sector has over the last decade being growing faster than in the formal sector which is rather minimal.[96]

In discussing the historical aspect of taxing the informal economy, one needs to understand how the sector has risen to such heights. The informal sector in Kenya started growing in Kenya in the late 1980s and 1990s.[97] This was precipitated by the state of the Kenyan economy then, and the public reform strategies put in place by the KANU government which was characterized by massive job cuts and retrenchments. The retrenched officers subsequently joined the informal sector as self-employed persons. Another factor that contributed to the rise of the informal sector in Kenya was the inability of most workers to survive from their various respective low incomes gotten from their formal jobs. Further, the informal sector has developed owing to the inability of the job market to absorb the high number of college and university graduates being churned out.

Other factors that also contribute to the development of the informal sector include lack of social safety nets for the various classes in the society like adequate pension schemes as well as the absence of a conducive business environment which was and is characterized by lengthy, complicated and expensive business registration procedures, tough business regulation measures and an unfriendly tax regime. Again, it has been said that the key determinant factor for the rise of an informal sector is the rise in tax and social burdens.[98] Tax increases also force people to engage in activities that they can earn more income and pay less tax.[99] The informal sector has thus seen massive growth because of the attractiveness it offers which is the non-taxation and minimal government regulation.

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[95] The ILFS 2006 indicates that the sector has grown from 35% to 40% of the GDP between 2001 and 2005 (URT, 2006)
[96] Ibid.
[97] Supra Note 44.
[98] According to Penalosa and Turnovsky (2004) , excessive taxation in the formal sector is distortionary as they shift capital and labour towards the informal sector.
[99] ibid.

According to a report published recently in the Business Daily Africa, the KRA lost Kshs.200 billion in three years due to the Kenyan government's inability to tax the informal sector.[100] Martin Masinde further notes that the government lost Kshs.63.5 billion, Kshs.69.73 billion and Kshs.79.27 billion in 2006, 2007 and 2008 respectively to the informal sector.[101] Martin Masinde again contends that revenue authorities in Kenya have put all their focus on the formal sector, which is easier to tax and thus encouraging tax payers to shift to the informal sector in an attempt to avoid paying taxes.[102] He further postulates that as more tax payers escape the tax net, they leave the burden of financing the national budget to the few workers in formal employment.[103] Masinde concludes by hypothesising that should the underground economy remains untaxed, the government will continue losing billions of shillings in terms of revenue and as more people move into the informal sector to escape the burdensome taxation, it will become increasingly difficult for the government to hit its revenue targets.[104]

Peter Churchill Ogutu refers to the sector as a booming and tax-free informal sector and urges that it is a threat to the formal sector, the main source of revenue for the government.[105] He further observes that the informal sector crowds out formal businesses since by avoiding taxes and that it offers lower prices on goods and services thus gaining an unfair advantage over formal businesses.[106] He again notes that this is unfair competition from non-registered businesses and would reduce growth in the formal sector and market access of registered businesses. Ogutu further theorises that a complicated tax system, compliance costs and hurdles in the informal sector complicates taxation of the informal sector.[107] He concludes that Kenya being a cash economy, it is difficult to have proper accounting and auditing systems for taxation purposes more so for the informal sector.[108]

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[100] An article published in the Business Daily Africa, called "Tax *authority loses Sh200 billion to informal sector"* that was published on the 8th of May, 2012

[101] According to Martin Masinde a fiscal analyst at the Parliamentary Budget Office in an article titled, "Informal Sector and Taxation in Kenya: Issues and Policy Options" presented at a pre-budget stakeholders' workshop on Tuesday 8th May 2012.

[102] Ibid.

[103] Supra Note 50.

[104] Ibid.

[105] Peter Churchill Ogutu of the National Informal Sector Coalition made the observations a presentation at a pre-budget stakeholders' workshop on Tuesday 8th May 2012 reported in the Business Daily Africa.

[106] Ibid.

[107] Supra note 54.

[108] Ibid.

2.5 Government attempts to tax the Informal Sector in Kenya.

Little can be said on the history of taxing the informal sector in Kenya. Available evidence suggests that the first attempt by the KRA to tax the informal sector in Kenya was in the year 2007 following the introduction of the TOT.[109] This however, failed to achieve its intended purpose.

Erastus Wanyaga observes that the TOT which is a form of Presumptive Tax where taxation is based on the turnover of a business was the first case for taxing the informal sector in Kenya.[110] The TOT which was introduced in Kenya in the year 2007 came into operation in 2008.[111] The TOT was targeting residents whose business turnover does not exceed Kshs.5 million and is not below Kshs.500, 000.00 during any year of income. The tax rate applicable in the TOT is 3% of the gross turnover payable quarterly commencing January of each year and it is a final tax.

Wanyaga submits that after the introduction of the TOT, the same faced several implementation difficulties.[112] Firstly, there were difficulties in determining the threshold for admitting businesses into the system. Secondly, the businesses in the informal Sector operate on a cash basis thus leading to under declaration because of lack of properly recorded data. Thirdly, the tax rate applicable in the TOT of 3% was seen to be very high by the businesses. Further, mobility of businesses in the informal sector has greatly impacted on the ability to tax the informal economy given that most of them have no fixed business premises thus making compliance impossible. There is also the inability of the KRA to reach tax payers due to human resource constraints. Again, illiteracy amongst tax payers in the informal sector and lack of willingness by the tax payers to register makes it hard for the KRA to determine the significant tax revenue from this sector as majority are either nil filers or non-filers. Finally, there is inadequate attention by the tax administrators to the informal sector because resources have been focused on the formal sector. This has contributed to heavy loss of taxes from the informal.

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109 Supra note 54.

110 According to Erastus Wanyaga in a presentation made at the ITD Africa Conference titled *"Lessons from the Operation of Presumptive Tax Regimes: The Case of Turnover Tax in Kenya"*.

111 Ibid.

112 Supra Note 59.

Apart from the TOT which has not been successful in bringing the informal economy to the taxation bracket, the local authorities (now succeeded by the county governments), charge the small businesses and other informal sectors for licenses which range from one local authority to another. Moreover, the government is at the moment engaged in campaigns to encourage the members of the informal sector to voluntarily register as tax payers, efforts which are not gearing the desired results[113].

2.6 Conclusion

In conclusion, this chapter gives a brief overview of the development of taxation in Kenya. The general overview covers the pre-colonial, colonial and post colonial Kenya. The chapter also gives a synopsis of the evolution of the informal economies in Kenya and the attempts by the government to tax the sector. The study points to the fact that the tax administrators admit to not taxing the informal sector despite the sector making significant contributions to the Kenyan GDP. The attempts made to bring this particular economy within the ambit of the tax bracket so far have been unfruitful or little success has been achieved. The introduction of the TOT in 2007 has also failed to facilitate taxation of the informal economy, mainly because this is an area that is highly unregulated and which is characterized by lack of formalities and hence making it difficult for the revenue authorities to tax.

The next chapter examines the opportunities and challenges of taxing the informal sector in Kenya and addresses the questions whether it is economically prudent to pursue taxation of the sector.

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[113] 10^{th} edition of the Africa Tax Spotlight, themed 'Taxation and the Informal Sector', 2012, second quarter, volume 3.

CHAPTER THREE

3.0 MAKING EFFECTIVE TAXATION OF THE INFORMAL SECTOR IN KENYA A REALITY: POSIBILITIES AND CHALLENGES

3.1 Introduction

Governments have tried to regulate (formalise) aspects of their economies for as long as surplus wealth has existed.[114] Yet no such regulation has ever been wholly enforceable. Archaeological and anthropological evidence strongly suggests that people of all societies regularly adjust their activity within economic systems in attempt to evade regulations. Therefore, if informal economic activity is that which goes unregulated in an otherwise regulated system then informal economies are as old as their formal counterparts, if not older.[115] The term itself, however, is much more recent. The optimism of the modernization theory school of development had led most people in the 1950s and 1960s to believe that traditional forms of work and production would disappear as a result of economic progress in developing countries.[116] As this optimism proved to be unfounded, scholars turned to study more closely what was then called the traditional sector. They found that the sector had not only persisted, but in fact expanded to encompass new developments. In accepting that these forms of productions were there to stay, scholars began using the term informal sector, which is credited to the British anthropologist Keith Hart in a study on Ghana in 1973, but also alluded to by the International Labour Organization (ILO) in a widely read study on Kenya in 1972.[117]

Hussmanns Ralf states that the informal economy plays an important role for employment creation, income generation and poverty reduction in many countries, especially developing and transition countries. He further argues that statistics on the informal economy are needed as an

[114] www.wikipedia.org/wiki/.informal _sector (last assessed on 17/11/2013
[115] Ibid.
[116] Supra note 114.
[117] ILO, (1972), 4

evidence-based tool for research and policy-making. They enhance the visibility of the many workers in the informal economy and of their economic contribution.[118]

Kenya been a developing economy has a large percentage of its wage earners in the informal sector. Understanding who these people are and how they contribute to the development of the economy is important for planning, revenue collection forecasting and economic growth projection. This study would therefore make meaningful findings and recommendations based on careful analysis and understanding of what the informal sector entails.

