Taxation and State Building in Kenya: Enhancing Revenue Capacity to Advance Human Welfare

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KENYA REPORT

Tax Justice Country Report Series

This is the second in a series of country reports that tackle tax justice issues. The purpose of these reports is:

- To analyze tax structures including national tax systems, distribution of tax, and incentive structures
- To explore emerging national or regional themes
- To create specific case studies focusing on inequalities in tax systems
- To address the extent and practice of tax avoidance and evasion
- To discuss current and future tax advocacy issues.

This report on tax justice in Kenya was written by the Tax Justice Network Africa (TJN-A) and the Tax Justice Network International Secretariat (TJN-IS).

The report is based on research conducted between November 2008 and April 2009 by Attiya Waris, Matti Kohonen, Alvin Mosioma, and Jack Ranguma. It draws on their collective experience in tax administration, research and advocacy, and on doctoral research conducted by Attiya Waris on Kenyan tax history and the connections between human welfare and taxation. The report was jointly authored by all four researchers and co-edited by Matti Kohonen and Attiya Waris.

The Tax Justice Network is an independent organisation launched in the British Houses of Parliament in March 2003. TJN promotes tax justice and tax cooperation and resists tax avoidance, tax evasion and tax competition. It operates on a not-for-profit basis by bringing together organisations, social movements and individuals working towards these goals.

The Tax Justice Network for Africa is a pan-African initiative launched at the World Social Forum in Nairobi, Kenya, in 2007. TJN-A promotes socially just, democratic and progressive taxation systems in Africa. It supports the creation of equitable tax systems that are also favourable to the poor, and public finance policies that foster development. It challenges harmful tax policies and practices which favour the wealthy and encourage inequality.

We are very grateful to all who have contributed their time and knowledge to this report. We sincerely hope that we have done justice to the diverse viewpoints of those who have participated, and that you will find the report useful. Finally, thanks are due to the Department for International Development in the United Kingdom for their financial support.

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Content

Foreword

Tax is widely considered a complex subject that should be left to experts. This perception has contributed to the huge gap in information available to the public on the issues of tax and development. This report seeks to narrow this gap by providing a broad overview of key policy issues in Kenya from a tax justice perspective. The report targets Kenyan readers and anyone else who wants to understand policy issues in tax and development in Africa.

This reports starts from a human rights perspective on tax and wealth distribution. Human rights are understood in this report to encompass not just socio-political but also economic human rights. The report argues that economic human rights include the right to food, education, health security and other basic rights: achieving these rights is conditional on the availability of financial resources to fund them. Tax is therefore key to ensuring that the Kenyan state can fulfil its human rights obligations.

The report considers the policy implications for Kenya of increased dependency on domestic resources - specifically tax - as opposed to external resources like aid and debt to finance development. There has been a noticeable shift away from cost sharing policies in education, health and other services as proscribed by the Bretton Woods Institutions. Today the Kenyan government is providing free education to primary school children and subsidising secondary education and health services. This progress can be linked directly to improved revenue collection by the government.

Until recently many economic justice organisations in Kenya have focused their attention on monitoring government expenditures. The Tax Justice Network hopes to encourage these organisations to widen the scope of their work to include the revenue side of government finance. This is important because as government expenditure as a proportion of total economic activity in Kenya increases, the question of who is carrying the tax burden becomes a central justice issue. Considering the inequality that exists in Kenya today the issues of how wealth and income are taxed, and how tax can be used as an instrument for redistribution, should become core themes for all organisations seeking to achieve economic justice.

With the debate on tax and development gaining a global audience, this report provides an international context through which this debate can be applied in Kenya. The authors contend that the role of tax as a tool for development has been largely ignored in development policy-making for decades. This is now changing rapidly, as international organisation including the United Nations, the IMF, the OECD and international civil society organisations led by the global Tax Justice Network work towards bringing the tax debate to the international development arena.

This report has the following structure. First, it lays out a tax and human rights agenda, making the case for greater revenue mobilisation beyond the minimal functions of the state. Next, it considers the history of tax in Kenya, tracing how pre-independence policies have shaped attitudes to tax, including a widespread culture of non-compliance and tax evasion. The authors then link tax to demands for reducing poverty and inequality, and study the current measures of the so-called local funds, and proposals for income transfers that could address the high levels of inequalities. Finally, the report links revenue and expenditure advocacy efforts by civil society groups to proposals for a better tax dialogue, making recommendations in all areas of tax policy and in particular suggesting further research to address the data needs of analysts wanting to work on tax and development issues.

Introduction

“Governments need money. Modern governments need lots of money. How they get this money and whom they take it from are two of the most difficult political issues faced in any modern political economy” — Sven Steinmo

The Importance of Tax

We are convinced that tax systems can play a key role both in furthering democracy and in ensuring higher standards of well-being through wealth and employment creation. With this in mind, we consider tax systems here not just in terms of raising revenue, but also in terms of social development.

Tax in State Building

How can a welfare state be funded in Africa[1]? To answer this question, we need to consider the evolution of both human rights and taxation and how they relate to the African context.

The concept of the welfare state evolved in Europe as a response to industrialisation[2] and an increasingly mobile workforce who needed to be protected by the ‘Poor Laws’ and other rudimentary welfare programmes. There is a clear parallel between what happened in early nineteenth-century Europe and what is happening in Africa today, with states moving away from poverty programmes towards social security funded through taxation[3].

Before a state can protect its citizens, it needs to raise money to finance the welfare programmes it wishes to create. Sources of revenue in developing countries include not only taxation, but also other earnings such as those from state-owned enterprises and mineral royalties. Foreign aid and grants are also a major source of revenue.

In funding welfare programmes, it is advisable to keep state income and donor aid separate, both because this facilitates accountability to taxpayers and because it helps national economies to avoid falling into the trap of dependency on foreign donors. Ideally, citizens rather than donors should hold governments accountable for any failure to deliver on expenditure programmes[4].

1 Cobham 2007
2 Schumpeter 1991
3 Esping-Anderson and Korpi 1987
4 Bräutigam 2002

Declaration of the Rights of Man and Citizen - 1789

13. A common contribution is essential for the maintenance of the public forces and for the cost of administration. This should be equitably distributed among all the citizens in proportion to their means.

14. All the citizens have a right to decide, either personally or by their representatives, as to the necessity of the public contribution; to grant this freely; to know to what uses it is put; and to fix the proportion, the mode of assessment and of collection and the duration of the taxes.

— Marquis de Lafayette (adopted by the French National Constituent Assembly, 26 August 1789)

Legal rights exist as a fiscal reality only when they have budgeted costs

Human Rights and Taxation

Human rights only become more than declarations of belief when they are clearly defined, have political backing and are legally enforced. Legal rights exist as a fiscal reality only when they have budgeted costs, and they cannot be protected or enforced without public funding and support from citizens[5].

Historically, human rights discourse has distinguished between rights that 'require goods and services' and those that do not. The argument goes that civil and political rights do not require public financing, while economic and social rights do. This somewhat artificial divide has resulted in the apparent valuation of civil and political rights over economic and social rights, and in the use of a 'limitation of resources' argument to undermine the enforcement of human rights.

By participating in the international human rights framework, states agree to ensure that their constitutions, laws, policies, and budgets reflect these legal obligations[6]. But deciding on the minimum acceptable standard for each human right and quantifying the resources required to uphold it remains a major problem, one on which the enforcement of human rights frequently founders.

A new approach emerged with the rise of the 'right to development', proclaimed by the United Nations in 1986. This right alone makes explicit the link between the right and the resources required to fund it.

5 Holmes and Sunstein 1999

6 Twomey 2007

There have been various attempts over the years to set minimum standards for particular human rights. For example, the 1952 Convention of the International Labour Office (ILO) on 'Minimum Standards of Social Security'[7] listed eight essential fields of social security: medical supply, medical insurance, social insurance, old age pensions, disability pensions, surviving dependants' pensions, benefits in the case of industrial accidents and occupational disease, child allowances and legal protection of pregnant and nursing mothers.

The Millennium Development Goals, a series of eight international development goals signed up to by 192 United Nations member states and at least 23 international organizations, are an attempt to create a practical benchmark for states to work towards in implementing human rights. However these Goals, which states aim to realise by 2015, did not come with revenue commitments.

The Financing for Development process designed to support the Millennium Development Goals, along with other development goals, includes statements on various ways of mobilising revenue. The 2008 Doha Declaration on Financing for Development[8] states that:

> 'We will step up efforts to enhance tax revenues through modernized tax systems, more efficient tax collection, broadening the tax base and effectively combating tax evasion. We will undertake these efforts with an overarching view to make tax systems more pro-poor. While each country is responsible for its tax system, it is important to support national efforts in these areas by strengthening technical assistance and enhancing international cooperation and participation in addressing international tax matters, including in the area of double taxation'. UN Financing for Development, Doha Declaration – article 16.

It is above all this article that establishes the need for domestic financing for development.

7 ILO 1952

8 UN Financing for Development 2008

Social Contract

A 'social contract' is the idea that individuals 'sign up' willingly to particular moral, legal or political obligations in return for protection and services, thereby legitimizing the state.

However, in the case of ex-colonies, it can be argued there is no social contract or that social contracts are weak since the geographical borders of these states were often the result of the 'carving up' of colonies by European powers. To facilitate an easy transition from colonialism to independence, the leaders of the newly independent states often accepted these somewhat arbitrary divisions[9], but in many cases the inhabitants did not. This has resulted in the creation of both governments and populations who do not feel strongly bound by the idea of a social contract.

The Financing for Development process now includes statements on various ways of mobilising revenue – both domestic and international.

The concept of citizenship is closely related to that of the social contract in that the term 'citizen' expresses the relationship between individual and state in terms of a contract bundling together rights and obligations. Historically, there are close connections between citizenship, paying taxes, and doing military service or jury duty, for example.

The nature of the social contract has varied throughout history. Ancient Athenian citizens, for example, had their citizenship taken away for cowardice in war or for failure to pay debts to the state[10]. Whereas in nineteenth-century France, the idea of social contract was based on Enlightenment philosophy[11], in which

9 Organisation for African Unity 1963

10 McDowell 1986: 160

11 While Locke and Montesquieu drew the social contract around inalienable property at a time of autocratic royal rule, the universal

inalienable property rights were an obstacle to creating redistribution via taxation.

While Europe and America in the nineteenth century developed embryonic social welfare policies, the same standards were not applied to their colonies. As a result, in Africa, as in other developing regions, the breakdown of traditional welfare systems through social solidarity was not replaced by new central welfare programmes.

Towards Human Welfare

There remains a need to justify taxation and to legitimise its collection in some developing countries. However, this can be achieved by working towards the recognition of the need for tax collection on behalf of citizens, and the subsequent benefits of redistributing this revenue to citizens.

Strengthening domestic revenue bases is key to creating fiscal space for Africa's development. A recent IMF report argued that:

> 'Tax increases incentives for public participation in the political process and creates pressure for more accountability, better governance, and improved efficiency of government spending. Domestic revenue mobilization can help strengthen fiscal institutions.'[12]

Indeed, the authors could have concluded that domestic revenue mobilisation, coupled with representative politics is about the only way to strengthen fiscal and other state institutions.

Pay Your Taxes

The motto of the Kenya Revenue Authority captures the essence of taxation when it states: 'Kulipa Ushuru ni Kujitegemea' ('Paying taxes is being independent').

The link between taxation and development is one that civil society cannot afford to ignore any longer. Experience has shown that true development is onlysustainable 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.

Beside generating the required resources to finance the government's development agenda, taxes have a significant role to play in strengthening governance structures in the country. Through taxation, citizens have a stake in government and governments can become more responsive to the needs of their people, and less vulnerable to the whims of the donor community. These developments are in line with the domestic resource mobilisation agenda outlined in the 2008 Doha Financing for Development (FfD) declaration.

Historically, there are close connections between citizenship, paying taxes, and doing military service or jury duty

declaration of rights that came as a result of the French revolution changed the basis of the social contract. As government was by and for the citizens, also property was considered less in its inalienable form so the state could redistribute it according to democratically agreed terms.

12 Gupta and Tareq 2008

Tax System in Kenya

"Aggressive tax avoidance is a serious cancer eating into the fiscal base of many countries." — Pravin Gordhan, South African finance minister

Tax Systems in Pre-Independence Kenya

Tributes and local money taxes did exist in the native African kingdoms and among pastoral farmers, but it was only following the advent of foreign rule that systematic taxation emerged in Kenya.

The Arabs who colonised East Africa in the seventh century taxed the coastal region of East Africa on the basis of Islamic law, which upholds the right of rulers to tax within bearable limits[13]. Traders were taxed by the application of a capitation or poll tax, as well as through customs duties. The capitation tax levied on traders was calculated by charging a fixed amount for each and every slave being exported out of the Sultanate of Oman. Customs duties were charged on all goods, at a time when the major exports included cloves, ivory and beads[14].