3.1.1 The Informal Sector Definitional problem

Most authors trying to measure the informal economy face the difficulty of how to define it.[119] However, one commonly used working definition of the informal sector is all the currently unregistered economic activities which contribute to the officially calculated (or observed) Gross National Product.[120]

As expounded earlier, the term informal economy was initially applied to Ghana by Keith Hart in 1971, but the first thorough investigations of the sector was conducted by the ILO in Kenya in 1972 and the 1972 ILO report on Kenyan unemployment was the first step to popularize the informal sector concept.[121] The report defined informal activities as all economic activities that are neither monitored nor taxed by the government, and are not included in the government GNP statistics.[122] More than three decades later, in 2002, the ILO released a report called "*Women and Men of the Informal Economy: A Statistical Picture*", in which it attempted to reconcile the term's many definitions and interpretations, as well as provide the first reliable statistical overview of the global informal economy. The ILO report also recognised that informality

[118] Hussmanns Ralf: *"Measuring the Informal Economy: From Employment in the Informal Sector to Informal Employment',* Working Paper No. 53", Policy Integration Department Bureau of Statistics, International Labour Office, Geneva, December, 2004.
[119] Supra Note 16.
[120] Ibid.
[121] The 10th edition of the Africa Tax Spotlight, themed Taxation and the Informal Sector, (2012),Second Quarter Vol.3; a paper prepared for the DFID-funded International Centre for Taxation and Development at IDS, at the ICTD annual conference in June 2011.
[122] Supra Note 160.

existed along a continuum, rather than as a binary characteristic. A number of variables therefore contribute to a business's level of formality, largely depending on the level of regulation and protection applied to enterprise's operations and relations. However, identification of informal workers without a clear designated enterprise status often makes them invisible to statistics and policy.[123]

Since then, the concept of the informal sector has been widely accepted in the literature.[124] In Kenya, the informal sector has been described as comprising of *'petty traders operating in the streets of main urban centers and mostly involved in the sale of second-hand items like clothes, some in the business of shoe shining, street vendors, carpentry, vegetable selling, repair and construction work..'*[125]

Nabuteya[126] has simply described the informal sector in Kenya as 'referred to as '*jua kali*', which literally means fierce sun in Swahili.[127] This name stems from the fact that the workers in the informal sector work under the hot sun beating on their heads and backs, while working on metal, wood or selling wares on the streets. The work involved is harsh and hard and usually done under harsh conditions unsuitable for neither labour, unregulated and unsafe.'

The term informal sector is used interchangeably with the term informal economy. The International Labour Conference also defined the informal economy as referring to "all economic activities by workers and economic units that are – in law or in practice – not covered or insufficiently covered by formal arrangements."[128] This is a broad definition that only looks at the extent to which the activities of an enterprise is regulated. To the extent that there is no

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[123] Ibid.

[124] Jeemol Unni, National Commission for Enterprises in the Unorganized Sector Informal Employment: Estimating Home-based and Street-based Workers in India, Paper presented at the 9th Meeting of the Delhi Group, May 11-12, 2006, New Delhi.

[125] Institute of Economic Affairs (IEA): *'The Informal Sector and Taxation in Kenya'*, A publication of the IEA Budget Information Programme, Issue No. 29 of September 2012.

[126] Amenya Nabuteya Gibson: 'The Informal Sector in Kenya', available at http://www.nayd.org/PDF/The%20informal%20sector%20in%20Kenya.pdf last visited on 20/08/2013.

[127] ibid

[128] "Decent Work and the Informal Economy", 90th Session (2002) of the International Labour Conference (ILC) available at http://www.ilo.org/wcmsp5/groups/public/---dvg reports/---stat/ documents/ normative instrument/ wcms_ 087484.pdf last visited on 27/09/2013.

regulation or that the activities are insufficiently covered by the law or practice, then the enterprise would be considered informal.

Andrew Henley, et al, in an attempt to define and measure the informal sector observe;-

> *"A comparative descriptive investigation of the sets of individuals defined as informal according to these different definitions reveals some substantial similarities, such as in demographic and educational status. However, a multivariate (probit) analysis reveals that some characteristics are more strongly associated with one measure of informality than another. For example, educational attainment is far more strongly associated with social security institute membership, and with informality defined according to employment status and activity than it is with the measure of informality based on compliance with labour regulation. On the other hand, social security institute membership appears to be less strongly associated with the demographic and informal status of others within the household."*[129]

Martha Chen in her recent paper used the expanded definition of the informal sector to classify it broadly using the nature of employment. She observes that:-

> *"The International Labour Office (ILO), the international Expert Group on Informal Sector Statistics (called the Delhi Group), and the global network Women in Informal Employment: Globalizing and Organizing (WIEGO) worked together to broaden the concept and definition to incorporate certain types of informal employment that had not been included in the earlier concept and definition of the "informal sector." They sought to include the whole of work-related informality, as it is manifested in industrialized, transition and developing economies and the real world dynamics in labour markets today, particularly the employment arrangements of the working poor.*[130]

According to Martha Chen, the informal employment is a large and heterogeneous category and therefore, for purposes of analysis and policy-making it is useful to divide formal and informal employment into more homogeneous sub-sectors according to status of employment.[131] She further indicates that the expanded definition focuses on the nature of employment in addition to

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[129] Andrew Henley, G. Reza Arabsheibani, Francisco G. Carneiro "Defining and Measuring the Informal Sector", Discussion Paper No. 2473, November 2006 P.3-4.

[130] Chen Alter Martha: "The Informal Economy: Definitions, Theories and Policies, Women in Informal Employment Global Organization (WIEGO), Working Paper No. 1 of August 2012, P.6-7 For more details, see WIEGO Working Paper No 2 (Vanek et al. 2012).

[131] Ibid , *"Employment status" is a conceptual framework used by labour statisticians to delineate two key aspects of labour contractual arrangements: the allocation of authority over the work process and the outcome of the work done; and the allocation of economic risks involved [ILO 2002a]"*

the characteristics of enterprises and includes all types of informal employment both inside and outside informal enterprises.

In 2003, the International Conference of Labour Statisticians broadened the definition of the informal sector to include the various types of informal employment outside informal enterprises: statisticians refer to this expanded notion as "informal employment".[132]

This recent approach expands the definition of the informal sector from enterprises that are not regulated or insufficiently regulated such as employers in informal enterprises, own account workers in informal enterprises, contributing family workers (in informal and formal enterprises), members of informal producers' cooperatives (where these exist and includes those employment relationships that are not legally regulated or socially protected such as employees of informal enterprises, casual or day labourers, temporary or part-time workers, paid domestic workers, contract workers, unregistered or undeclared workers and industrial outworkers (also called home workers).[133]

All in all, despite the definitional difficulty, the informal sector can be described by the primary aim of the sector which is to generate income for those involved. It is mostly encouraged by the failure of the government to provide employment. Therefore most of the ventures in the informal sector have very little or no structures of engagement with other actors like the government and labourers. It is this lack of structures of engagement with government that condones the evasion of taxes and the exploitation of those engaged as labourers in these units.

3.1.2 Scope of the Informal Sector

The first time, comprehensive efforts were made at defining and explaining the scope of the informal sector was at the Fifteenth International Conference of Labour Statisticians in January

[132] Supra Note 128.
[133] Ibid.

1993.[134] The objectives of the resolution were that countries where the informal sector plays a significant role in employment, income generation, economic and social development should aim, where practicable, at developing a comprehensive system of statistics on employment in the informal sector to provide an adequate statistical base for the various users of the statistics, with account being taken of specific national needs and circumstances. The system to be developed should contribute to the improvement of labour statistics and national accounts as an information base for macroeconomic analysis, planning, policy formulation and evaluation, to the integration of the informal sector into the development process and to its institutionalisation. Further, it should provide quantitative information on the contribution of the informal sector to various aspects of economic and social development, including employment creation, production, income generation, human capital formation and the mobilisation of financial resources. The system may also provide data for the design and monitoring of specific support policies and assistance programmes for the informal sector as a whole or parts thereof with a view to increasing the productive potential and employment- and income-generating capacity of informal sector units, improving the working conditions and social and legal protection of informal sector workers, developing an appropriate regulatory framework and promoting the organisation of informal sector producers and workers, and for the analysis of the economic and social situation of particular groups of informal sector workers such as women, children, rural-urban migrants or immigrants."[135]

The informal sector is organized into different enterprises. It is these enterprises that are 'organized into private unincorporated entities owned by individuals or households that are not constituted as separate legal entities independently of their owners, and for which no complete accounts are available that would permit a financial separation of the production activities of the enterprise from the other activities of its owner(s).'[136]

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[134] Resolution Concerning Statistics of Employment in the Informal Sector", adopted by the Fifteenth International Conference of Labour Statisticians (January 1993):Report of the Fifteenth International Conference of Labour Statisticians available at http://www.ilo.org/wcmsp5/groups/public/---dvg reports/---stat/ documents/ normative instrument/ wcms_ 087484.pdf last visited on 19/08/2013.

[135]Supra Note 128.

[136] Surendra Pratap, Informal Sector in India and Challenges for its Transformation Centre for Workers Education, New Delhi Email: Web: ttp://workerscentre.wordpress.com/ (accessed on 28/09/2013).

The ILO defines the informal sector as one characterized by ease of entry, reliance on indigenous resources, family ownership of enterprises, small scale of operation, labour-intensive and adapted technology, skills acquired outside the formal school system, and unregulated and competitive markets.[137] This definition appears to be the best description of the informal sector in many African countries where the sector encompasses a wider section of the economy. Increasingly many businesses in sectors such as housing, public transport and other related service industry operate under the guise of informal sector purposefully to escape the tax net.

The 15th ILC Conference in 1993[138] proceeded to make the following findings regarding the different informal sector enterprises and categorizes them as house hold enterprises which are classified as units engaged in the production of goods or services which are not constituted as separate legal entities independently of the households or household members that own them. No complete sets of accounts (including balance sheets of assets and liabilities) are available which would permit a clear identification of any flows of income and capital between the enterprises and the owners. As long as they are run as family ventures and unincorporated, they remain under the informal economy. Even incorporated partnerships which run as family ventures form part of this classification.

Many governments however have a different terminology and approach to the informal economy because they use the concept of the underground economy to group all types of activities that fall under the radar of the revenue authorities. The underground economy lumps together legal and illegal activities, as well as monetary and non-monetary components. This is unhelpful in terms of policy-making, since different policy measures would apply to different aspects of the underground economy. Currently, the Kenyan government tends to tackle all underground activities using a law-enforcement approach.[139]

In view of the foregoing and considering that this study has demonstrated that the informal economy comprises of both legal and illegal activities, it could be said that this approach by the

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[137] Supra Note 128.
[138] Supra Note 134.
[139] Supra note 1 P. 37.

government has widened the rift between the informal sector and the government further impeding the government's efforts at formalizing the sector and bringing it under the tax regime.

3.2 A case for including the Informal sector in the Tax Bracket

Many arguments have been advanced for taxing the informal sector. However, for purposes of this study, the benefits of taxing the informal sector are to be discussed in two-fold; firstly, that it increases government revenue and secondly, that taxing the sector recognizes it as a legitimate source of economic activity which in turn increases economic participation. As a result, the sector will be included in economic infrastructure, service provision and other development initiatives all which will spur economic growth.

It is important also to point out that efforts by governments to widen the tax base will greatly increase revenue leading to a reduction in the reliance on donor funding and also in incidences where governments are forced to increase taxes on basic commodities.[140]

Joshi Ayee[141] gives the reasons for interest in the taxation of the informal sector as revenue need following the introduction of neo-liberal reforms under structural adjustment programmes (SAP) with emphasis on liberalization, downsizing and changing tax policy as well as tax administration that has brought to the fore the urgent practical necessity of increasing revenues for the state to deliver basic services with primary objective to revenue maximisation. The informal sector therefore becomes the obvious avenue to be drawn into the tax net having been mostly out of it.[142] Besides, the phenomenal size and growth of the informal sector due to the liberalization of world economies as a result of SAP has pushed many formal businesses into the informal sector in most developing countries. Further, recent calculations estimate that the size of the informal sector in developing countries varies between about 20 percent in Indonesia to

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[140] Abubakar Yusuf, Assignment on the informal Sector of Nigeria, http://www.academia.edu/4118240/accesed on 28/09/2013.

[141] Prof. Joshi Ayee (2007) Paper presented at the foreign investment Advisory Service of the World Bank Group Regional Conference on the theme *"Enterprise Formalization in Africa"*, Alisa Hotel, Accra – Ghana, January 10-11, 2007

[142] Ibid.

around 67 percent of GDP in Bolivia. Thus, the informal sector is complex and heterogeneous comprising of large enterprises and small; urban firms and rural ones; visible activities as well as invisible ones; owners as well as workers; local activities as well as those that cross jurisdictional boundaries which makes it the ideal area for revenue collection.[143]

Furthermore, the impact on tax compliance in the formal sector whereby the legitimate taxpayers in the formal sector perceive the state as being unfair in pursuing them for taxes while the informal sector continues to operate untaxed is great. Thus, ignoring the informal sector activities will lower compliance morale and increase the risk of generalized non compliance.[144] Further, there is some evidence from Latin America suggesting that tax compliance in the formal sector is higher in countries which have a relatively small informal sector. Additionally, the tax accountability link whereby governments are dependent upon earned revenues such as taxes (as opposed to unearned revenues such as aid or mineral wealth) are more likely to be responsive to their citizens for various reasons. The flip side of the argument suggests that citizens who pay taxes will demand more responsive governments. By encouraging people within the informal sector to come within the tax net, it is thus assumed that they will start the process of a constructive engagement with the state—of gaining services and rights and becoming full citizens. In short, widening the tax net will spark off a virtuous cycle of taxation and accountability that is at the heart of consolidating democracies.[145]

What is more, state legitimacy in formalization might be indicative of the fact that operators see no value in engaging with the state in the protection of life and property, and therefore legitimacy becomes a serious concern. In order to regain legitimacy, governments are looking for ways to incorporate informal activities into formal systems. Taxation is therefore a good route into the problem, as it enables governments to recognize informal activities without legitimizing the breaking of other rules and regulations. Broadening the tax base and developing

[143] Supra Note 141.

[144] Terkper Seth (2003) *Alternative Methods for Taxing Individuals: Improving Taxpayer Accounting for SMEs and Individuals.* Andrew Young School of Policy Studies Annual Conference on Public Finance Issues George State University.

[145] Joshi, Anu and Ayee, Joseph (2006a) "Associational Taxation: A Pathway into the Informal Sector?", in Deborah Brautigam, Odd-Helge Fjeldstad and Mick Moore (eds.) *Capacity and Consent: Taxation and State-Building in Developing Countries* (Cambridge: Cambridge University Press), forthcoming.

a 'culture of compliance' can achieve more than simply increasing revenues; it can be a way of re-engaging citizens with the state. Furthermore, research on the informal sector shows that those within the informal sector are willing to pay taxes, specifically when these are in exchange for some legitimacy, stability and protection from arbitrary harassment from state agents.[146] For many within the informal sector, the tax burden is not onerous, especially as they are paying informally anyway, albeit as bribes to street level bureaucrats, in order to continue operating.

Finally, Johnson et al.,[147] argue that countries with complex and costly taxation and regulatory schemes end up in an economically unproductive equilibrium with a large informal sector. Also, high taxes on the formal sector induce non-compliance, that is, informal businesses. This reduces government revenue and thus the amount of funds available to provide and maintain market-supporting, public sector goods and services such as the court system, government administration agencies, roads and so on.[148] The fewer funds and the impossibility of preventing informal sector operators from using many of these services without paying for them diminishes their quality, increases prices, and leads to congestion. This, in turn, encourages even more entrepreneurs to leave the formal sector to avoid bearing an increasing share of the tax burden for poor goods and services. A good equilibrium is therefore, one where tax revenues are used to provide quality public services that encourage participation in the formal sector and discourage informal sector activity.[149]

3.3 Challenges in Taxing the Informal Sector and Realizing a Fair and Equitable Tax System in Kenya

As observed from the synopsis on the tax reforms which have taken place in Kenya right from the colonial period to date, it is noteworthy that the various tax reforms have failed to bring the requisite taxation equity and equality into Kenya's taxation system.

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[146] Ibid.

[147] Johnson S., Kaufmann D. and Shleifer A. (1997), The Unofficial Economy in Transition, Brookings Papers on Economic Activity, Vol. 2, p.159.

[148] Emmanuel G. Ofori, A Dissertation presented to the Institute of Distance Learning, Kwame Nkrumah University of Science and Technology, Kumasi Taxation Of The Informal Sector In Ghana: A Critical Examination May, 2009.

[149] Supra Note 168

In order to understand in-depth, the reasons why the informal sector in Kenya has not been efficiently and effectively netted into the taxation bracket, a study was carried out in September, 2013 on the small business owners in Machakos County with a sample size of 200 informal sector operators. Primary data was mainly obtained from closed –ended questions and multiple answers provided to limit respondents to choices. The study also aimed at measuring the attitude of the small business owners towards payment of taxes. The data collected on the attitude of the small business owners in Machakos County towards payment of taxes is presented in **Table 3.3.A below**:

Table-3.3.A: Attitude of the Small Business Owners in Machakos County on Tax Matters

	Attitude of the Respondents	**A**	**U**	**D**
1	Tax payment is time consuming			100
2	Tax payment is costly	80	20	
3	I don't know how much KRA expect me to pay	40	50	10
4	I don't know how to pay taxes online	30	10	60
5	I do not own a computer or electronic tax register	20	30	50
6	My ETR register keeps breaking down	10	10	80
7	I regularly employ the services of a tax advisor	20		80
8	I attend tax clinics and take part in tax payer education exercises	20		80
9	I keep up-to-date records of all my business transactions	70	10	20
10	I understand Kenya tax law	70	10	20
11	I take advantage of all tax incentives in Kenya		70	30
12	I own the Kenya Tax Handbook	10	20	70
13	I file my tax returns every year	30	20	50
14	I get all tax refunds owed to me on time		40	60
15	I know how to calculate how much tax refund is owed to me	10	30	60
16	I know about the tax incentive available in Kenya	10	30	60
17	Any Comments: I don't know about tax	40	-	-

Source: Field Survey data, September, 2013

In **Table-3.3.A** above, **A,** measured agreement with the issue raised, **U,** measured the attitude of unawareness and **D**, measured the attitude of disagreement. From the survey, a whopping 100 percent of the respondents did not find payment of tax to be time consuming. However, 80 percent of the respondents agreed that tax payment was expensive. Over 70 percent did not know how much tax they were expected to pay while 60 percent admitted that they did not know how to use the online services offered by the Kenya Revenue Authority to file tax returns. Half of the respondents did not own a computer or electronic tax register. About 80 percent of the respondents operating from permanent structures like shops and hotels owned electronic tax registers which were in perfect working condition. However, only 20 percent of the respondents employed the services of a tax advisor. This contrasted greatly with 70 percent of the respondents who admitted to keeping up to date records of their daily business transactions yet never sought the services of a tax advisor. Further, over 70 percent of the respondents did not own a Handbook of Kenya Taxation even though they claimed that they filed their tax returns every year. Interesting, none of the respondents had knowledge of applying for tax refunds or the various tax incentives available to Kenyan taxpayers. Further, over 80 percent of the respondents were not aware of tax clinics and had not taken part in any taxpayer education exercises. Finally, 40 percent of the respondents admitted their ignorance about taxation generally.