13 Chapra 1976: 161

14 See Waris 2008 for explanation of these taxes, for Zakat see also Kuran 1995: 159

When the Portuguese started to exert control over the coast of East Africa in the fifteenth century, the terms of the treaty they agreed with the Sultan of Oman included the rights to maintain forts and garrisons, and to exercise control over revenue and customs duties and introduce settlers[15]. In addition, the Sultan was to receive one third of the customs revenue as his personal property[16]. Similar treaties were signed with other sultans including those of Mombasa, Zanzibar and Kilwa. As in Portugal, Christian clergy in East Africa were exempt from all taxes including customs duty. This provision remains in force today.

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When the British colonised East Africa in the late nineteenth century, direct taxation was introduced since external trade was minimal and customs duties would not raise enough funds for the administration, protection and welfare of settlers[17]. The British colonial policy of fiscal self-sufficiency forced colonial states to rely on locally generated tax revenue, thus increasing their dependence on settler and indigenous labour for both production and trade. In Kenya, the result was a strengthening of the links between settlers and state.

The Hut Tax Regulation of 1901 was a property tax payable by the owner or occupier of a dwelling. This was superseded in 1910 by a flat-rate Poll Tax[18] payable by individuals, which had the official intention of encouraging young unmarried men to find paid employment on settler farms in order to meet the new tax obligation and thus enter the monetary economy.

The basic non-native income tax imposed in 1921 was criticised and later abandoned only to be re-imposed in 1937 under a different guise[19]. In 1923 the first excise tax was applied on beer. However, the revenue from excise taxation only became important when sugar, tea, cigarettes and tobacco were brought into the tax net in 1931. Mining royalties were imposed in 1940, as well as indirect taxes, including import duties, excise duties, stamp duties and licences.

Despite an increasing native tax burden, an active social policy did not figure on the agenda of colonial officials or European entrepreneurs. Costs such as pensions, social security, education and health, which in twentieth-century developed nations would be met from wages or profits, were borne by the parallel Kenyan economy.

The Creation of the Kenyan State

At independence in 1963, Kenya, like India, had a decentralized and quasi-federal form of government operating under its first written constitution, based on the Westminster-style of government[20]. The new constitution was immediately seen as supporting the authoritarian administrative structure inherited from the colonial period.

However, constitutional amendments soon after independence abolished the federal system and centralised power in the office of the president. The opposition to this move, while it existed, was based on the fear of marginalisation of minority ethnic communities and therefore stressed the protection of their interests rather than the dangers inherent in centralising power in one office.

The pre-independence negotiations that paved the way for the eventual agreement by the British Crown to grant independence peacefully had several conditions: all colonial legislation, international treaties and agreements that the British Crown had undertaken on behalf of the Kenyan colony were to be adopted by the newly independent state and parliament. The only exception to this was the request that the new government re-negotiate all Double Taxation Agreements[21]. This was to favour the repatriation of profits of colonial-era enterprises back to Europe as independent Kenya gained fiscal sovereignty.

15 Gray 1957
16 Strandes 1961
17 Lugard 1913-1918
18 Protectorate of Kenya 1910
19 Lewis 2000 : 133
20 Singh 1965

This quick summary reveals the history of the fiscal architecture of Kenya.

Revenue Capacity and Fiscal Architecture

The widely held supposition that tax plays an insignificant role in funding state expenditures in Africa is incorrect.

Compared to OECD (Organisation for Economic Co-operation and Development) standards, the tax take (measured as the ratio of tax to GDP) in many African countries is relatively low today, measuring an average of 18 per cent compared to an average of 35 per cent in OECD countries[22].

However, it is important to point out that the tax to GDP ratio is on the increase in many African countries. On average it has increased from 15 per cent in the 1980s to 18 per cent in 2005[23].

It is also important to note that the ratio of tax to GDP can be a misleading measure of the overall tax take, since it does not measure the potential tax capacity, nor is tax capacity fixed by a country's geography or demography alone. It also does not take account of variation in 'tax handles' – the various opportunities authorities have to raise revenue.

> '[T]he ability to collect tax across countries may differ as a result of varying availability of tax handles and in particular because the overall level of development may differ.'[24]

Tax handles include all the issues affecting the taxable base of income, consumption, rents and wealth.

A country's revenue base is largely determined by the structure of the industries, what is produced, and the kinds of employment that go along with production. Changes in tax rates have an impact on the tax revenue collected, as do the existence of trade blocs and harmonization of tax rates between countries in a regional block.

In Kenya, as in most sub-Saharan African countries, variations in the level and composition, education and health of its population affect revenue. In particular:

1. Growth in the population requires increased expenditure on public goods, and therefore exerts pressure on the sources of revenue.
2. Advancement in technology creates the need for more sophisticated methods of collecting revenue as e-business and e-money transfers introduce avenues for shrinking revenue.
3. The distribution of population growth by age, labour force and physical location has implications for revenue.
4. Excise and VAT taxes are consumption-based revenue sources and therefore the level of population affects the total potentially taxable consumption.
5. The age distribution of the population affects the volume of consumption.
6. HIV/AIDS generally afflicts people in the most productive years of their lives, between the ages of 20 and 50, with an impact for the tax base.
7. On the government end, more resources are required as expenditure on healthcare to tackle AIDS increases.
8. A more educated population ensures a supply of trained manpower with significant implications on income tax and consumption.
9. Tax base is what is designated by the tax legislation; it can be reduced by special incentives to foreign direct investment, or increased by making taxes apply for a wider range of income and goods.

Taken together, these forces define the country's current fiscal architecture[25].

21 See Irish 1974: 299 note 24
22 Fjeldstad and Rakner 2003
23 Gupta and Tareq 2008
24 Martinez-Vazquez 2008: 191
25 Adopted from Karingi, Wanjala et al. 2004: 46-49

Table 1: Income Taxes

Income Type	Income Band/Status (in Ksh, Kenya Shilling)	Tax Rate
Employment Income (PAYE)		
	The first 121,968	10%
	The next 114,912	15 %
	The next 114,912	20 %
	The next 114,912	25 %
	All income over 466,704	30 %
Personal Income (PIT)[a)]		10 to 30%
Corporate Income (CIT)[b)]		30%
Interest, dividends, etc (WHT)[c)]		5 to 15%

a) bands apply as above, after expenses, b) after expenses, c) withholding Tax Rates apply

Source: GoK 1969 Schedule 3, 4 and 5 (These bandwidths were last amended in 2004)

Table 2: Current VAT rates

Income Type	Tax Rate
Standard VAT Rate	16%
Hotels and Restaurants	14%
Some food items, e.g. bread, flour, milk	0%

Source: GoK 1989

The Tax System in Kenya Today

Kenya at independence thus had income tax, corporation tax, trade taxes and excise taxes. Value-added taxes were introduced later.

Personal and corporate income tax

Income tax is levied on individuals, corporations and certain specified earnings. It takes the form of tax on actual earned income in the case of individuals and on company profits. A withholding tax is charged on other sources of income including royalties, dividends and rental income among others[26]. These taxes generally capture formal sector business profits and employment income only.

Income tax is divided into four separate categories: Personal Income Tax (PIT), Pay as You Earn (PAYE), Corporate Income Tax (CIT) and Withholding Tax (WHT). Personal Income Tax (PIT) is a tax on income from individual businesses paid largely by self-employed entrepreneurs. At the end of each year, they lodge their self-assessment income tax returns for their businesses to show income and deductible business expenses. They then pay PIT[27] on the profits.

Income from employment is also taxable and is subject to Pay as You Earn (PAYE). Under the PAYE system the employer, as an agent of the tax authority, is required to recover tax on employment income including the value of all benefits except medical ones. That income is taxed in full, as expenses are not deductible in the case of employment income[28]. In the cases of both PIT and PAYE, tax is charged at the same graduated scale tax rate but on different tax bases[29].

Value Added Tax

Value Added Tax is a multistage consumption tax applied to the sale of goods and services at all stages of the production and distribution chain. Only registered traders are required to charge VAT, and for a trader to qualify for registration under VAT, he or she must have an annual sales turnover of Ksh 3 million[30].

26 GoK 1969 cap 470

27 GoK 1969 section 3-4

28 GoK 1969 section 3

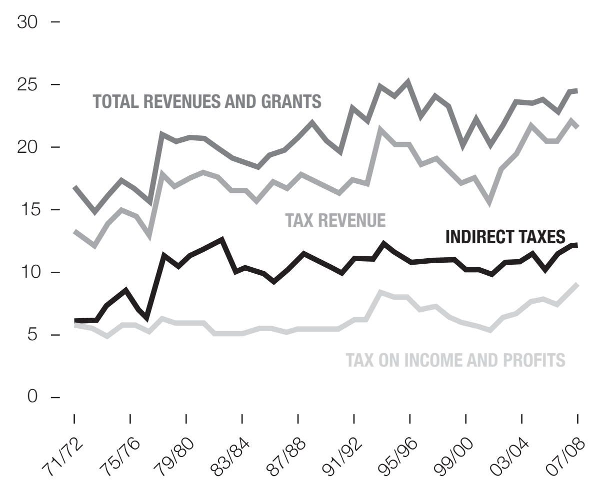
29 GoK 1969 schedule 3

Trade taxes

Trade taxes are taxes on exports and imports. Customs or import duty is the most dominant of the trade taxes and is charged on the CIF value (cost value including insurance and freight)[31] of imported goods based on tariff bands ranging from 0 to 100 per cent.

Excise tax is also a trade tax applied to either production or sale, to domestic output or imported, with either ad valorem or specific rates. Kenya's excisable commodities at the moment are alcoholic beverages, soft drinks, mobile air time, bottled water, tobacco, fuel, cosmetics, jewellery and motor vehicles. Excise tax rates are particularly high in cases where a negative impact results from consuming harmful goods or services, or in cases of luxury goods that have a lesser substitution effect even with higher tax rates.

Composition of Government Revenue 1971-2008 as a percentage of tax per GDP



Source: Prichard forthcoming, based on KIPPRA, World Bank Development Indicators, IMF

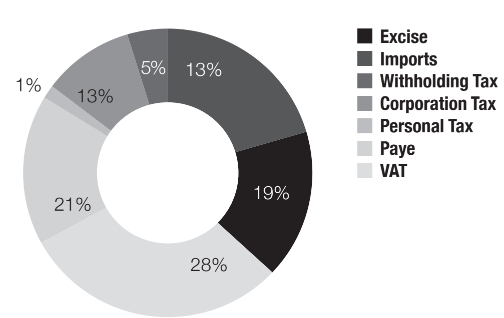
Over the last forty years, tax collection while having gradually improved has experienced large fluctuations when measured as a ratio of actual tax share of gross domestic product (GDP). Revenue collection has recently increased, and has now reached the GDP levels that existed in the early 1990s.

30 GoK 1989 section 11

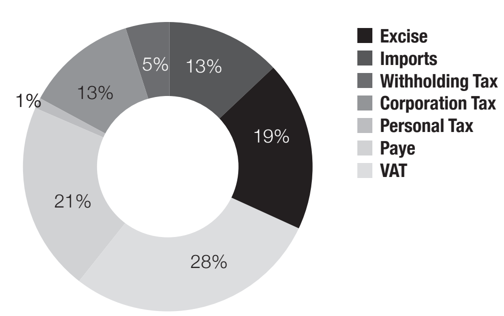
31 CIF is a tax term used to include not only the purchase price of the item in a foreign country, but also the cost of transport and the insurance cover required to allow its transport to the destination.

Figure 2: Tax revenue 2000/01; 2004/5; 2007/8

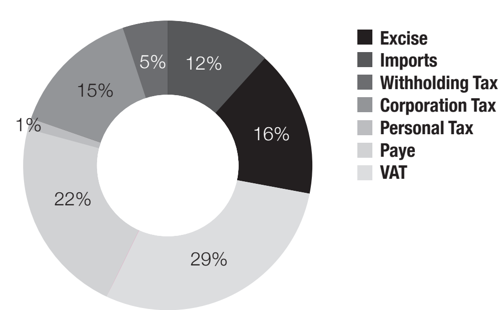
Tax per GDP in 2000/2001 per type of tax



Tax per GDP in 2004/2005 per type of tax



Tax per GDP in 2007/2008 per type of tax



Source: KRA, Various reports

Looking at Figure 2 shows that proportions of revenue collection from different sources have remained largely static throughout the last eight years. The structure of revenue collection has thus remained similar since the fiscal year 2000/2001.