An analysis of the data collected from the above study established that the earlier mentioned factors that make the informal sector hard-to-tax were very common in Machakos County as a result of the predominance of cash transactions, poor record keeping, high illiteracy rate, little or no barriers to entry, lack of laid down procedures, ignorance of tax laws and the peripatetic nature of the informal sector in Kenya. These figures indicate clearly that a large number of the informal sector operators have at least one reason for not paying tax. This study reveals the stark reality that the general level of tax evasion in the informal sector may further discourage the few informal sector businesses that do pay taxes currently from doing so in future. This is a deeply disturbing signal that must be dealt with by the tax authorities so as not to worsen the problem of tax evasion.

A further study was undertaken on the small business owners in Machakos County with the objective of determining the numbers of businesses operating in the informal sector/economy in the County of Machakos. The study also aimed at determining the amount of income that is subject to taxation in the informal economies in the County of Machakos. The data on the number of the business and industry in Machakos County is presented in **Table 3.3.B** below.

Table-3.3.B: Number of the Informal Business and Industry in Machakos County

Industrial Category	No. of operators	Estimated Turnover per year (Kshs)
Agriculture e.g. Green grocers (Market Vendors - Farmers selling produce at the Market & Mama mbogas & cereals)	592	786,000.00
Traders (Non-Agriculture) e.g. Market vendors not selling 'mbogas ' (Newspapers vendors, toys vendors, DVD vendors, Plastic papers & others)	34	642,000.00
Mining & Quarrying, sand harvesters and sellers	4	1,248,000.00
Manufacturing – Jua kali eg. jikos, sufurias, boxes, wheelbarrows,	234	1,026,000.00
Water - to include water Kiosks, clean water tankers, Mkokoteni water vendors, hawkers of Mineral waters	67	228,000.00
Construction- to include all related industry carpenters and masons	505	4,533,000.00
Hotels and Restaurants – to include food kiosks	199	1,134,000.00
Transport, Storage & Communication e.g. Matatu, Tuktuk, boda boda, taxis, Mobile repairs, bicycle repairs, garages, driving schools	853	5,364,000.00
Financial Services e.g. Mpesa, Jamii, airtel, equity & Cooperative money shops	288	2,622,000.00
Community Services eg. Health Clinics, pharmacies,	58	4,268,000.00
Saloons & Barber shops	136	2,064,000.00
Tailors & dress makers	305	606,000.00

All other Sectors	607	888,000.00
TOTAL	**3882**	**25,409,000.00**

Source: Field Survey data, September, 2013

The survey at **Table-3.3.B** above, took place immediately after the VAT Act 2013[150] was enacted. This affected the respondents' answers in respect to their businesses turnover per year since majority appeared unwilling and totally uncooperative to discuss their business earnings openly probably for fear of exposing themselves to tax claims. The amounts reported may therefore be the lowest turnover in any given year and the researcher believes that the actual turnover could be four times the amount appearing above for the reasons that firstly, most of the interviewee confirmed that their business was the sole source of their income and secondly, majority of the interviewees had extended families all dependent on them. All this makes it hard to believe that the interviewees only depended on the disclosed merge source of income.

The representative sample from the survey however shows that the informal sectors in all the 47 counties in Kenya have a great potential for the necessary domestic revenue mobilization which can assist in reducing the huge budget deficits. Further, the study reveals that a large number of the country's active labour force is in the informal sector where it could be generating significant amount of income that goes untaxed. Owing to high population growth in the urban centres and high competition brought about by imported cheap products, the informal sector is expected to expand exponentially in the near future and perhaps serve as a "goldmine" for higher revenue mobilization. The effective and efficient imposition of taxes on the informal sector therefore holds the great prospect of closing the yawning gap in the domestic revenue generation.

A final study on the subject was carried out within the same period by interviewing 7 officers randomly selected from the following institutions:- National Treasury, Kenya Revenue Authority, Parliamentary Budget Office Kenya and the Institute of Public Policy and Research Analysis. The study intended to assess the attitude of the officials involved in tax collection,

[150] The Value Added Tax Act No.35 of 2013

policymakers, tax planners and tax analyst on what they perceived to be the biggest hindrance in taxing the informal sector. The data in **Table 3.3.C** below represents the responses by the tax specialists on the matter.

Table-3.3.C: Biggest Hindrance in Taxing the Informal Sector in Kenya

TAX EXPERTS – (On a scale of 1 – 10 rank the following factor(s)) which is the biggest hindrance when taxing the informal sector?

Large Size of the Sector	**51%**
High Proportion of Nil and Non-Filers in KRA Database	**43%**
Lack of Vital Statistics on the Sector	**73%**
Low Remuneration of Employees in the Sector	**23%**
Any Comments:	**NIL**

Source: Field Survey data, September, 2013

From the study in **Table 3.3.C** above, it is evident that the main hindrance in taxing the informal sector in Kenya is lack of vital statistics on the sector. According to the study, 70 percent of the tax officials interviewed agreed that the government lacks a database on the informal sector. This appears to be the main reason KRA is not able to meet its targets on TOT. There is also no framework of sharing tax information between various government agencies this was especially so between the defunct city and local authorities and the KRA. This has made it almost impossible for the tax authorities to know the exact physical location of the businesses which are issued with the annual business permit by the counties. Further, 51 percent of the respondents indicated that the large size of the informal sector hinders tax collection. This may be so due to the fact that with limited resources, it becomes difficult for the Kenya Revenue Authority to decentralize its services and carry out automation of services in all the branches. Lack of shared government infrastructure among all the government agencies is also said to be an impediment which bars the tax agency from netting the informal sector in Kenya. Finally, it is important to note that only 23 percent of the respondents interviewed agree that employees in the informal sector do not pay taxes due to low remuneration while only 43 percent of the respondents felt that failure to file returns in the informal sector impedes tax collection. This leads to the inference that lack of a database on the informal sector is the main hindrance in taxing the economy.

Brautigam et al., observe that the informal economy comprises a large number of small-scale operators, each with low turnover and that many activities in the sector are carried out within homes and out of public sight.[151] Barriers to entry are low, leading to fierce competition and a high degree of transience and uncertainty.[152] As a result, businesses in operation today may not exist tomorrow.[153] In activities like transportation or street vending, operators may be very mobile. Low levels of literacy and lack of access to banking services mean that cash transactions are dominant in the sector. The family-oriented, small-scale nature of most businesses leads to a lack of separate accounting of personal and business transactions. Affordable accountancy services are rare. As a result it is difficult to identify small scale operators for tax purposes.[154]

Further, in a presentation at the International Tax Dialogue Global Conference in 2007, the immediate former Commissioner General of the KRA Waweru M. G., observed that administering a system that adheres to the principles of designing presumptive tax system regime namely, ease of compliance, ease administration, compatibility with existing regimes, fairness and transition across regimes, are the main key challenges in taxing the informal economy.[155]

Other factors identified by Waweru are the dilemma of having a simplified tax regime versus bringing informal sector into the tax bracket. He wondered whether policy makers can achieve both principles.[156] Again, Waweru advised that there is the risk of vendors who were initially maintaining book accounts for tax purposes, stopping doing so since they will now fall below the

[151] Supra Note 22.
[152] Ibid.
[152] Supra Note 22.
[153] Ibid.
[154] Supra Note 22.
[155] Supra Note 17.
[156] Ibid.

threshold. This would eventually lead to a huge number of taxpayers enjoying a lower tax obligation and hence, the tendency to remain in the regime instead of graduating to the regular regime.[157] The issue of requiring vendors operating informal sector businesses without maintaining accounting records to pay fines or penalties was also identified by Waweru as among the factors affecting taxation in the informal economy. Fines and penalties discourage compliance altogether in that the vendor would merely try to evade detection and not pay any tax.[158]

Additional challenges cited as affecting the informal economy by Waweru included orienting the tax administration system around the key segments of taxpayers and developing strategies for enhancing compliance based on taxpayer segments. This has been made worse by lack of credible data sets that can be used for analysis of taxpayer segments.[159]

Studies have also shown that there are specific challenges affecting the informal economy in Kenya.[160] They include firstly, the large size of the informal sector in Kenya because out of the 43,057 formal establishments in Kenya in 2006, about 25,020, (or 58%) of them are Micro and Small Enterprises. This high proportion of MSEs in the country is a challenge in the endeavour to tax the sector.[161]

The second challenge specific to Kenya is the high proportion of nil and non-filers in KRA database. Out of the total VAT registered taxpayers of 65,528, in 2006 there are 18,200 payment filers, representing 27% of the registered VAT taxpayers. The number of nil and non -filers was 22,617 (or 35%) and 24,711 (or 38%) respectively. Thus, the proportion of nil and non filers to the total number of VAT registered taxpayers was 73%, and hence posing administrative challenges in taxing the MSMEs.[162]

Moreover, lack of documented statistics on the sector is another challenge cited by the findings. Out of the 31,956 MSMEs, 45% are in non-commercial community while 7% are in

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[157] Supra Note 17.
[158] Ibid.
[159] Supra Note 17.
[160] Lumumba Omweri Marti, et al Taxpayers' Attitudes And Tax Compliance Behaviour In Kenya AIBUMA Publishing African Journal of Business & Management (AJBUMA*) **http://www.aibuma.org/journal/index.htm*** Vol. 1 (2010), accessed on 27/09/2013).
[161] Ibid.
[162] Supra Note 160.

agriculture.[163] Attempts to tax the sector have therefore been complicated by the high proportion of the MSMEs in the non-commercial community. This is because majority of their transactions are cash based and unrecorded. Again, a good number of MSMEs are not registered and hence not captured in the national statistics.