Table 3: Kenya's Revenue Capacity and Tax Effort (in Ksh millions)

Type of tax	Year	Revenue Tax Effort	Capacity	Percentage
Compliance				
Personal income taxes	2000/01	46,9z	30,487	65.0%
	2001/02	48,551	32,451	66.9%
Excise tax – Beer	2000/01	7,395	6,395	85.2%
Excise tax – Cigarettes	2000/01	6,579	3,795	57.7%
	2001/02	5,389	2,806	52.1%
Import Duty	2000/01	44,651	28,664	64.2%
	2001/02	43,412	21,286	49.0%
Corporate tax	2000/01	78,730	27,359	34.8%
	2001/02	79,764	28,044	35.2%
VAT (Total tax base 451,766)	2000/01	83,309	50,381	60.4%
VAT (Total tax base 496,000)	2001/02	91,400	50,900	56.0%

Source: Karingi, Wanjala et al. 2004

Table 4: Kenya's Revenue Capacity and Tax Effort (in Ksh millions)

Type of tax	Year	Revenue Tax Capacity Ksh Million	Tax Effort/Ksh Million	Compliance Percenteage (est.)	Loss
Personal income taxes	2007/08	113,584	89,368	66.9%	24,216
Excise tax	2007/08	47,689	34,050	71.4%	13,639
Import Duty	2008/08	66,406	32,539	49.0%	33,867
Corporate tax	2007/08	163,164	57,434	35.2%	105,730
VAT	2007/08	198,228	111,008	56.0%	87,220

Source: Karingi, Wanjala et al. 2004, extrapolated to fiscal year 2007/2008 figures

Revenue Capacity Findings

Kenya's revenue capacity has been calculated by the Kenya Institute for Public Policy Research and Analysis (KIPPRA) in 2004 using 2000/2001 and 2001/2002 figures. The representative tax system methodology used in the study[32], relies on proxies for determining the tax base, and assumes an average fiscal effort and not full collection of all types of revenue. The study could be replicated, as household expenditures, census and macroeconomic modelling are kept up to date.

From Table 3 we can see that the highest level of tax collection is for beer excise duty, of which about 85 per cent is collected. Next, at a significantly lower rate comes personal income taxes which relate to Pay As You Earn (PAYE) and Personal Income Tax (PIT) collection efforts. Finally, the lowest success rate is in collecting corporate taxes, which lags behind at 35 per cent largely due to the size of the informal economy.

The tax gap between effort and capacity is a clear indicator of how much additional revenue could be raised in Kenya if a higher level of consent among taxpayers to paying taxes were to be achieved. In the case of the excise tax an average is taken between the easily collectable beer excise duty, and the cigarette duty, which, in comparison to other taxes, is relatively easily evaded through smuggling.

Assuming that tax effort did not increase in the years running up to 2007/2008, we can estimate that Kenya loses Ksh 264 billion every year in lost tax revenue, which corresponds to an average revenue effort of 44.9 per cent when revenue capacity is compared to revenue losses. This means that over half of potential revenues remain uncollected, creating a tax gap of 55.1 per cent. This is similar to government estimates[33].

32 Martinez-Vazquez and Boex 1997

In the corporate sector, an additional Ksh 106 billion could be collected. In the area of income tax, the underground economy also plays a large role, but as salaries are lower than in formal wage employment and tax rates are marginal the income tax capacity of the informal economy is lower. It is possible that the wage capacity of the underground economy is underestimated (Appendix 2: Table 1), and the potential figure could very well be much higher, in particular for the personal income taxes (PIT) which includes the self-employed.

The Underground Economy

Contrary to popular belief, the underground economy incorporates a wide range of perfectly legal activities.

Table 5: Classification of underground activities

Activity Status	Monetary transactions	Non-monetary transactions
Legal activities	Tax avoidance Unreported income Wages, salaries and assets from unreported work Under invoicing Employee discounts Fringe benefits	Tax avoidance Barter of legal goods and services All do it yourself and other unpaid help
Illegal activities	Tax evasion Trade in stolen goods Drug dealing and manufacturing Gambling and racketeering Prostitution Money laundering Counterfeiting Smuggling Fraud	Tax evasion Barter of drugs Theft for own use Production of drugs for own use Child labour

Source: KIPPRA 2007, adopted by Attiya Waris for tax terminology

To tackle the various issues involved in the underground economy, it is necessary to distinguish between legal and illegal activities, and between barter and monetary trade. In terms of scale, the legal and monetary components of the underground economy far outweigh the illegal components in most developing countries including Kenya[34].

The 'Jua Kali' sector (literally meaning the 'hot sun') provides work, housing and training for an estimated 7.9 million workers in 2008

Various trends have converged in the emergence of Kenya's underground economy, also known as the 'second economy'[35], the 'popular economy'[36], or the 'Jua Kali'[37] sector (literally meaning the 'hot sun'), which provides work, housing and training for a large part of the workforce in Kenya, estimated at 7.9 million workers in 2008[38]. The 'second economy' refers to a segregated economy, much like that in the colonial times where indigenous people were not allowed to access state protection or services. The 'popular economy' signifies activities that take place outside the state due to mistrust in state institutions and lack of representation. While the 'Jua Kali' initially referred to solidarity among craftsmen working under the sun, and thus did not include criminal activities.

The convergence of these trends mean that a vast part of the population is socially excluded from the formal economic structures, including pensions and social security. However, many of the activities in the underground economy exhibit mutual ties and social solidarity that can be harnessed for future development.

33 Waweru 2004

34 Baker 2005

35 Du Toit and Neves 2007

36 Nyssens 1997

37 King 1996

38 GoK 2009b

The Political Economy of Taxation

“Taxes are what we pay for a civilized society”— Oliver Wendell Holmes

Taxation Since Independence

During the first decade and a half of independence, the Kenyan state mainly dealt with taxation as and when there was a desperate need.

The first post-independence strategy was set out in Kenya’s earliest planning document entitled Sessional Paper No. 10 of 1965 on African Socialism and its Application to Planning in Kenya[39]. Its main purpose was to guarantee every citizen full and equal political rights. It was stated specifically that the economic approach of the government would be dominated by ensuring Africanisation of the economy and public service[40]. Among other things, this planning document declared that the government would concentrate investment in places where it was likely to maximise returns, which would subsequently be redistributed to the rest of the country.

To realise its objectives, the government promoted national unity and formulated a variety of policies through parliamentary sessional papers, special policy reports and commissions. Emphasis was placed on the roles of the urban, rural and provincial levels of government in the national economy, which required decentralised and redistributive development planning[41]. This background provided the basis for the subsequent policies.

39 GoK 1965
40 Himbara 1994
41 GoK 1965

Kenya’s Structure Plans were modelled on those devised by central planners in the 1920s, with Long Term Plans covering 15 to 20 years complemented by Short Term Plans covering five-year periods. Since then, comprehensive development plans have been prepared – largely of five-year durations – reflecting the dynamic policy environment since 1966. For example, the 1966–1970 National Development Plan established the basic structure for urban and regional planning at the provincial and district levels, leading to the distribution of technical personnel.

Thus, Kenya’s fiscal performance can be divided into two phases. The first phase, from independence in 1963 through to 1972, was a period of commendable growth with an average annual growth rate of 6.8 per cent; the country witnessed low inflation and a viable balance of payments with steadily increasing reserves. The fiscal policy carried forward from independence aimed at reducing reliance on external funding, but no real tax reforms were undertaken. Some progress was however made in expanding the tax net, as persons registered in PAYE increased, leading to a rise in the collection of income taxes. In the 1968/69 fiscal year, 42 per cent of total revenue was direct as compared to 36 per cent in 1963/4[42].

In 1970/71 the ministry changed the policy of cautionary spending and began an expansionary policy. This led in 1973 to the introduction of sales tax, which, coupled with the first oil crisis of 1973, led to an economic shock and a rising debt problem. Resulting

42 GoK1969

fiscal reforms were: 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.

The fiscal policy carried forward from independence aimed at reducing reliance on external funding, but no real tax reforms were undertaken

The collapse of the East African Community (EAC) in 1977 also required public money to form corporations and buy out others. These debts were finally paid off by the Kenyan government as recently as 1994[43]. When the second oil shock came in 1979/80, import prices once again deteriorated, leading to reduced availability of domestic credit and lower returns from agriculture and commerce, causing a large drop in revenue. The government responded by increasing sales taxes from 10 to 15 per cent and excise duties from 50 to 59 per cent, while Personal Income Tax was actually decreased from 36 to 29 per cent in response to increasing tax competition in East Africa[44].

In 1986, the government's intention was to increase tax collection to 24 per cent of GDP by 1999/2000. A review of the tax system recommended steps to favour savings and investment and to increase taxes on consumption. A further review[45] of tax revenue performance, as well as tax design and administration changes during the period 1996 to 2005, established priorities for further tax reform. It revealed the adverse effects of inflation on tax revenues, that the tax structure is less buoyant and possibly inelastic, although indirect taxes (such as VAT), and not direct taxes, have the capacity to improve the flexibility of the tax system to cope with revenue shortfalls linked to business cycles.

43 Bevan, Gunning and Collier 1990

44 Bevan, Gunning and Collier 1990

45 Moyi and Ronge 2006

Budget Policy Making

A government budget is much more than a balance sheet. It involves forecasting both revenues and expenditures under several different scenarios, providing for policy directions, costing government programmes in the planned fiscal year, and at the same time identifying resources to implement them[46].

Prior to 1970, Kenya's budget process lacked consultation and was merely an accounting exercise on revenue and spending. In 1970 the Programme Review and Forward Budget (PR&FB) was introduced to:

1. Provide concrete budget constraints
2. Establish costs for particular programmes and a process for reviewing priorities
3. Establish criteria for reviewing performance and strengthening the link between budget and planning[47].

In the 1980s, concerns were raised about the productivity of government investments. These concerns focused on the inadequacy of provision for the operation and maintenance of existing projects and a bias toward initiating new programmes, leading to a growing number of 'white elephant' mega projects. A Budget Rationalization Program (BRP) was introduced in mid 1980s to improve allocation of resources and to link budgeting to development priorities[48].

Sessional Paper No. 1 of 1986 on Economic Management for Renewed Growth strengthened the involvement of the private and informal sectors and the community in the process of economic development and planning. The introduction of Rural Trade and Production Centres helped to strengthen the implementation of the rural-urban balance strategy by emphasising the importance of rural-urban relationships and resource hinterlands.

46 Masya and Njiraini 2003

47 Nyaboke Oyugi 2005

48 Peterson 2003

However, by the late 1980s, the Kenyan parliament realised that the BRP alone was insufficient to achieve a higher level of strategic investment planning, the basis for forward budgeting. The 1990s was a time of falling tax revenues, a problem compounded by the adoption of Structural Adjustment Plans (SAPs) promoted by the World Bank and the IMF.

Thus, the Public Investment Program (PIP) was introduced in the 1990s to strengthen the forward budget by providing a more comprehensive instrument for planning and prioritization of public spending, by dividing it into three categories 'core', 'high priority' and 'other'[49]. The PIP also aimed to make the project cycle more robust, introducing revenue forecasting and aid coordination to the budgeting process. The financing of the objectives was considered in terms of debt sustainability.

Prior to 1970, Kenya's budget process lacked consultation and was merely an accounting exercise on revenue and spending

Revenue forecasting is conducted by the Kenya Revenue Authority (KRA) staff jointly with the Fiscal and Monetary Affairs Department (FMAD) of the Ministry of Finance. The forecast is based on a combination of the Economic Survey that outlines key indicators, as well as the growth estimate for various sectors. This process builds towards the Finance Bill, which is debated in parliament.

Poor forecasting, however, has been noted as one of Kenya's problems with budgetary planning, leading to poor quality development projects, partly due to internal 'earmarking' which is then aggravated by unexpected business cycles[50]. These revenue forecasts are not made public, making it significantly more difficult to monitor the revenue side of the budget.

49 Nyaboke Oyugi 2005

50 Kiringai and West 2002

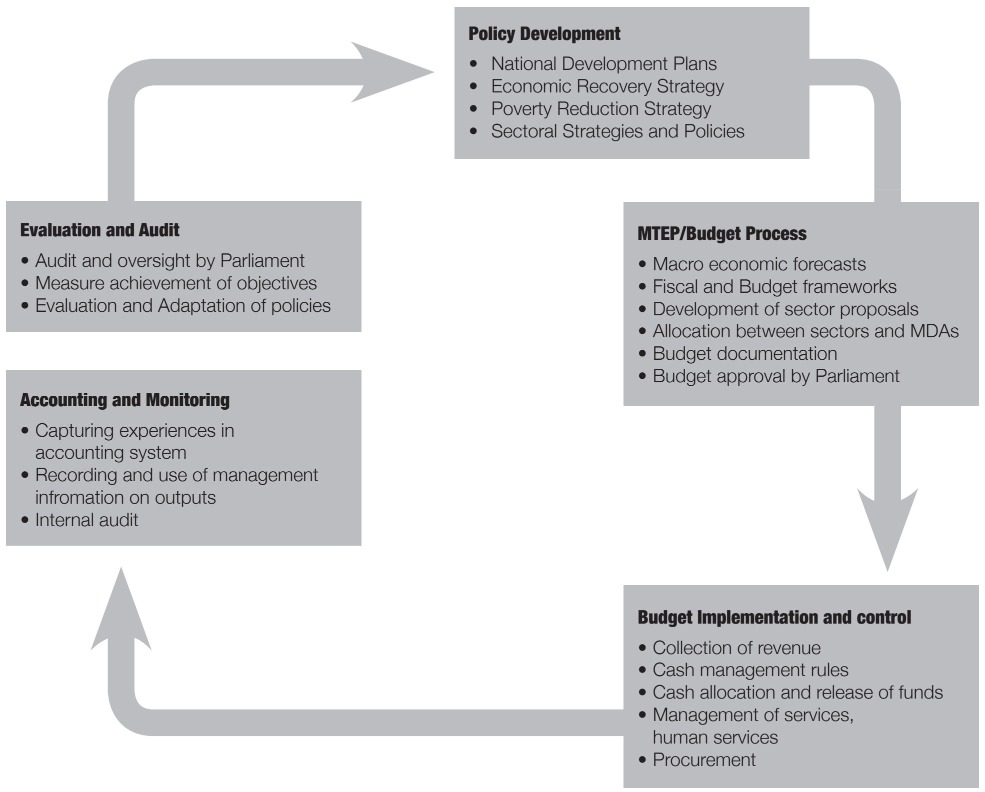
By the mid-1990s, World Bank and IMF monitoring of poverty trends confirmed the adverse effects of Structural Adjustment Plans (SAPs), leading to the introduction of the Poverty Reduction Strategy Paper (PRSP). The PRSP required governments to specifically incorporate strategies responding to citizens' views on how the poverty affecting them could be managed, but did not address revenue transparency. Kenya's PRSP was incorporated into its NARC (National Rainbow Coalition) government's strategy for reviving the economy after the poor growth years of the KANU (Kenya African National Union) regime – the Economic Recovery Strategy for Wealth and Employment Creation 2003–2007, referred to as the ERS[51].

By late 1990, it was clear that the budget was not supporting economic development. In particular, regional poverty and inequality remained high, as the composition of public expenditure was inappropriate and inefficient. In response, in 2001 the government introduced the Medium Term Expenditure Framework (MTEF) budgeting method. The MTEF Budget Framework is a significant improvement in Kenya's budgeting process. It is designed to:

- Link the annual budget, the agreed national policies and long term national development plans
- Ensure budget credibility by improving macroeconomic targets
- Improve allocation of resources to agreed strategic priorities, in sectors and ministries
- Increase the incentive for more effective and efficient utilization of resources
- Institute fiscal discipline through accountability.

51 GoK 2003b

Figure 3: Kenya's MTEF Budget Framework



Source: Adapted from Nyamunga 2008

The MTEF operational structure is comprised of a Macro Working Group (MWG) and Sector Working Groups (SWG). The MWG is responsible for preparing consistent macroeconomic forecasts, the fiscal framework, including revenue forecasts and the expenditure framework, and the more recently developed budget instruments. The MWG comprises members from key institutions responsible for macroeconomic management – the Ministry of Finance, Ministry of Planning and National Development, Central Bank of Kenya, Kenya Revenue Authority, Kenya National Bureau of Statistics, and Kenya Institute of Public Policy Research and Analysis (KIPPRA)[52].

52 GoK 2003b

Kenya and Foreign Direct Investment

Foreign Direct Investment Flows

The level of Foreign Direct Investment (FDI) flowing into Kenya has become the key indicator in the country's export-led growth model. This model assumes that foreign investments will be the key engine of domestic growth, increasing productive capacity, tax revenues and transferring skills. The success of this model has been mixed. While there have been increases in the productive capacity of the country reflected in the increasing GDP, the corporate and income taxes haven't increased, largely due to the tax incentive structures (Annex 2, Table 2). This demonstrates that FDI often does not necessarily have an immediate corresponding effect on increasing tax revenues.

FDI inflows to Kenya have not been a sustainable source of development financing as shown by the cyclical fluctuations in Annex 2 Table 3, which plots the years 1970-2007. What is noticeable from these data is that there have been three distinct cycles of FDI, 1970–1980, 1995–2000 and the current cycle of 2002–2007 that probably came to an end at the start of the global financial crisis in mid-2008. More recently, in 2000 and 2007, major privatisations or acquisitions of Kenyan companies by foreign investors took place, causing dramatic increases in recorded FDI.

Export Processing Zones and Special Economic Zones

Any investment regime that treats domestic and foreign capital differently faces difficulties due to 'ring-fencing'. Companies in Export Processing Zones (EPZs), with special labour, tax and regulatory regimes can enjoy a ten-year tax holiday at 0 per cent and a further ten-year discount at the rate of 25 per cent[53] among other exemptions. There are approximately 40 different EPZs in Kenya, encompassing a workforce of 40,000 people, mostly in the garment sector, which represents 37 per cent of enterprises and 90 per cent of EPZ jobs[54].

EPZs were created during the fiscal crisis of the early 1990s, when the World Bank provided 80 per cent of the capital needed for their establishment, the government providing the remaining 20 per cent[55]. The conditions of the World Bank loans that play a part in EPZ development mean that it is the country's citizens who will eventually have to pay such loans back, not the foreign investors installed in the EPZ zones. Quota systems also plays a role; for example, the African Growth and Opportunity Act (AGOA) passed by the USA was a major stimulus in establishing the garment industry in Kenya, and EPZs were created as a vehicle to deliver the AGOA quotas for preferential US market access[56].

According to recent estimates, the existing EPZs in Kenya do not use up the AGOA quotas, which cover over 6,500 different products, of which only 21 are currently being exported, mainly in the clothing sector. The AGOA envisages a 1.5 per cent of US market share for Sub-Saharan African produce, but this figure has not been attained in reality[57].

The policy of export-promotion focuses largely on quotas, rather than on improving the country's competitive advantages in a broader sense. Therefore opportunities for skills transfer and local economic multipliers are limited. While nominal GDP and employment may increase, the effects are not sustainable due to high dependency on preferential treatment clauses such as the AGOA. As such incentives or quotas expire, garment factories can move elsewhere, as happened recently with Tri-Star. Before being laid off, staff in Kenya trained the company's future staff in Uganda, which was offering a preferential corporate tax incentive[58].

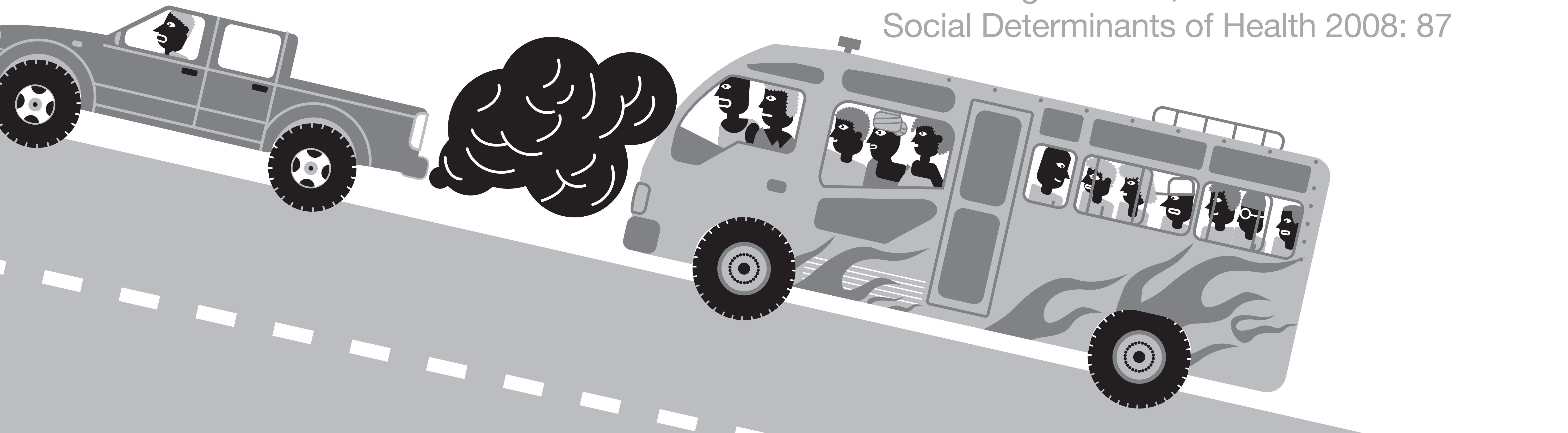
Quota and tax shopping seem to be significant factors in FDI destinations[59]. Official figures for FDI do not mention the tax incentives that are given to support FDI, and they do not measure the quality of FDI. Quantity of FDI is not a sufficient measure of success, and so monitoring the impact and quality of FDI is crucial to future economic planning, including an element of revenue forecasting.

Following a bill presented to the Kenyan parliament in August 2009, Special Economic Zones (SEZs) will replace EPZs. The goal of the SEZs is to diversify the country's manufacturing base through new incentive structures and by aligning free ports and business parks to one another as part of the 2030 strategy[60]. While EPZs have been based on the coast line, the SEZ policy envisages the creation of the Athi Basin Industrial Corridor from Nairobi to Mombasa, along the railway line, as well as dedicated industrial parks within the country. Many of the plans cite diversification and industrialisation as the main objectives, but most do not mention tax holidays, export tax breaks, and other regulatory incentives, which in India for example have been the driving force behind SEZs.[61].

53 GoK 1990
54 Ouma, de Feyter, et al 2008
55 Mireri 2000
56 Omolo 2006
57 Anami 2009
58 Ouma 2008
59 UNCTAD 2005: 25; 100
60 Oyuke 2009
61 Johnson 2006

Taxes and inequalities: the missing link

"Evidence suggests that income redistribution, via taxes and transfers, the latter of which are key to social protection, are more efficient for poverty reduction than economic growth per se." — World Health Organisation, Commission on Social Determinants of Health 2008: 87



The Crisis of the Fiscal State

A 'fiscal state' is one that uses taxation and similar forms of revenue in order to obtain adequate income for its survival and development. Fiscal historians describe how different fiscal crises across the ages have pushed states into evolving new kinds of relationships with their citizens[62].

The Kenyan state can currently be considered as being in a period of fiscal expansion, which follows the previous fiscal crisis of the 1980s[63]. As a result of this crisis, taxpayers were unhappy with the high rate of income tax. This resulted in the state capping income tax at 40 per cent[64] and developing local funds, in particular the Constituency Development Fund (CDF), similar to the Development Levy in Tanzania[65].

The process of fund creation in developing countries such as Kenya and Tanzania points to a process by which their respective governments attempt to re-legitimise the collection and disbursement of tax revenue by the state.

Ring-fencing of Revenue and Expenditure

The main reasons for ring-fencing are the legitimisation of new levies and taxes both towards the parliament and the taxpayers by creating dedicated funds through which they would be used, and the demise of direct budget support from foreign aid donors and corresponding move towards disbursing aid to specialist funds.

Ring-fencing occurs on both the revenue and expenditure sides of public finance, and while the discussion here has so far focused predominantly on expenditure, it is also worth looking at the ring-fencing of revenue.

While supporters of the practice of ring-fencing point to the benefits of targeted and locally managed expenditure, opponents say it diverts attention from more difficult aspects of tax policy, for instance corporate and personal income taxes. Also, ring-fencing tends to favour highly visible aspects of expenditure, such as roads and primary education, while neglecting less visible areas such as maternal care and public security. Finally, the tax burden created by these programmes is worthy of further study, both in terms of the immediate impacts and the long-run sustainability of these programmes.

the issue of local funds has created an unprecedented public debate that has raised awareness about taxation among ordinary Kenyans in recent years

Nevertheless, it is clear that the issue of local funds has created an unprecedented public debate that has raised awareness about taxation among ordinary Kenyans in recent years. Interest groups have been established focusing on issues relating to the allocation of specialist funds, and members have started to consider the sources of these funds.

Kenya has the following decentralised funds:

- Secondary School Education Bursary Fund (launched in 1993/94);
- Road Maintenance Levy Fund (1994)[66];
- Rural Electrification Programme Levy Fund (1998; but active from the late 1970s);
- Local Authority Transfer Fund (1999);
- District/Constituency HIV/AIDS fund (1999);
- Constituency Development Fund (2003)[67];
- Free Primary Education Fund (2003).[68]

The Secondary School Education Bursary Fund (SEBF) was re-launched in 1993/94, after a previous scheme had dwindled with the economic stagnation of the 1980s. Its special focus is orphans, children from slums, arid and semi-arid lands and girls. Revenue to this fund is collected from ordinary tax revenue, on the basis of needs assessment from Constituency Bursary Committees.