Lastly, low remuneration of employees in the sector is also cited as a challenge because despite the fact that the sector is a source of livelihood for a high proportion of Kenya's labour force, most of the employees are either unskilled or semi-skilled and therefore, they are paid wages and salaries that are below the PAYE threshold of Kshs 10,163 (US$ 150).[164]

From the foregoing, it is apparent that there is little government control on the informal sector which rakes in inconceivable profits to the proprietors. Moreover, for scholars working on tax policy, the issue of taxation of the informal sector has generally not been of much interest because the sector is considered too complicated and requiring considerable effort with few returns.[165] As a result, a lot of focus on tax reforms over the past twenty years has been on simplifying tax systems, widening the tax base through the introduction of VAT and improving tax administration, by partly creating autonomous tax authorities.[166] This neglected the informal sector which is not surprising especially when considered in contexts where governments lack good instruments for taxing, and where much of the emphasis is on extending indirect taxation (VAT) that is expected eventually to penetrate the informal sector.[167] Notwithstanding, this study shows that the government should pay more attention to taxation of the informal sector because of the returns expected there from, if the economy is properly netted in the tax bracket.

3.4 Projected benefits in Taxing the Informal Sector

An equitable tax system ensures that individuals with higher incomes bear greater tax burden compared to individuals on low incomes. Most players in the formal sector are already paying

[163] Ibid.
[164] Supra Note 171.
[165] Ibid.
[166] Bird, R.M. and Oldman, D. eds. (1975) *Readings in Taxation in Developing Countries* (Baltimore: The Johns Hopkins University Press).
[167] Supra Note 17.

taxes heavily at the expense of others who should have been in the tax bracket.[168] As clearly espoused by John Mutua, tax fairness should be considered as an important goal by policy makers for the following reasons: fair taxes are essential to adequate funding of public services because they tax those who have the most to give. Again, fair taxes help the government in its relations with its citizens, who are likely to support and tolerate tax reforms that will lead to fair tax systems. A fair tax system is also important on grounds of moral imperative.[169]

As previously stated, it is also important to properly bring the informal sector under the tax regime in order to: - lessen the burden on the formal sector, enhance tax compliance, spur growth in the informal sector, inspire security of employees involved in the sector, reduce corruption and reinforce social contract between citizens and state.[170]

3.5 Conclusion

This chapter has explored in details, the definition and scope of the informal sector. The chapter has also discussed the arguments for and against the inclusion of the informal sector in the taxation regime. The study appreciates that there are challenges in bringing the informal sector within the taxation bracket. However, the challenges discussed in this chapter are insignificant considering the projected advantages of bringing the informal sector into the tax administration.

The case study conducted in Machakos County clearly illustrates that there is a lot of potential tax in the informal sector. However, because of lack of a verifiable database, poor recording keeping and use of cash transactions, it is difficult to determine with certainty, the turnover of the sector. Lack of a database in the sector also affects the collection by the KRA agents.

The next chapter will discuss the various ways of sealing the loopholes used by the informal sector to evade tax payment and also, consider the best practices that have helped net the informal sector into taxation.

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[168] Mutua M. John: "A Citizen's Handbook on Taxation in Kenya", Institute of Economic Affairs, Kenya, 2012.
[169] Supra Note 17.
[170] Ibid.

CHAPTER FOUR

4.0 TAXING THE INFORMAL ECONOMY: THE BEST PRACTICE IN DEVELOPING AND EMERGING ECONOMIES

4.1 Introduction

Whereas the informal sector varies from country to county, the importance of the informality is very wide and this uniqueness is useful when it comes to reforms in the sector.[171] Further, it is possible that administrative and institutional reforms related to the collection of informal sector taxes may be able to address narrow administrative shortcomings, and shift incentives among taxpayers, political leaders and administrators.[172] Again, in recent years, there has been increased attention paid to the question of taxing the informal sector.[173] This has seen several countries experiment with different approaches as discussed herein below.

4.2 Best Practice in Tanzania

Political stability has been a central feature of Tanzania since independence in 1964. The central government of Tanzania however, ten years after independence, continued to administer the Poll Tax then labelled "the personal tax" which contributes about 7 percent of the total domestic revenues collected while the income tax contributes about 18 percent of the total domestic revenues.[174]

[171] Enrique Ghersie, the Informal Economy in Latin America, Cato Journal, Vol. 17, No.1 (Spring/Summer 1997).
[172] Supra Note 161.
[173] Ibid.
[174] Supra Note 26, p.119.

On the other hand, development of the micro-enterprises in Tanzania after independence grew rapidly but declined after the Arusha Declaration in 1967, because the private entrepreneurship was contradicting the socialist policies. Lerise concludes that there was little development of the small-scale enterprises in Tanzania in the 1970s under the Ujamaa system.[175] However, there were efforts under the Small Industries Development Organisation to establish modern small-scale enterprises aided by the Swedish SIDA. This however, focused more on the technology transfer and industrialisation than on entrepreneurship and failed.

However, despite the differences in the East African economies, Tanzania has more developed informal sector than Kenya. This is due to the fact that the definition of the informal sector in Tanzania as is in Uganda, is narrowed as consisting of only the parastatals and large private enterprises, giving more chance for the informal sector development.[176]

In order to tax the informal sector in Tanzania, the Tanzania Revenue Authority (TRA) is piloting the Block Management System that concentrates resources on one geographically defined block at a time, with the aim of identifying potentially taxable firms and nurturing a culture of taxpaying.[177] Other measures taken by the Tanzania government through TRA comprise of the following; simplification of Taxation schemes (laws) and geographical capturing of information as well as correct level of economic activities and gathering valuable tax information. In addition, the TRA has also resorted into the application of withholding taxation for operators with no Tax Identification Number (TIN) or informal operators for income taxation. The TRA has also provided the SMEs with permanent trading sites and infrastructure.[178]

Further, the TRA has identified, registered, trained and guided SMEs on business management basics, such as bookkeeping, marketing and obtaining loan facilities. Tax amnesty which allows individuals traders or firms to pay previously unpaid taxes without being subject to criminal penalties is encouraged. For purposes of curbing tax evasion and enhancing voluntary

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[175] Supra Note 26. P.121
[176] Ibid.
[177] Supra Note 161.
[178] Tanzania Revenue Authority Midyear review Meeting paper presented at the ITD Conference at Kigali, Rwanda in April, 2009 available at ww.itdweb.org/.../ (accessed on 29/09/2013).

compliance by tax evaders (including informal actors), the TRA has taken deliberate initiatives to receive information from different parts of the country (known as Whistle- blowers Mechanism).[179] This is coupled by close monitoring and rigorous enforcement for tax compliance by all taxpayers.

The TRA has also taken additional measures for purposes of improving tax collection in the informal sector. These measures include: improving the business environment and using physical surveys like door-to-door surveys to identify and register liable taxpayers who are not currently in the bracket. Again, the TRA is in the process of simplifying tax systems, improving tax audits, monitoring and enforcement for tax compliance and more importantly, enhancing taxpayers' education on how more tax revenue contribution can improve public goods provision.[180]

4.3 Best Practice in Ghana

The economy of Ghana is largely made up of individual and small-scale enterprises. It is argued that the small-scale sector provides diverse sources of income which, if taxed, could increase the government internally generated revenue.[181] The Institute of Statistical, Social and Economic Research (ISSER) in 2003, stated that "the main source of employment in Ghana is the informal sector and estimated that the sector provides employment opportunities for at least 80 percent of the labour force".[182] The estimated size of the informal sector presupposes that the sector makes significant contribution to the Gross Domestic Product (GDP) and so the sector could equally make a major contribution to the tax revenue. A further survey conducted in Accra by Jobs and Skills Programs for Africa (JASPA) in 1990/91, established that the informal sector accounts for about 22 percent of Ghana's real GDP.[183]

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[179] For more information on Tax Reforms in Tanzania see Mbilinyi Apronius Vitalis 'Taxing the Informal Sector: Challenges for Revenue Enhancement in Tanzania'. The author is an Assistant Research Fellow at the Economic and Social Research Foundation (ESRF).

[180]Ibid.

[181] Supra Note 35.

[182] The Institute of Statistical, Social and Economic Research (ISSER), The State of the Ghanaian Economy in 2003, p. 193

[183] Ibid.