A second education fund covered Free Primary Education (FPE). Founded on the incoming National Rainbow Coalition's (NARC) 2002 election promise rather than any substantive law, FPE has since been incorporated into the education ministry's KESSP 2005–2010 and Sessional Paper No. 1 of 2006. In line with donor MDG commitments the scheme received nearly Ksh 4.5 billion for capital investment in its first operational year[69] while government spending was also raised, with education accounting for 7.1 per cent of GDP in 2003/2004, significant in an African context.

A 1993 Act of Parliament established the Road Maintenance Levy Fund (RMLF) targeting roads under the control of the Ministry of Roads and Public Works, Kenya Wildlife Services, and district roads committees. Originally collected at toll booths across the country, mismanagement of RMLF revenues led to the creation in 1999 of the Kenya Roads Board to manage revenues collected as levies on fuel purchases. Originally set at Ksh 1.50 per litre for petrol and Ksh 1.00 per litre for diesel, the rate for this levy has since been increased several times, most recently in the 2006/07 financial year, which saw a rise from about Ksh 5.80 to Ksh 9.00 per litre for both petrol and diesel, raising some Ksh 18 billion in 2007/8[70].

In 1998, the Rural Electrification Programme Levy Fund (REPLF) was established to improve the rural coverage of the network, focusing on market centres and public institutions[71]. The revenues are collected through a 5 per cent charge on electricity company revenues, up from 2 per cent in the previous scheme, which was replaced under the terms of the 1997 Electric Power Act.

The Local Authority Transfer Fund (LATF) was launched in 1999[72]. It is a block grant based on 5 per cent of the Pay as You Earn to improve service delivery and financial scrutiny in local authorities. LATF incorporated the Local Authority Service Delivery Action Plan (LASDAP) to focus expenditure of this grant, which currently accounts for approximately 25 per cent of these authorities' resources. As the revenue is drawn directly from PAYE it can be seen as a form of municipal taxation, with the distinction that local authorities have little autonomy over the expenditure of these resources as they are linked to national poverty reduction plans.

The Constituency Development Fund (CDF) was established in 2003. In the fiscal year 2008/2009 the CDF allocation stood at about Ksh 10.1 billion[73]. The CDF is calculated as 2.5 per cent of ordinary government revenue. In the fiscal year 2008/2009 funds were still allocated according to the 1997 census figures due to lack of more up-to-date data, which became available during 2009. The measurement of poverty in the country has a real impact on the allocation of funds directed to the CDF, as the fund's primary objective is the reduction of poverty in Kenya.

The Constituency Development Fund (CDF) is calculated at 2.5 per cent of ordinary government revenue.

The Government declared HIV/AIDS a 'national disaster' in 1998 requiring more focused attention and leading to a Presidential Order in Legal Notice No. 170. The National AIDS Control Council was set up to streamline the pandemic's management, leading to AIDS Control Units in all ministries, administration levels and constituencies. This led to the 1999 establishment of the District/Constituency HIV/AIDS Fund, which has successfully gained two consecutive five-year grants from the Global Fund for AIDS, Malaria and Tuberculosis, first in 2003 and then in 2008, for US$ 68 million and US$118 million respectively. Other donors have also contributed to the fund.

62 Ormrod, Bonney and Bonney 1999
63 Esping-Andersen 1990
64 Messere 1998
65 Fjeldstad 2002
66 GoK 1993
67 GoK 2003a
68 KIPPRA 2006
69 Sawamura and Sifuna 2008
70 Institute for Economic Affairs 2008
71 GoK 1997
72 GoK 1998
73 GoK 2009a

Decentralisation should be supported when it leads to better representation, which we believe to be one of the key objectives of taxation. While decentralisation and ring-fencing can contribute to better representation, they should adopt the long-term objective of creating more open and transparent tax systems at all levels, and of moving towards fairer local taxation systems, under which local authorities will gain a share of certain taxes for their own use without intermediaries.

Addressing Poverty and Inequalities

Social inequality is a key indicator of the health of the fiscal state. In Kenya, the definition of poverty is based on consumption of a basket of goods that represents a level of minimum nutritional requirements, and the cost of meeting basic non-food needs. A poverty line of Ksh 1,239 is derived for rural households and Ksh 2,648[74] for urban households per person in monthly expenditure[75]. This poverty line is constantly moving as the expense of goods considered essential for meeting basic needs changes.

Measuring Poverty and Inequalities

The evolution of poverty reduction measures have been traced in two comprehensive studies. In the 1997 Welfare Monitoring Survey, poverty measured in the manner outlined above suggests that 53 per cent of the Kenyan population were living below the poverty line, which variations ranging from 31 per cent in Central Province and 44 per cent in Nairobi to 65 per cent in Nyanza, and 64 per cent in the North Eastern Provinces.

These data were then updated in the Kenya Integrated Household Budget Survey (KIHBS) 2005/2006, which indicated that the percentage of Kenyans living below the poverty line had fallen to 45.9 per cent[76], while in absolute numbers it had increased from 13.4 million to 16.5 million citizens due to population growth.

Kenya also has a high degree of income inequality.

74 For present value poverty line figures, the sum should be adjusted to inflation, but these sums are still serve as the bench marks.

75 GoK 2005: 5

76 GoK 2006: 8

Kenya's Gini coefficient[77] of income inequality per capita stands at 62.5[78], which is significantly above the African average and among the highest in the world. Inequality between regions is high, with the highest concentrations of wealth in the Rift Valley, Eastern and Western Regions; and inequality remains more extreme in rural areas than in the urban areas, owing to the growth of the middle class in major cities and a wider formal sector employment structure that includes some elements of social protection, thereby reducing inequalities.

Table 8 : Gini Coefficients by Geographical Regions:

Region	Household income	Per Capita Income	Household Expenditure	Per Capita Expenditure
Nairobi	58.6	58.6	56.5	55.6
Central	51.6	55.8	51.4	54.1
Coast	51.1	59.5	45.0	55.9
Eastern	57.1	62.5	54.5	58.0
N. Eastern	43.9	47.3	40.6	51.6
Nyanza	56.3	58.1	57.4	59.9
R. Valley	57.5	63.0	56.1	61.6
Western	58.6	60.4	55.8	57.6
Total	57.1	62.5	55.8	61.2
Rural	54.9	57.7	54.1	56.1
Urban	54.0	55.4	49.6	51.9

Source: Chanyisa Chune 2003: 10

In contrast to poverty, inequalities provide a picture of how Kenyan citizens compare to each other in relative terms rather than against an absolute poverty line. The relative measure is important since it allows us to consider the bargaining power of different political forces involved in taxation and other advocacy efforts.

The most robust way to measure inequalities is by looking at actual incomes. In Kenya, this means looking at the 1998/1999 Integrated Labour Force Survey (ILFS)[79], and the data in the Welfare Monitoring Survey (WMS) 1997, which uses expenditure as a proxy to

77 The Gini index measures income inequality, and in the measure 100 represents absolute inequality, while 0 means absolute equality of income

78 Chanyisa Chune 2003

79 GoK 2001

measure income, as is the practice in many low-income countries where accurate employment data is lacking. Generally speaking, expenditure data tend to mask income inequality, since those in the lowest income brackets may benefit from food and money transfers from family and relations, while those earning the most may be living abroad and their expenditure may be split between the country where they are working and where their family lives.

Here we adopt the figures of the ILFS which uses actual income data rather than using expenditure as a proxy. The resulting Gini coefficient from the ILFS is of 64.0[80] or 62.5[81] depending on method of calculation. The WMS gives a much lower figure of 42.5, which has subsequently been adopted in official statistics and the UNDP Human Development Report.

The difference between the highest and lowest 10 per cent in terms of expenditure in the WMS is a multiple of 13.6, while based on incomes in the ILFS the difference is of an order of 56.21[82]. This is roughly equivalent to the situation in other transitional states such as Brazil (51.3) and El Salvador (57.5), while not as unequal as Namibia (128.8)[83]. In Kenya the top ten per cent of households earns 42.72 per cent of the total income, while the bottom ten per cent earns only 0.76 per cent[84]. This phenomenon is also known as the 'missing middle'[85], where the progression of income inequality is not linear, but skewed at the top and the bottom.

Reducing Poverty and Inequalities

The possibility of an income transfer programme, under which money is allocated to poor families with children, is often brought up as a feasible method of redistributing wealth, modelled on the Brazilian 'Bolsa Familia'. This would target poverty through a transfer of Ksh 759 per qualifying household (Ksh 350 per school age child), reducing inequality (projected Gini index from 64 to 61), and effectively targeting most households under the poverty line. A similar scheme is presented in the

80 Zepada 2007

81 Chanyisa Chune 2003: 10

82 Society of International Development 2004

83 UNDP 2007

84 Society of International Development 2004

85 Birdsall 2007

2005 UNDP Human Development Report, under which a projected 5 million people would escape poverty in Kenya as a result of a 7.0 per cent transfer in total household incomes to the poorest[86]. The cost of the programme is calculated at 2.8 per cent of total household revenue.

The difference between the highest and lowest 10 per cent in terms of expenditure is a multiple of 13.6, while based on incomes the difference is a multiple of 56.12

Both these money transfer programmes propose targeting the top 20 per cent of tax payers, who have benefited most from economic growth. This would mean raising the level of income tax for higher earners, with the top 20 per cent paying 40 per cent income tax rather than the current 30 per cent. Other possible means of raising the required money include raising the effectiveness of tax collection, which may be a preferable option in the first instance as much of existing tax capacity isn't tapped into.

Income transfer would bring many of the poorest people into a direct revenue bargaining position towards the state. They would have to justify their benefits and demonstrate that they were meeting obligations such as school attendance, child vaccination, and family visits to health clinics, including in some cases testing for HIV / AIDS status. These are all measures which will result in long-term human development improvements and introduce the social contract to more citizens on a practical level. Such a scheme has it critics, in particular some warn of the potential for infringing people's privacy and civil liberties.

Capital Flight and Tax Evasion

Illicit capital flight is one of the most pressing concerns

86 Zepada 2007; UNDP 2005

when attempting to raise both the tax effort and levels of tax compliance among top earners. The same phenomenon applies to company taxation. Kenya has its share of large taxpayers, many of whom are likely to avoid their responsibilities by placing both their wealth and property outside of Kenya, while still living and working in the country. This phenomenon is commonly known as capital flight, and it is only illicit if the capital that has been moved abroad is of criminal origin, is transferred illegally, or illegally utilised[87]. Measuring illicit capital flight is difficult and often employs proxies such as unrecorded financial flows.

Global Financial Integrity, a US-based think-tank, estimates that illicit financial flows from developing countries amount to US$900 billion per year[88], of which only three per cent is identified in the data as originating from sub-Saharan Africa. This gives us an annual figure of approximately US$30 billion of capital leaving the country illegally, which corresponds precisely to the annual flow of aid into the same region. The figure is an understatement according to the authors, since the limitation of available data mean that overall sums are conservative estimates. The think tank's methodology focuses on balances of payments, trade statistics and international price monitoring data in order to determine 'trade mispricing'. Trade mispricing involves manipulating import and export prices to keep profits low in countries where they will incur a higher level of tax.

Meanwhile, according to a recent estimate by Boyce and Ndikumana, the legal capital flight out of 40 sub-Saharan African countries between 1970 and 2004 amounted to US$607 billion (including implicit interest earnings). This exceeds the debt stock of the same region by a factor of 2.9 and equates to an annual lost capital stock of US$18 billion (not taking into account depreciation). Africa therefore can be considered a net creditor to the rest of the world. For gross capital formation, this means that accumulation of physical as well as investment capital in Africa is seriously impeded. These figures exclude the 'unrecorded' or 'illicit' aspects of capital flows.

Examining the components of illicit capital flight, we found two interesting studies currently underway. The first looks at trade mispricing, and the second looks at wealth held offshore. The common feature in both cases is the extensive use made of tax havens – also known as 'secrecy jurisdictions' because of their lack of disclosure. Christian Aid has estimated that developing countries as a whole lose US$160 billion due to trade mispricing[89] and false invoicing, two of the largest components of illicit financial flows, comprising 45 per cent of total illicit financial flows[90]. The share of low-income countries is estimated at US$22.4 billion constituting a significant outflow, although country level estimates are not available.

A second study looks into statistics analysing trade between developing nations and their major trading partners. The astonishing results suggest that between 2005 and 2007 Kenya lost an average of US$17.60 million annually in tax revenues due to bilateral trade mispricing with the 27 European Union nations and the USA[91]. Capital outflow is also measured: US$16.5 million annually to the EU's 27 nations, while the amount to the USA was US$4.55 million. With current exchange rates the proportion of tax losses to annual capital flow resulting from bilateral trade mispricing is 82 per cent for Kenya. This means that nearly all trade mispricing is purely profit shifting in the Kenyan case.

Finally, there is the issue of private wealth held offshore which globally represents US$11.5 trillion[92] of which estimates for sub-Saharan Africa may constitute up to US$270 billion[93]. The Kenyan share of this is difficult to calculate because national studies have not been conducted. The available data come from studies of private wealth of High Net Worth Individuals (HNWI), meaning persons who have liquid assets of over and above US$1 million, calculated as the total wealth excluding fixed assets such as houses of residence. The World Wealth Report 2008 estimated that there are about 101,000 Africans in this category, growing at an annual pace of 10 per cent[94]. Of these, 2.0 per cent are considered as Ultra-HNWI, persons who have over US$30 million in financial assets, or only 2170 persons on the entire continent. This is an underestimate, since assets of wealthy and especially ultra-wealthy Africans are likely to be spread to various family members, while trust funds or incorporated accounts are not identifiable to a single person.

In the absence of a country by country break-down, it is hard to know how much of the total private wealth held offshore can be attributed to Kenya. In addition, the absence of capital gains taxes in Kenya means that some offshore earnings may be exempted from tax.

The establishment of a rights-based society requires a commitment to redistribution

The private wealth of an average Kenyan adult is US$7,878 (in Purchasing Power Parity terms)[95], distributed across the population in an even more unequal manner than income (wealth Gini index 69.9). But this figure does not include estimates of wealth held offshore, since household income and wealth surveys do not attempt to correct for capital flight, or assets held offshore.

These wealth inequalities are both a cause and a consequence of a lack of tax justice. Firstly, if there were a well-administered progressive income tax in Kenya, income inequalities would be significantly reduced. Secondly, with better international tax cooperation, Kenya would be able to tax capital gains and wealth held offshore. The low level of corporate tax payment is inherently linked to the practice of trade mispricing, with the majority of capital flight linked to profit shifting.

Rebirth of a Nation

The Kenyan government faces increasing pressure from Kenyan citizens to tackle poverty and wealth inequality. To maintain social stability it will need to engage more effectively with even the poorest citizens, not on the basis of ethnicity or family affiliation, but as citizens with rights and duties.

The establishment of a rights-based society requires a commitment to redistribution. As agendas shift and democracy matures in Kenya, human welfare and redistribution emerge as key agendas to be considered in the public sphere. Redistribution is a logical continuation of the rights-based agenda, as outlined by the sociologist T.H. Marshall in describing the development of the welfare state in Europe[96]. Similar development in Kenya is neither impossible nor utopian, and should form the basis of a welfare agenda.

87 Baker 2003, Baker 2005

88 Kar and Cartwright-Smith 2008

89 Christian Aid 2008; transfer mispricing denotes the practices of internal book-keeping, underpricing or overpricing of cross-border trade between subsidiaries of the same TNC.

90 Baker 2005: 172

91 Christian Aid 2009

92 Tax Justice Network 2005

93 Baker 2005: 164, extrapolated based on the US$ 11.5 trillion figure

94 Merrill Lynch and CapGemini 2008

95 Davies et al. 2007

96 Marshall 1950

The Role of Tax Advocacy

"Massive poverty and obscene inequality are such terrible scourges of our times... that they have to rank alongside slavery and apartheid as social evils." — Nelson Mandela, former president of South Africa

General Issues

To tackle injustice we need to find strategies to address the factors that cause injustice. This includes tackling external factors such as the lack of transparency in international accounting standards, offshore assets and structures, and banking transactions. These factors place the Kenyan government in a position where it is incapable of delivering even minimum standards of social protection for ordinary people.

However, tax advocacy is typically focused on the national sphere, since it is national governments which levy and spend most taxes. For tax advocates, this means understanding the local tax system and its incentive structures, the process of revenue and expenditure bargaining, and in particular the budget making process in detail, and being able to find entry points to campaign for reform.

It is through taxation that citizens and the state engage in a bargaining process whereby citizens comply with tax demands in return for some form of institutionalised influence over the level, form and usage of tax revenue[97]. The wider the tax base, the more diverse the stakeholders engaged in the tax bargaining process. The process creates a citizenry that is more watchful in monitoring government activities, improving the overall transparency and accountability.

Tax advocacy can be an effective tool for furthering economic justice. It is often the case that poor tax payer morale is linked to poor service delivery. But the opposite is also the case, tax payments increase when tangible benefits are available. This can be demonstrated by the case of Freetown, Sierra Leone, where the mayor's popularity and high standard of service delivery has been cited as the reason people are lining up to pay taxes[98].

National Tax Advocacy

The fiscal policy arena in many developing countries and particularly in Africa has so far failed to attract participation from wider society. Discussions and debates are limited to a small group of specialist organisations: government bureaucrats, professional associations, multilateral and regional organisations, and industry representatives. In Kenya, as in many African countries, debates about the role of tax in achieving social goals have been largely absent[99]. But ordinary Kenyans

97 Moore 2007

98 Everest-Philips 2008, however, recently in March 2009, the inauguration of a clock tower costing £45,000 in East End Place of Freetown has been perceived as a waste of resources, and tax payer enthusiasm has dramatically reduced.

99 Moore 2004

have a legitimate right to have their say on how taxes are collected and spent, and to organise themselves into advocacy groups to make their voices heard.

Academics[100] refer to a 'trilemma' facing African countries with regard to tax:

1. Governments are under pressure to generate more revenues to provide and maintain public services;
2. Those with political power and wealth do not want to pay taxes;
3. Those without political power are the poor majority who pay a disproportionate amount of their household income in the form of sales taxes and other indirect levies.

In Kenya, as in many African countries, debates about the role of tax in achieving social goals have been largely absent

Solving this trilemma requires analysis of the diverse players in tax policy, and specific proposals for improving political representation.

Corporate Lobbyists

Paying all due taxes is the foremost corporate responsibility of all firms, whether foreign affiliates or home grown. In Kenya, the tax gap of the corporate sector was found to be wider than the gap for any other category, highlighting the fact that there is much room for improvement in paying and collecting corporation taxes.

Private sector companies organised under the Kenya Association of Manufacturers (KAM) and the Kenya Private Sector Alliance (KEPSA) have managed through negotiations and involvement in high-level government policy-making structures to influence government decisions on tax policy. Forceful lobbying by big companies, backed by financial might, makes them highly persuasive.

100 Fjeldstad and Rakner 2003

One example of the power of companies to influence tax policy in Kenya involved the passing of the tobacco act. Cigarettes manufactures were involved in directly lobbying parliamentarians not to pass the bill. British American Tobacco's (BAT) regional director stated: 'the law was actually drafted by us but the government is to be congratulated on its wise actions'[101]. In this case, the company's involvement in tax policy is well documented and relatively public. In others, it is not so obvious.

It is not only companies that receive tax incentives: wealthy home buyers can benefit from a tax incentive through special loans programmes[102]. The Home Ownership Savings Plan (HOSP) leaves many of the financial intermediaries outside the proposed law, effectively excluding savings and credit cooperatives (SACCOs) and state housing investment funds such as National Housing Corporation (NHC) and National Social Security Fund (NSSF) that target the wage workers and the rural populations.

Savings and credit cooperatives (SACCOs) have brought small-scale financial services to many low-income households, especially in rural market towns. The Kenyan cooperative credit movement is the largest in Africa with Ksh 170 billion in savings, representing 20 per cent of total savings[103]. Further assistance given to the cooperative movement in terms of legislative recognition, specialist regulation and relevant business advice would help to extend benefits for the mainly rural population of Kenya.

Foreign Investors

While domestic industries and the Trade Negotiations Committee and their domestic subsidiaries play a disproportionate role in shaping tax policy, the influence of foreign investors is often even more troubling. The tax tug-of-war situation between Kenya, Uganda and Tanzania (and in some industries Ethiopia and Rwanda) has resulted in a bidding competition between states to provide the most generous tax incentive regimes without any real assessment of the costs associated, nor the transparency of the actual agreements signed with investors. This is especially evident in the horticulture[104] and garment sectors.

101 Patel, Collin and Gilmore 2007
102 Khalif 2007
103 KUSCO 2009

The queue of companies wanting tax deductions seems to outpace their enthusiasm towards the Kenya Revenue Authority (KRA)

Tax incentives are better seen as tax privileges, since they create an uneven playing field between domestic and foreign-owned enterprises operating in Kenya. The implementation of the Export Processing Zones (EPZs) in Kenya provides a useful illustration of how this works[105]. The problem with EPZs is that they provide a platform for 'footloose' multinationals[106] that seek tax incentives rather than real and lasting productivity or value-added gains in the destination economies. Once tax incentives expire they may move next door to a neighbouring country or reapply under a different name.

Another example is that of the lobbying power of GSM Africa, the group of mobile phone manufacturers and operators within Africa who are calling for lower excise and import duties on mobile phones on the basis of their potential for growth multiplier effects constituting up to 5 per cent of GDP in 2006[107]. Half of this is considered to be a productivity increase, while a significant part of the remaining is in employment created for vending and handling of airtime commissions.

GSM Africa argues that by reducing the airtime excise tax in East Africa, an additional growth effect of 1.3 per cent on GDP would be experienced in a decade, while the tax decrease would pay itself out within six years in increased government revenues. Reduced prices would increase profitability and allow for increased investment to widen the coverage of mobile networks.

104 Ouma et alii. 2008
105 Ouma et alii. 2008
106 Rolfe and Woodward 2005
107 GSM Association 2007; GSM Association 2009

However, the argument has its flaws; even taking the calculation at face value, the question remains how to replace lost government revenue during the years when revenues would decrease. Unless other taxes are increased, the government would have to increase borrowing. This was also the case when trade taxes were removed by WTO treaties in the mid 1990s, which led to the adoption of the VAT regime that actually makes the bulk of mobile airtime taxes (16 per cent) rather than the excise tax (10 per cent).

Perhaps before asking for tax cuts, it might also help if the mobile phone companies and operators were to publish the amount of their tax payments in their annual reports. The queue of companies wanting tax deductions seems to outpace their enthusiasm towards the KRA.

Underground Operators

The government uses 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. A more pluralistic approach – tackling illegality, while at the same time strengthening capacity and dialogue with the legal part of the underground economy – would have clear advantages.

As mentioned above, the Jua Kali component of the underground economy originated in solidarity among craftsmen working 'under the hot sun' rather than in any criminal activity. The government should provide shelter to these activities by extending business counselling services to workers, studying the revenue potential of the sector, and then taxing them fairly in exchange for legal status and protection. Many Jua Kali operators would not reach the minimum tax threshold for PAYE, PIT or in some cases the VAT, so they would only be liable to registration, licence fees and regulation. However, regulating the sector through tax registration would help the government to identify larger transactions and operators.

Other aspects of the informal economy relate to pastoral farming, where the structures of the formal economy are hard for people to access. One solution here would be to bring the state closer to the people, rather than trying to enforce the opposite. Taxation at community level has been a source of contention in many countries including Uganda. It is often viewed as a double taxation and an over burdening of already overtaxed poor people. To counter this and encourage formal participation in the taxation system, the government could provide incentives such as credit facilities to small entrepreneurs, with the possibility of selling goods and services to government through micro-enterprise procurement.

Members of Parliament

The political elite in Kenya have in the past argued for near diplomatic immunity from paying taxes, thus removing themselves from the responsibilities imposed on most ordinary Kenyans.

The justification they give for being exempt from taxes is that the expectations of constituency members that comes with their position, means that they have to give direct social assistance to ordinary people from their salaries. This argument is one that ignores the role of the state as the provider of social assistance, where the role of the MPs should not be to circumvent the state's role, but to assist the state to perform better and provide information for citizens to access public services.

The Constituency Development Fund (CDF), to which approximately 2.5 per cent of ordinary government revenue is allocated, should remove the personal social assistance burden that MPs feel towards their constituency members. Indeed the CDF is a Kenyan solution to a typical problem that exists in countries where the role of the state is not well defined through the social contract, where rights and responsibilities are attached to personal forms of solidarity, social assistance and extended-family based welfare models.

The role of MPs, district level representatives and municipal councillors needs to be more clearly defined to include an oversight role towards the institutions that make up the state. When the Kenyan Parliament makes an inquiry about the functioning of the tax system, the civil service must abide by the authority of the Parliament and provide the relevant information. For instance, MPs should be able to make information requests on behalf of their citizens into the workings of the tax incentive systems, the concessions given to TNCs and other foreign investors, and all tax privileges including their own extraordinary concessions.

Taxation in Kenya should be based on a rights-based approach to providing increased social services funded by tax revenues

Transparency and accountability begin at the level of ordinary citizens wanting to know about the affairs of their government, and their questions being answered within reasonable timelines and adequate quality. The Freedom of Information Act does provide a platform for ordinary citizens to ask what their executive is doing on their behalf. Such requests also often require the help and political support of parliamentarians, and other elected representatives.