The Ghanaian government has attempted collection of taxes from the informal sector using associational taxation that encapsulates; negotiation with the informal sector trade associations to help collect presumptive income taxes.[184] In order to bring the informal sector into the tax net, Identifiable Grouping Taxation (IGT) (associational taxation) was initiated in Ghana.[185] Under this method, informal sector associations are used as agents for income tax collection.[186] The standard assessment of tax, is payable yearly at first and then quarterly and drivers were required to pay a lump sum in advance. The Ghana Passenger Road Transport Union (GPRTU) was at the forefront of this movement towards associational taxation and it has been observed that the associational taxation has been quite successful in raising revenues from an area of the economy which had not been paying taxes.[187]

In 2003, the government of Ghana introduced the standardized assessment system called the Vehicle Income Tax (VIT) under which transport owners and drivers pay income tax on a quarterly basis through a sticker system. The stickers are sold for cash to the associations to make them easily available to operators. Since January 2005, the IRS also introduced a tax stamp for the self-employed in the sector with a view to widening the tax. These tax stamps cover artisans such as carpenters, dressmakers, masons and mechanics as well as petty traders, mobile-to-mobile operators and other businesses in the informal sector, which constitute about 80 percent of the economic activity in the country. This tax stamp mode of taxation was introduced because of the insignificant contribution made by the informal sector to national tax revenue.

4.4 Best Practice in Zambia

A World Bank Enterprise Survey conducted in 2007 in Lusaka and Kitwe and a Zambia Business Survey conducted in late 2008, concludes that the economy of Zambia is largely made

[184] Supra Note 164
[185] Ibid.
[186] Supra Note 161
[187] Ibid

up of the small-scale sector which employs about 90 percent of its workforce.[188] The surveys further indicate that the informal economy in Zambia provides diverse sources of income which, if taxed, could increase the government internally generated revenue. The World Bank Survey concludes that only 5 percent of the small-scale enterprises (about 50,000 firms) report VAT payment, about 2 percent of the firms reported having a cash register, indicating limited scope for VAT collection. However, about 63 percent of the firms reported buying inputs from other businesses or government, rather than individuals, indicating possible VAT payments.[189]

Due to the large size of the informal sector in Zambia, , there are various methods used by the Zambia Revenue Authority in estimating the size of the informal sector, including the so-called direct approaches that use surveys and indirect methods that try to make estimates based on macroeconomic relationships.[190]

Because of this large tax base, there are several taxes levied by the Zambian Revenue Authority on the informal sector. Firstly, there is the personal income tax which is assessed outside the salary income. The personal income tax is largely employees' tax deducted at source (that is PAYE). Secondly, the Government uses deterrent and punitive measures to compel businesses to register for Income Tax or VAT. For example, the Advance Income Tax (AIT) for traders was raised from 3 percent to 6 percent in 2009 to encourage registration for tax purposes and increase compliance given that traders opted to remain unregistered even after the introduction of AIT.[191] As the most broad-based tax in Zambia, VAT captures some of the transactions of the informal sector when the informal sector purchases goods and services from the formal sector.

Similarly, in Rwanda and Cameroon, governments have focused on improving taxpayer services for small enterprises and engaging through newly created institutional spaces.[192] Strengthening tax and expenditure linkages through budget transparency is another strategy currently pursued in Sierra Leone.[193] Cameroon and Ethiopia national tax authorities are also considering ceding

[188] Source; ZBS 2008 and World Bank Enterprise Survey, 2008.
[189] Ibid.
[190] Supra Note 164.
[191] Ibid.
[192] Supra Note 161.
[193] Ibid.

tax collection of small and micro enterprises to local governments in order to enhance efficiency in taxation in the sector.[194]

4.5 Best Practice in India

The Indian National Commission on Labour (1966-1969), was the first attempt by the Government of India to define its informal sector. The Commission defined the informal/unorganized sector workforce as:-

> *"those workers who have not been able to organise themselves in pursuit of their common interest due to certain constraints like casual nature of employment, ignorance and illiteracy, small and scattered size of establishment".*[195]

Just as in the ILO definition, the Indian Government considers informal sector as the small enterprises which comprises of household establishments, owned and operated by own-account workers, either alone or in partnership with members of the same or other households, which may employ contributing family workers and employees on an occasional basis, but do not employ employees on a continuous basis. They are mostly small enterprises which are mostly run without the need for permanent external employees and are mostly not registered under the relevant national legislations either as companies or factories.[196]

In India, employees are considered to be in informal employment when their employment relationship, in law or practice, is not subject to: national labour legislation, income taxation, social protection or entitlement to certain employment benefits, for example paid annual leave, sick leave, etc.[197] Considering that there is no formal wage policy set by the Indian government, wages set by the state governments are as per some cost of living calculation and central government directives on minimum wages.[198]

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[194] Supra Note 161
[195] Supra Note177.
[196] Ibid.
[197] Supra Note 177.
[198] Ibid.

On taxation, just like in Uganda, India has experimented with auctioning tax collection rights in the informal economy to private firms.[199] The major tax enactment in India is the Income Tax Act of 1961, which imposes a tax on income of individuals and corporations.[200] This Act imposes a tax on income under the following five heads: income from house and property, income from business and profession, income from salaries, income in the form of Capital gains, and Income from other sources.[201]

However, this Act is intended to be repealed and be replaced with a new Act which consolidates the law relating to Income Tax and Wealth Tax. The new proposed legislation is called the Direct Taxes Code.[202] This Direct Taxes Code 2010 is said to replace the existing Indian Income Tax Act, 1961.[203] The Direct Taxes Code includes a common threshold Income Tax limit on men and women proposed at 200,000 Rupees per annum (proposed), up from 180,000. Secondly, 10 per cent tax on annual income between 200,000-500,000; 20 per cent up to 1 million, 30 per cent above 1 million rupees. Tax burden at the highest level will come down by Rs. 41,040 annually.

There is also a proposal to raise tax exemption for senior citizens to Rs. 250,000 from 240,000. The Union budget 2011-12 proposed implementation of this proposal.. Corporate Tax is to remain at 30 per cent but without surcharge and cess. MAT is to be set at 20 per cent of book profit, up from 18.5 per cent. There is also a proposal to levy dividend distribution tax at 15 percent with exemption for investment in approved funds and insurance schemes provided at Rs. 150,000 annually, against 120,000 currently.[204]

While the Direct Tax Code of India provides to lower corporate tax rates simultaneously it incorporates new provisions which will result in broadening the tax base[205]. For example, the government is proposing a 35 percent tax rate for those earning more than Rs 10 crore in the Direct Taxes Code. The Bill has however not been enacted into law and it is indicated to be

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[199] Joshi Anarudha, Prichard Wilson and Heady Christopher this report can be downloaded at http://www.ictd.ac/en/publications/taxing-informal-economy-challenges-possibilities-and-remaining-questions-publication.

[200] Sections 4 and 5 of the Indian Income Tax Act, passed by the Parliament of India in 1961.

[201] Sections 4, 5 and 8 of the Indian Income Tax Act.

[202] The Direct Taxes Code, 2010 Bill No. 110 of 2010.

[203] Supra Note 213.

[204] http://www.ey.com/IN/en/Services/Tax/Direct-Tax-Code.

[205] Supra Note 217.

pending debate in Parliament during the on-going session.[206]. in implementing the new code, the Government of India also intends to streamline and simplify legislation and in the process, ensure equity in taxation of all including the informal sector.

4.6 Conclusion

The chapter has considered in details, the various options applied by Tanzania, Ghana, Zambia and India in taxing the informal sector. The tax reforms in Tanzania and Ghana especially the use of associations as agents to collect taxes on behalf of the government can be emulated in Kenya to tax the informal sectors which have strong organisations such as the Mitumba Traders Associations, Matatu associations and other established associations. This will saves costs for the KRA and is easily enforceable by the association members. Ceding of tax collection in the informal economies to the county governments is also likely to enhance efficiency in taxing the informal sector.

[206] Supra Note 210.

CHAPTER FIVE

5.0 CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

This study has explored, analyzed and canvassed diverse issues affecting taxation of the informal sector in Kenya. The study investigated the factors that make the informal sector extremely difficult to tax and the circumstances contributing to the evasive behaviour of the informal sector entrepreneurs when it comes to taxation.

5.2 Research findings

The following findings are deductible from the study;

Firstly, most micro and small businesses in the informal economy evade taxation because of the existing legal, institutional and policy weaknesses. Lack of a dependable database on the informal sector makes it hard for the tax authorities to develop tracking measures on tax remission. This also places the sector entrepreneurs at disadvantaged position in terms of accessing policy updates. Also, huge administrative costs and human resource constraints make it difficult for the tax authority to follow up on every single taxpayer operating in the informal sector. As a result, in most parts, tax evasion in the informal sector goes unchallenged.

Secondly, it is evident that compliant taxpayers have to bear the burden of meeting revenue targets for the economy and they shoulder high tax burdens, thereby creating an uneven ground for competition. This portrays that the taxation system in Kenya is systematically unfair which is contrary to article 201 of the Kenyan Constitution that requires the sharing of the taxation burden equally.

Thirdly, the nature of the businesses undertaken in the informal sector creates a conducive environment for the proprietors to evade taxation. Most proprietors have no permanent business address and operate on cash basis. The low levels of literacy and lack of access to banking services means that cash transactions dominate the mode of payment in exchange for goods and services in the informal economy. The family-oriented, small-scale nature of most businesses in the informal economy leads to poor record keeping. As a result, it is difficult to identify small scale operators for tax purposes. [207]

Again, the informal sector has limited access to training and professional services that would enable them adapt sound corporate governance practices and as a result, majority of the proprietors in the sector are ignorant of their tax obligations.[208] Further, majority of the workers in the informal sector have low education background. Moreover, complicated tax systems and numerous processes of licensing make it difficult and expensive for start-up firms to correctly interpret the tax laws and as a result, they end up paying too high a tax or attract punitive fines. This is deterrent to business investors.

Further, poor communication and cooperation between the operators in the informal sector and the government are other factors hindering taxing of the informal sector. Prospective entrepreneurs in the informal economy are ignorant of business start-up regulations and taxation procedures. The entrepreneurs in this kind of economy lack adequate information on government policies. This prevents prospective entrepreneurs from entering into the formal economy. In addition, businessmen and women who opt not to pay licence fees for their business, operate *incognito* in back alleys and roadsides. They are often mobile and in most cases engage in running battles with the law enforcement and county authorities. In the process of evading taxes, they end up paying more money in the form of bribes, to the law enforcers.[209]

Besides, policies regarding the informal sector are poorly coordinated and disseminated across five different but related government departments namely finance, trade, industrialization, devolved governments and labour. Lack of shared government infrastructure or framework for sharing tax information between the various government agencies complicates what would

[207] Supra Note 229 above.
[208] Supra Note 3.
[209] Kenya Budget Focus, © 2011 Institute of Economic Affairs Taxation of the informal Sector in Kenya Issue No. 29 September 2012.

otherwise be a simple exercise and affect the government efforts to net the informal sector in the tax bracket. For example, the KRA and the Nairobi City County Government operate on different tax systems which make it difficult to share tax information when it comes to licensing of SMEs and taxation of the landlords.

Lack of participation and involvement of those in the informal economy while the government is undertaking reform processes in the sector also, breeds opposition to further reform initiatives. For example, many business regulations, tax laws and tax systems are formulated and introduced with little participation of those adversely affected by the same. In most cases, no studies or impact assessment and surveys are carried out before introducing new tax requirements. As a result, many workers and business entrepreneurs in the informal sector feel that they have not benefited enough from such democratic reforms and therefore create roadblocks during implementation of the new measures.

5.3 Conclusion

The study discussed the constitutional provisions relating to equitable and fair distribution of the taxation burden. The study has also elucidated why the informal sector should be brought within the taxation regime in Kenya in order to comply with the Constitution. The findings from the previous chapters indicate that the current institutional and regulatory framework have a number of inadequacies resulting to inefficient and ineffective taxation of the informal sector.

It is clear also from the study that the formal sector shoulders the tax burden as the informal sector evades tax payment thereof. The current tax regime is thus non-inclusive, is inequitable, inefficient and contrary to the Constitution. It should be urgently corrected and made to comply with the constitutional principles. The Kenya government should therefore undertake tax reforms in order to simplify the tax systems and address the inequity question in the distribution of the tax burden. This will also strengthen tax administration and ensure revenue adequacy.

The new constitutional dispensation in Kenya establishes the devolved system of government with enormous resource requirements. It is therefore of paramount importance to unlock the revenue potential so that adequate revenue allocation from the national to the county governments become a reality. To this end, the informal sector offers an opportunity to expand the tax base by tapping on its enormous and potential tax base and bringing the sector within the taxation regime. Enlisting as taxpayers and acquiring formal status enables entrepreneurs in the informal economy to access formal markets investment with security, obtain new sources of credit, participate in the government procurement and defend their rights. As a result, the informal economy contributes immensely to tax revenue.

The research has also established that different tax collection initiatives established by different countries have helped enhance tax collection from the informal sector. For example, in Tanzania, MSMEs have been identified, registered, trained and guided on business management basics, such as bookkeeping, marketing and obtaining loan facilities. Tax amnesties to traders are also encouraged. This allows individuals or firms to pay previously unpaid taxes without being subjected to criminal penalties. In order to curb tax evasion and enhance voluntary compliance by tax evaders (including informal actors), the TRA has taken deliberate initiatives to receive information from different parts of the country (known as Whistle- blowers Mechanism). This is coupled with close monitoring and rigorous enforcement for tax compliance by all taxpayers. The TRA has also embraced use of physical surveys such as door-to-door surveys to identify and register liable taxpayers not currently in the tax bracket. Taxpayers' education on how more tax revenue contribution can improve public goods provision has also gone a long way in ensuring tax compliance. Likewise, in Ghana different categories of informal sector entrepreneurs are organized into 'unions' and their taxation negotiated.

From the study on the best practices and experiences on selected African countries, it is apparent that revenue growth for any country depends on how best that country can rope into its tax bracket, this vital informal sector of the economy. Studies have also shown that most African countries are losing out on this crucial source of revenue yet it contributes greatly to their GDPs.[210] The options explored by Tanzanian, Ghana, and Zambia demonstrates that there is potential tax in the informal sector.[211] Accordingly, effort by the tax authorities to widen the tax

[210] Supra Note 161.
[211] Supra Note 32.

base will greatly increase revenue leading to reduction in the reliance on donor funding and incidences where the government is forced to increase taxes on the basic commodities in order to meet the fiscal targets.

5.4 Recommendations:

The study has established that administrative and institutional reforms are necessary so as to address the challenges currently making it difficult to tax the informal sector. The following options are therefore proposed as solutions in achieving the constitutional principles of fairness and equity in taxation in Kenya.

5.4.1 Institutional Reforms:

The governments' ability to raise the revenue it needs to pay for the expenses of implementing its policies and goals is an important element of state capacity.[212] The high costs on revenue collection associated with taxing the informal sector appears to have forced the KRA to rationalize its staff and put more effort in areas where it can get maximum revenue mainly in the formal sector.[213] However, instead of lumping the TOT regime with the general Domestic Revenue, there is need for the KRA to segregate the taxpayers more and give the necessary attention to the taxpayers in the informal economy. The Customs Services department also be refocused to its primary mandate of trade facilitation and effective border control. An new department under a County Director or Assistant Commissioner should be established in each county and strengthened to concentrate on revenue collection at the County level. This will simply the process of registration and profiling of all the business entrepreneurs operating from different counties. A data base on the informal sector will provide the crucial information on classification of the informal sector entrepreneurs into various tax bands.

[212] Skocpol, Theda (1985) "*Bringing the State Back In: Strategies of Analysis in Current Research*", in Peter Evans, Dietrich Rueschemeyer and Theda Skocpol (eds.) Bringing the State Back In (Cambridge: Cambridge University Press).
[213] Supra Note 170.

The KRA and other supporting tax agencies should also enforce rules and regulations governing tax compliance. Those found to be have defaulted in their tax obligations must face sanctions. Moreover, the KRA should prosecute those individuals in the informal sector who fail to pay their tax. Further, special tax courts should be established to deal expeditiously with cases of tax evasion.

5.3.2 Electronic tax Payment System:

Modern technology has allowed the creation of an efficient electronic payments system.[214] It should cost almost nothing to transfer money from an Individual's bank account to the merchant's bank account when a purchase is made. For a while, the KRA has been pursuing the implementation of a GPRS-Integrated ETR (G-ETR) system in VAT revenue collection. The GPRS-integrated ETR is now the most accurate, most reliable, and the fastest VAT revenue collecting device.[215] The new GPRS-integrated ETR is designed to provide automatic management and control of G-ETR from one place. This system solves the problem of updating of the VAT collected from the large number of the G-ETRs located in distant vendor locations. The system makes possible for the KRA to control the VAT collected and payments made by the G-ETR users. Use of the GPRS–integrated ETR also results in efficient and simultaneous communication between the KRA central server and all its registered G-ETRs. This facilitates centralized management of G-ETR registered by the KRA. There is also automatic data input into the G-ETR and automatic sending of the VAT revenue to the KRA server since connections to numbered G-ETR is unlimited. This creates possibilities of connecting kiosks (smallest shop) anywhere in Kenya and hence making it easy to tax from merchants operating from shops, hotels and restaurants, boutique and all other manners of the informal business scattered all over the counties. Again, the collected data can be sent quickly while sending of daily reports at specified times. According to available information, the G-ETR is foolproof and in the event of breaking of the connection with the GSM network, the device will automatically make the connection as soon as possible.[216]

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[214] Stiglitz, J. E, Reforming taxation to promote growth and equity", Roosevelt Institute, May, 28th 2014
[215] Ibid.
[216] Supra Note 239.

5.3.3 Public Sector Reforms

Joshi, Anu and Ayee, Joseph pose challenges as to whether there is a best way of taxing the informal sector and further, if the culture of taxpaying can be created in the informal sector that has avoided taxation for a long time. They then provides a number of mechanisms which have been applied in taxing the informal sector in other jurisdictions.[217] The Associational Taxation System applied in Ghana and the Block Management System applied in Tanzania are success stories for the use of the informal sector information and database available on associations as agents for income tax collection. The Associational Taxation System use associations who have intimate knowledge of the activities of their members and could collect taxes without much added effort. The taxes may be collected daily at first, and later weekly to reduce the high costs of printing and monitoring daily receipts, making the payments small and affordable to most members. The collection system should ensure equity. For example, in the cases of commercial drivers, the taxes should only be payable when the drivers earn income. If a vehicle is not in use, taxes should not be paid. Incentives to collect taxes for the state may be created for the associations. For instance, they may be offered a percentage of the total revenue collected.