The Individual

In conclusion, taxation in Kenya should be based on a rights-based approach to providing increased social services funded by tax revenues. The tax agenda should be presented to all stakeholders as an opportunity to build upon the grass-roots potential of tax advocacy, as well as to plug leaks at national and international level. In the effort to build a fiscal state which can respond to the increasing demands of its citizens, high level initiatives such as reporting standards and asset recovery programmes need to be complemented by learning from grass roots rights-based groups and campaigns that are active on the ground.

Linking Revenue and Expenditure Monitoring

To strengthen the social contract, the link between revenue and expenditure needs to made clear to taxpayers. Campaigns to improve public services often fail to take the opportunity to points out the link between tax and public services.

The International Budget Project (IBP), a vast regional network for tax advocacy, state in their manual 'A Guide to Tax Work for NGOs' that:

> 'CSOs (civil society organisations) can help broaden the debate and bring a new focus on fairness and needs of the disadvantaged to the discussion of tax policy.'[108]

The manual encourages groups that have been hitherto focused on budget analysis and monitoring to expand their scope to consider how governments raise revenue. This area of tax advocacy is currently underdeveloped.

Providing decent living conditions

The W Nairobi W! Campaign,[109] based in the Nairobi slum of Korogocho, was launched in 2004 to stop the Kenyan government's programme of mass evictions and demolition of the slums of Nairobi. The second stage of their campaign has focused on funding issues, the rehabilitation of the slums and land redistribution.

So far, the Campaign have made appeals to international donor agencies, in particular Italian Cooperation who now fund the Korogocho Slum Upgrading Programme (KSUP) working together with the Kenyan Government. Improving service delivery was pegged to the availability of external financing, with strict monitoring requirements. Campaigns and petitions to the city council and the national government failed due to lack of political will – but also to the lack of taxpayer representation.

If the Campaign were to calculate the sum of taxes paid by Korogocho inhabitants, or stage a tax protest, the government might perhaps be more inclined to listen to their demands. Korogocho is well known for active social and faith-based associations, and a vibrant cultural scene in the heart of Nairobi. Nevertheless, the W Nairobi W! Campaign relies on outside sources and not on the social solidarity of Nairobi residents. The public leaders of the campaign are church-based advocacy groups, as well as two Italian priests who live in Korogocho and are active in the campaign both in the practical and the fund-raising sense.

Campaigns to improve public services often fail to take the opportunity to points out the link between tax and public services

Being able to benefit from international aid flows and other innovative development financing, such as fair trade and artisanal goods sold abroad, is a significant source of additional development revenue. However, the very same residents also pay rent on which their landlords do not pay property taxes. These taxes, if implemented, could be put into a special fund to improve housing conditions.

An example of successful collective resistance against government demands came in 1995, when a residents' association representing the Nairobi suburbs of Karen and Langata sued the Nairobi City Council. Motivating the lawsuit was the City Council's failure to supply the Karen and Langata District Association with budgetary records detailing how their tax revenue was being spent. Residents complained that garbage went uncollected, roads had deteriorated, water supplies were unreliable and sewage pipes frequently burst and remained unattended. The association demanded accountability for the Ksh 803 million (US$13.3 million) in annual service charges the Nairobi City Council collects from ratepayers.

108 Friedman 2008

109 International Alliance of Inhabitants 2009

The claim was based on part XVII of the Local Government Act[110] requiring local authorities to keep proper accounts. The High Court forced the Nairobi City Council to set up a joint fund with the suburbs of Karen and Langata and levy rates against its residents only through that fund. Victory, however, was only partial, because the city council decided it was easier simply not to use the funds rather than engage with the residents and their demands. The difference between Korogocho and Karen-Langata is that while residents in the first constituency mobilised international assistance networks, the second constituency demonstrated that their taxes do not pay for services.

Gender Based Needs

The attitudes and perceptions of Kenyan women in paying taxes largely reflect issues related to service delivery. The maternal mortality rate (MMR) in Kenya is 560 out of every 100,000 pregnant women, meaning that pregnancy-related complications amount to 14,700 deaths of women every year, with a further 400,000 suffering from injuries and disabilities due to childbirth[111].

The situation is not made any better by the public hospitals, where young people and poor people seek assistance in conditions that fall well below the proper standards of care. A recent report titled Failure to Deliver[112] found that:

> '[T]he situation at Pumwani Maternity Hospital (PMH), Kenya's largest public maternity hospital, vividly illustrates the Kenyan government's failure to take responsibility for severe human rights violation in health facilities.'

The result is a high level of tax resistance by the very same constituency, on the grounds that essential services are not being provided.

The statistical tables below should be viewed through the lens of perceptions of service delivery. The sample is representative enough to give a general direction of sentiments on taxation.

110 GoK 1977

111 FIDA 2007

112 FIDA 2007

Table 9: The Effect of VAT and PAYE on Young Women's lives

Effect on lives	VAT	PAYE
Ruins their lives	33 (7.2%)	29 (6.7%)
Negatively affects them	213 (46.3%)	202 (46.7%)
Do not know	145 (31.5%)	154 (35.6%)
Positively affects them	61 (13.3%)	40 (9.2%)
Does not affect them at	8 (1.7%)	8 (1.8%)
	N= 460	N= 433

Source: Otieno 2006

Table 10: How VAT and PAYE should be administered

	VAT	PAYE
Fairly	167 (35.9%)	149 (31.4%)
Not equitably	32 (6.9%)	59 (12.4%)
Equitably	210 (45.2%)	181 (38.2%)
Absolutely equitably	56 (12%)	85 (17.5%)
Total	465	474

Source: Otieno 2006

Table 10: Rating of VAT and PAYE

	VAT	PAYE
Absolutely fair	4 (0.8%)	3 (0.6%)
Fair	39 (8.1%)	39 (8.1%)
Neither fair nor unfair	114 (23.8%)	44 (9.2%)
Unfair	167 (34.8%)	198 (41.3%)
Very unfair	156 (32.5%)	196 (40.8%)
Total	480	480

Source: Otieno 2006

A successful area of tax advocacy by women's groups targeted VAT reductions on basic necessities such as food and medical products. In 2004 Kenya had already witnessed a groundbreaking action by women and women's rights organisations demanding a reduction in the price of sanitary pads in 2004 by removal of the 16 per cent VAT levy on the grounds that the pads were a necessity. The result of the campaign was that the president ordered the sanitary pads to be zero rated, and they have remained so ever since[113].

113 Adongo and Rop 2004

International Tax Advocacy

The role of international tax advocacy is to look at grass roots, local tax advocacy efforts and to take relevant issues and concerns forward to the national and international arena. The interplay between global campaigns and national campaigns need to be managed through coordination. This can be challenging as an issue that is highly visible outside the country such as mispricing of trade, may not be the main issue within Kenya where revenue transparency as well as the underground economy are more prominent issues.

Tax advocacy starts at the local and national level, and therefore, the international efforts listed below should be rather seen as complementary to these objectives and in terms of providing further platforms for actors to achieve wider domestic policy goals.

International Financial Reporting Standards

Accounting standards followed by most multinational corporations are set by a privately owned and directed body called the International Accounting Standards Board (IASB), which is based in London but registered in the US State of Delaware, a secrecy jurisdiction. This body sets the International Financial Reporting Standards (IFRS) that are mandatory for companies operating in an ever increasing number of countries. Current reporting standards allow companies discretion to determine the geographical basis on which they publish their accounts. In practice most companies publish accounts on a very broad geographical basis, often grouping entire continents or more than one continent (Africa and Europe, for example) into a single segment. This makes it impossible for those reading company accounts to know where profits are being generated and where taxes are being paid.

The EU adopted the IFRS in 2005, meaning that most multinationals had to change their accounting rules. The USA has created a roadmap towards adopting IFRS standards starting from 2010, with full adoption in 2014, while Canada is likely to adopt the standards fully in 2011. Many emerging nations have also already adopted them. Kenya was amongst the front-runners, adopting the standard for companies listed on the Nairobi Stock Exchange in 1999. A recent study regarding compliance mentions that fair value accounting remains an area of non-compliance[114], in particular stipulating the need to use standardised methods for determining prices in internal trade to counter transfer mispricing.

There are reasons why accounting standards are crucial for Kenyan development, and most of them relate to the simple fact that corporate taxes in Kenya represent under 2 per cent of GDP. Gaining an additional 2-3 per cent of GDP for taxation would stimulate massive progress, as it could either fund income transfers or provide for significant increases across a range of development funds. The issue of accounting standards goes to the heart of the social contract that enterprises have with their host state, often discussed under the title of corporate responsibility. The issue can also be dealt with through codes of conduct, where companies sign up to codes that include paying all due taxes, along with protecting the human and labour rights of their employees, and acting in line with environmental sustainability.

Kenya was among the front runners to adopt the International Financial Reporting Standard (IFRS) for companies listed on the Nairobi Stock Exchange in 1999

Inter-company trade among transnational corporations accounts today for between 60[115] to 70 per cent of world trade[116]. This part of world trade is not regulated by any international treaty besides the OECD guidelines given for transfer pricing that discuss the

114 UNCTAD 2006a: 13

115 Neighbour 2002

116 OECD 28 January 2010

arm's length principle[117], whereby companies trading with affiliates of the same group should charge market prices in inter-company trade. However, this is often not observed, as can be seen in the case of the banana trade, for example[118]. Kenya has adopted the OECD transfer pricing convention, making it illegal to misprice inter-company trade. However, because tax inspection and price-evaluation are difficult, very few cases have ever been challenged by the tax inspectors.

Intercompany trade of Transnational Corporations accounts today approximately 60 per cent of world trade

The regimes that currently attempt to tackle these issues are the:

1. Anti-Money Laundering (AML) regime, since the 1980s
2. Financial Action Task Force (FATF), since 1997 (revised in 2003)
3. Extractive Industries Task Force (EITI), since 2002
4. Leading Group on Innovative Financing for Development, since 2004
5. Taskforce on Financial Integrity and Economic Development, since 2009

Of these groups, Kenya is a member of the AML and FATF (through the East African group ESAAMLG), while participating in neither the Leading Group[119], nor the Taskforce[120]. The AML regime is based on self-regulation by the financial sector itself, and the FATF is a non-binding peer-review mechanism composed of 40 key recommendations on money laundering, and nine supplementary recommendations designed to tackle terrorist financing.

In contrast, the Leading Group proposes binding treaties for instance to levy a tax on financial transactions, which would raise significant additional financial resources if it were to apply to the Nairobi Stock Exchange, which is currently exempted from the 1 per cent shares and securities transaction tax that applies to non-listed companies. The recently launched taskforce started a global campaign on country-by-country reporting going far beyond the voluntary agreements made in the FATF framework.

117 Neighbour 2002
118 Christensen 2009
119 Leading Group 2009
120 Task Force 2009

Double Tax Treaties

Currently, Kenya has double taxation treaties (DTAs) with the United Kingdom, France, Germany, Norway, Sweden, Denmark, Canada, India, Kuwait and Zambia. But Kenya lacks effective treaties governing tax payments with the East African Community (where a non-ratified model treaty exists since 1977 awaiting Ugandan ratification) or COMESA partners, not to mention the USA or China. The reasons lie both in the pitfalls of DTAs, as often they may mean losing tax revenue from foreign resident companies, while others argue that a better treaty network would facilitate trade[121]. A Nairobi-based tax analyst considered that tax losses due to the DTA with the UK may be significant:

> 'In all the treaties, the UK treaty is probably the most aggressive with regards to the reduction of withholding taxes. For instance, whereas the domestic withholding tax rate on management fees stands at 20 per cent that under the UK/Kenya treaty stands at 12.5 per cent, that with Germany is at 15 per cent while with India it is at 17.5 per cent[122].'

No doubt costs and benefits need to be weighted, and debate needs to take place on the concessions given in such treaties to foreign resident companies.

Ethical Codes of Conduct

Internationally there has been a campaign for a UN Code of Conduct in which the Tax Justice Network participates, to regulate the behaviour not only of local individuals within their countries but also of people and institutions towards both their own countrymen and other people and nations worldwide.

At the domestic level, the New York Bar has issued an opinion that giving tax advice to encourage tax avoidance amounted to malpractice against an ethical code of conduct. This is a campaign that can also be pursued by local professionals in Kenya via associations such as the Kenya Law Society, the Institute of Certified Accountants of Kenya, and the Institute of Certified Public Secretaries of Kenya.