The attempt by the National Transport and Safety Authority to introduce the cashless transport management system is tailor made in the form of Block Management System. In addition, the government should make use of the new the National Transport and Safety Authority[218] to enhance collection of revenue on the transport sector using registered Matatu associations as agents for tax collection. If amendments are carried out on the Income Tax Act and the VAT Act to allow registered SACCOS and other associations in industries like Matatu, Food Processing, Textile/Leather Works, Woodworking, Metal Fabricating, Beverages, Repair Services, Auto repairs, Handicrafts, Commerce and Building Construction to collect taxes from their members at a commission, this will increase revenue base for the government.

Secondly, the VAT collection form is the most broad-based tax in any nation and the only lifelong revenue for a government. The new VAT Act should be strengthened and its

[217] Supra Note 145
[218] Act No. 33 of 2012

performance enhanced. Administration of the VAT, particularly on domestic VAT, needs to be improved further. This is critical because VAT captures some of the transactions of the informal sector when the informal sector purchases goods and services from the formal sector. Thus, over time, exemptions would be rationalized and streamlined.[219] The case for enhancement of the performance and strengthening of the VAT is further justified by the fact that the Personal Income Tax is payable by gainfully employed people only as long as they are gainfully employed and when the employment closes, the tax revenue ends. Similarly, with Corporate Tax, if the Corporation does not make profit or shuts down, the tax revenue ends. The VAT is therefore, the only tax payable by a person directly or indirectly from cradle to coffin. When a child is born, the life giving milk of the mother and other essential nourishments, the baby garments the child uses, as it grows most of the needs, living or educational, are directly or indirectly subject to the VAT. When the child grows and begins to earn a living, his purchases are subject to the VAT. When the child finally retires, most of their needs continue to pay the VAT, and when finally life ends in the coffin, some of the funeral expenses also pay VAT. As such VAT remains the only tax that follows a person from cradle to coffin.[220] The current impulse in Kenya in relation to the VAT Act, 2013 should be resolved and the government should determine with finality, its policy on revenue collection through the VAT.

Tax compliance is also linked to reforms in the public sector because compliance itself depends on change in attitudes of citizens and the capacity of tax collection institutions to perform. Reforms aimed at enhancing efficiency, accountability and transparency of public financial management should be undertaken.[221] The Kenya government needs to have more up-to-date and more accurate information on how much money it is collecting, how much it is spending, where and for what purpose, and what its future obligations are likely to be. In addition, harmonization of the activities of the KRA will in the long term ensure tax compliance.[222] The KRA is required to work closely with other government agencies such as the police and the judiciary in order to enforce compliance.

[219] Supra Note 233.

[220] Ibid.

[221] Supra Note 181 Lumumba Omweri Marti, et al Taxpayers' Attitudes and Tax Compliance Behaviour in Kenya AIBUMA Publishing African Journal of Business & Management (AJBUMA) ***http://www.aibuma.org/journal/index.htm*** Vol. 1 (2010), accessed on 27/09/2013).

[222] Brown, R.E & Mazur, M.J (2003). IRS's Comprehensive Approach to Compliance. Paper presented at National Tax Association Spring Symposium in May 2003, Washington D.C.

The KRA is also obligated to ensure that all the landlords earning rental income pay their due share of taxes to the exchequer. For equity and fairness and to ensure that these privileged Kenyans pay taxes, the KRA is to leverage on technology, map out all rental property in urban areas and put in place a robust institutional framework for bringing all the landlords into Kenya's tax net before the end of the 2014/2015 financial year.

Concerted and sustained sensitization of the public ought to be undertaken by all the sectors involved in taxation and governance. A culture of tax compliance depends on changing attitudes and perceptions.[223] Apart from incentives such as quality provision of goods and services to motivate people to pay tax, incentives such as national awards for tax compliance and hefty rewards to those exposing tax defaulters in both the formal and the informal sector should be established and sustained. The culture of punishing tax defaulters in the informal sector and not rewarding those who have fulfilled their obligations and those who expose the defaulters should cease.[224]

5.3.4 Public Education

There is a general principle in economics that there is no such thing as a free lunch. To the extent that we can however, improve the efficiency of tax and expenditure programmes, there is a free lunch.[225] The reality, however, is that efficiency enhancing measures are unlikely to suffice by themselves.[226] Dialogue between the taxpayers in the private sector and the government should be undertaken and continued with the aim of developing confidence in the governments' ability to deliver and fostering willingness by the taxpayers to pay taxes. MSMEs should be trained on improved bookkeeping among micro and small enterprises by offering incentives, such as application of a lower presumptive tax rate for small businesses meeting certain recordkeeping standards. Again, training on tax matters should be undertaken with bias in enhancing the capacity of the informal sector and offering facilities like; business counselling, training and reducing the costs of business registration which hinders growth in the informal sector. Tax reforms in particular areas offer a path towards both resolving budgetary impulses and making the kind of public investments that will strengthen the fundamentals of the economy.

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[223] Supra Note 240 at p.114.
[224] Ibid.
[225] Supra Note 214
[226] Ibid.

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APPENDIX - 1

A. QUESTIONNAIRE TO SMALL BUSINESS OWNERS

The purpose of this questionnaire is to help collect information concerning the attitude and understanding of the Small business owners/proprietors on tax matters. The information you provide will be of great benefit, as it will be used in planning, policy making and legislation. This information will be solely for the purpose stated above and will be treated with most confidentiality.

Thank you in advance for your contributions, cooperation and patience in completing this questionnaire.

Please answer the questions by use of (√) in the options provided. "A" stands for Agreed, "U" stands for Undecided and "D" stands for Disagree. Those without options, please answer appropriately and precisely as required.

Please Tick where applicable.

	Attitude of the Respondents	**A**	**U**	**D**
1	Tax payment is time consuming			
2	Tax payment is costly			
3	I don't know how much KRA expect me to pay			
4	I don't know how to pay taxes online			
5	I do not own a computer or electronic tax register			
6	My ETR register keeps breaking down			
7	I regularly employ the services of a tax advisor			
8	I attend tax clinics and take part in tax payer education exercises			
9	I keep up-to-date records of all my business transactions			

10	I understand Kenya tax law			
11	I take advantage of all tax incentives in Kenya			
12	I own the Kenya Tax Handbook			
13	I file my tax returns every year			
14	I get all tax refunds owed to me on time			
15	I know how to calculate how much tax refund is owed to me			
16	I know about the tax incentive available in Kenya			
17	Any Comments: I don't know about tax			

B. QUESTIONNAIRE TO TAX EXPERTS

The purpose of this questionnaire is to help collect information concerning the challenges faced by the tax collectors (Kenya Revenue Authority) in taxing the informal business sector (Small business owners/proprietors) in Kenya. The information you provide will be of great benefit, as it will be used in planning, policy making and legislation. This information will be solely for the purpose stated above and will be treated with most confidentiality.

Thank you in advance for your contributions, cooperation and patience in completing this questionnaire.

Please answer the questions by use of (√) in the options provided. Those without options, please answer appropriately and precisely as required.

Please Tick where applicable.

(On a scale of 1 – 10 (where 1 is the least and 10 the greatest), rank the following factor(s)) which is the biggest hindrance when taxing the informal sector?

Large Size of the Sector	
High Proportion of Nil and Non-Filers in KRA Database	
Lack of Vital Statistics on the Sector	
Low Remuneration of Employees in the Sector	
Any Comments:	

C. SURVEY ON THE NUMBER OF INFORMAL BUSINESSES AND INDUSTRIES OPERATING WITHIN MACHAKOS COUNTY

Industrial Category	No. of operators	Estimated Turnover per year (Kshs)
Agriculture e.g. Green grocers (Market Vendors - Farmers selling produce at the Market & Mama mbogas & cereals)		
Traders (Non-Agriculture) e.g. Market vendors not selling 'mbogas ' (Newspapers vendors, toys vendors, DVD vendors, Plastic papers & others)		
Mining & Quarrying, sand harvesters and sellers		
Manufacturing – Jua kali e.g. jikos, sufurias, boxes, wheelbarrows,		
Water - to include water Kiosks, clean water tankers, Mkokoteni water vendors, hawkers of Mineral waters		
Construction- to include all related industry carpenters and masons		
Hotels and Restaurants – to include food kiosks		
Transport, Storage & Communication e.g. Matatu, Tuktuk, boda boda, taxis, Mobile repairs, bicycle repairs, garages, driving schools		
Financial Services e.g. Mpesa, Jamii, airtel, equity & Cooperative money shops		
Community Services eg. Health Clinics, pharmacies,		

Saloons & Barber shops		
Tailors & dress makers		
All other Sectors		
TOTAL		

APPENDIX – 2

Sheriffsam M. Mwendwa,
Reg. No. G62/68608/2011,
P. O. Box 41842-00100,
NAIROBI.
E-mail: Sherrifsam@yahoo.com
Tel: 0723 365 410
19th September, 2013

The Ministry of High Education,
Utalii House, 4th Floor,
P.O.Box 30623-00100,
NAIROBI.

RE: RESEARCH PERMIT FOR MASTER OF LAWS THESIS PROGRAMME

The above matter refers.

I am a Kenyan Citizen and currently registered for Master of Laws Degree (LL.M Programme 2013/2014 Academic year). I am scheduled to carry out a research in Kenya on Taxation of the informal Sector.

Accordingly, I request for your Approval and issuance of a Research Permit so as to enable me undertake the above research.

Attached herewith, please find the Research proposal duly approved by the Supervisor and the relevant questionnaires.

Yours faithfully,

Sheriffsam M. Mwendwa,
ID/No. 1378388