121 Thindi 2008
122 Thuo 2009

International Institutions

The recent financial crisis has demonstrated once again the way in which Africa finds itself at the periphery of the wider global economy and society – unable to influence the policy redesign in the wake of the crisis. South Africa was the only African country invited to the G20 meetings in Washington D.C. in November 2008 and in London in April 2009. Neither the African Union nor ASEAN or even Mercosur representatives were invited to participate alongside European Union representatives.

The only multilateral organisations at the table were the International Monetary Fund and the World Bank, both of which have been criticised on the grounds of their weak representative structures and poor policy advice relating to strengthening public finance and tackling inequalities. It is disturbing that the G20 countries decided to strengthen the IMF's role, while leaving truly multilateral organisations in the UN weaker than before.

While the 2009 G20 resolution[123] called for more regulation of financial markets, banks, and tax havens, it fell short of designing a world where the global economy is governed in a more democratic fashion[124]. Indeed as one of our African partners in Cameroon mentioned, 'the financial crisis for Africa is also a crisis of identity'[125]. The only two avenues in which Africans can influence the agenda of the G20 are through the Financial Action Task Force (FATF)[126] and by participating in the OECD Global Forum. The FATF, working closely with the IMF is unlikely to be a representative forum for African interests, while the OECD, having created the Global Forum seems to be evolving towards African membership in this area. The role of African institutions and the United Nations needs to be reinforced to correct this problem.

123 Group of 20 2009
124 Choike 2009
125 Bikoko 2009
126 Group of 20 2009: Annex 2

African nations should begin to work towards further tax cooperation among themselves by starting a process of automatic information exchange, as is already the case with the European Union's Savings Tax Directive

African nations should begin to work towards further tax cooperation among themselves by starting a process of automatic information exchange, as is already the case with the European Union's Savings Tax Directive. The process in Africa should not only involve personal bank accounts, but also corporate accounts, since these are the ones most likely to be abused for tax evasion purposes. Indeed, Africa could set an example on automatic information exchange that could lead to a global standard.

Key Lessons and Recommendations

Taxation and Governance

Engage the public in tax policy: the purpose of this country report is to improve the common knowledge base on tax issues, which can then be expanded according to the needs, contradictions and opportunities as identified in the report. Government should also enhance the dialogue with members of civil society. We welcome all initiatives towards outlining and achieving our common goals.

Tax Administration

Make the KRA more approachable: the tax administration needs to work in constant dialogue with taxpayers answering their queries particularly in the rural areas through extension services with other agencies, possibly the post offices. These measures would entail the KRA hiring more staff in order to allow citizens to make appointments with the tax officers. Increased revenue achieved through better dialogue, would mean that increased staff spending would quickly pay for itself.

Tax Policy

Equity and fairness considerations: fairness is the overriding tax policy consideration. For instance, VAT impacts everyone equally and therefore may be considered regressive since poorer households spend a larger slice of their incomes on household goods and services and therefore pay proportionately more tax than richer households. This situation can be made more equitable either through exemptions on basic necessities or through redistribution. We argue that the second option is better in the long-run because exemptions are easily manipulated and cannot be traced for impact, whereas redistribution can be targeted provided that the right person receives the income grant subsidy, or an entitlement to a public service.

Tax Law

Laws establishing special funds: the issue of special development funds has become an important topic in the debate concerning the tax system in Kenya since it involves a large share of public financing, and the majority of development spending. The legal foundations of these funds, however, are not uniform because they have been founded in a series of 'earmarking' practices involving donors, central government funds, and new levies and taxes. A common legal framework should be established, stating also the mode of public participation in the various stages of revenue collection, decision-making and delivery.

Tax Incentives

Tax incentives and Free-Zones: a multi-stakeholder working group should urgently review all tax holidays, and further technical studies need to be conducted. The policy review needs to be carried out before the planned expansion of the regime takes place. The EPZ or the proposed SEZ regimes is not a panacea for increasing formal sector employment, rather encouraging domestic savings and more local-market seeking FDI should be attracted. Kenya has the capacity to attract much higher value-added FDI.

Tax Avoidance and Evasion

Fair Value Accounting: this issue should be raised within the IFRS framework in Kenya. Fair value means that accounting registers a realistic estimate of the value of each asset and transaction, rather than manipulating prices and valuations for either regulatory or tax avoidance. The issue relates to the lack of commonly agreed standards in conducting fair valuation, and guidelines need to be set before compliance can be expected.

Country-by-Country Reporting: currently many of the accounts of multinationals are prepared on a regional basis, whereas what matters in paying taxes is to know about a company's activities at national level. The information needed for such reporting is already in most cases contained in the company's internal accounts, as it is vital for management purposes to know in which jurisdiction profits and liabilities are booked. This information needs to be made public in annual reports.

Tax Information Exchange

The Government should outline a policy for tackling illicit financial flows and take part in international initiatives aimed at tackling secrecy jurisdictions. This is now taking place within the Taskforce on Financial Integrity and Economic Development.

Kenya should also participate in the OECD Global Forum and sign further tax information exchange agreements (TIEAs) especially with countries and territories that are likely destinations of illicit capital flight.

Beyond the existing standards, the government should work towards the adoption of automatic tax information exchange as the appropriate standard both in the African and international arena. This will act as a far stronger deterrent to tax evasion than the 'upon request' approach of many existing information exchange treaties with secrecy jurisdictions.

Areas of Further Research

The tax system of Kenya remains relatively under-researched:

Trade mispricing: to understand through detailed customs and corporate accounts analysis how Kenya loses public finances linked to the international trade and investment relations.

Export Processing Zones and Special Economic Zones: these tax and regulatory policy-measures are currently under-researched in terms of their impact on government revenues, overall turnover and employment activity, as well as their impact on local businesses who do not benefit from such a special regime.

Illicit financial flows: investigating the outflows both in terms of criminal and commercial activities that contribute to tax losses accruing from illicit flows. A country-specific study is needed to understand the relevant components.

Income and wealth inequalities: the recent focus on poverty reduction has neglected the equally important issue of wealth inequalities. The 1998/1999 Labour Force Survey should be updated and made part of a broader strengthening of the statistical apparatus of the state.

Revenue monitoring: understanding the structures of revenues is crucial to mobilising the public around the importance of tax, making the link between state and civil society more visible.

Public finances: the different areas of leakage constitute a wider agenda for monitoring public finances, and fostering the state's capacity to finance its development through domestic resources. Public finance research should also include the monitoring of external constraints and opportunities linked to the international climate, and making proposals for remedying such constraints.

Conclusion and Recommended Reading

This report has discussed current Kenyan tax trends and policy from an economic and social justice perspective. A major contribution has been to put tax in a human rights and social welfare context, making tax a part of a rights-based approach to governance.

Citizens have rights, but also responsibilities in tax matters. Tax justice requires a sustained campaign to ensure that the voices of less powerful people are heard alongside the voices of powerful special interests. The need for citizens to engage in the advancement of tax justice was seen in the colonial era, when taxes were imposed but no representation was granted to native Kenyan citizens, but is also visible in the contemporary struggle by the slums dwellers associations of Korogocho in Nairobi for greater accountability on the part of local government for how tax revenues are spent.

Representation is possible today, as beneficiaries of district and constituency level development funds are discovering. After all, they are the people who pay the tax revenue used by these funds. These funds are now allocated according to poverty reduction targets and programmes, rather than being discretionary and arbitrary. These are demonstrations of social welfare policies in action.

The role of civil society is to foster a culture of accountability and represent the interests of poor people in tax policy formation. A citizen dialogue involving all levels of society is required to promote a culture of peaceful and democratic decision-making.

To find out more about the key issues discussed here we recommend the following publications, all mentioned in the bibliography:

- Taxation and human rights: the classic text is by Sven Steinmo, *Taxation and Democracy: Swedish, British and American Approaches to Financing the Modern State,* while an African perspective is provided by Attiya Waris: *Taxation without Principles*, which traces the history of tax in Kenya form early colonialism to the present day.
- Governance: we recommend Mick Moore's working paper titled *How Does Taxation Affect the Quality of Governance,* as well as a classic by Joseph Schumpeter *The Crisis of the Tax State*.
- Welfare: we recommend the relevant chapter: *From Poor Relief to Institutional Welfare States: The development of a Scandinavian Model* by Gøsta Esping-Andersen and Walter Korpi. Alex Cobham adapts this chapter to a developing country context through his recommendations in *The Tax Consensus has Failed!*
- Illicit capital flight: we recommend a chapter by John Christensen outlining the international banana scam titled *Taxing Transnational Corporations*.

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Appendix 1: Tax Collection Data

Table 1 Annual Collections by Tax Type (Annual Tax Revenue in million Ksh)

	2000/2001	2001/2002	2002/2003	2003/2004	2004/2005	2005/2006	2006/2007	2007/2008
IMPORTS	88 992	83 474	89 297	97 174	110 201	94 788	117 909	132 654
Import Duty	28 664	21 286	18 332	21 958	23 149	21 388	27 910	32 539
Excise Duty	28 285	32 110	35 932	40 109	44 855	29 187	32 742	34 050
VAT On Imports	24 131	24 452	28 780	27 362	32 473	34 034	44 744	53 634
IDF	5 912	5 626	6 253	7 745	9 724	10 179	12 513	12 431
DOMESTIC	82 541	87 274	99 478	115 690	143 767	179 533	209 825	252 022
Pay As You Earn (PAYE)	28 887	32 894	36 350	43 906	53 325	61 503	72 470	86 140
Personal Tax	2 050	2 018	2 008	2 217	3 051	2 801	2 977	3 228
Corporation Tax	17 620	18 087	23 297	26 354	31 947	38 799	43 146	57 434
Withholding Tax	7 511	7 573	9 350	9 445	11 792	12 300	14 180	18 826
Other Taxes	178	255	209	287	487	402	256	525
Capital Gains Tax (Suspended)								
VAT Domestic	26 295	26 447	27 586	31 411	40 183	42 151	51 829	57 374
Excise Duty Domestic						17 615	19 609	22 070
Excise on airtime			678	2 070	2 982	3 962	5 358	6 397
Turnover Tax								28
TOTAL REVENUE	169 533	170 748	188 775	212 864	253 968	274 321	327 734	384 676

Source – KRA various publications

Table 2 Annual Collections as Percentage of Total Revenue (Percentage contribution to total tax revenue)

	2000/ 2001	2001/ 2002	2002/ 2003	2003/ 2004	2004/ 2005	2005/ 2006	2006/ 2007	2007/ 2008
IMPORTS	51,31	48,89	47,30	45,65	43,39	34,55	35,98	34,48
Import Duty	16,91	12,47	9,71	10,32	9,11	7,80	8,52	8,46
Excise Duty	16,68	18,81	19,03	18,84	17,66	10,64	9,99	8,85
VAT On Imports	14,23	14,32	15,25	12,85	12,79	12,41	13,65	13,94
IDF	3,49	3,29	3,31	3,64	3,83	3,71	3,82	3,23
DOMESTIC	48,69	51,11	52,70	54,35	56,61	65,45	64,02	65,52
Pay As You Earn (PAYE)	17,04	19,26	19,26	20,63	21,00	22,42	22,11	22,39
Personal Tax	1,21	1,18	1,06	1,04	1,20	1,02	0,91	0,84
Corporation Tax	10,39	10,59	12,34	12,38	12,58	14,14	13,16	14,93
Withholding Tax	4,43	4,44	4,95	4,44	4,64	4,48	4,33	4,89
Other Taxes	0,10	0,15	0,11	0,13	0,19	0,15	0,08	0,14
Capital Gains Tax (Suspended)								
VAT Domestic	15,51	15,49	14,61	14,76	15,82	15,37	15,81	14,91
Excise Duty - Domestic						6,42	5,98	5,74
Excise on airtime			0,36	0,97	1,17	1,44	1,63	1,66
Turnover Tax								0,01
TOTAL REVENUE	100,00	100,00	100,00	100,00	100,00	100,00	100,00	100,00

Source – KRA various publications

Appendix 2: Economic Analysis

Table 1 Estimates of the Size of the Underground Economy in Kenya

Kenya Shillings Millions						% of GDP	% of GDP
Official Economy		**Underground Economy**					
	Estimated Nominal Currency	Estimated Nominal Currency	Money Velocity	Potential GDP	Tax Potential	Potential GDP	Tax potential
2000	32323.90	24937.61	7.16	178648.73	35988.33	26.04	5.24
2001	36207.28	25881.73	7.24	187407.71	37401.67	20.67	4.12
2002	39192.85	26960.02	6.30	169904.49	32687.31	18.76	3.61
2003	44932.58	33393.52	5.31	177421.23	34218.50	17.55	3.38
2004	50431.92	39110.18	5.56	217519.27	45137.31	19.03	3.95
2005	58208.10	46249.99	5.58	258878.03	54946.13	20.05	4.26

Source: Ouma, Njeru et al. 2007

Table 2 Tax Incentive Schemes to Influence FDI

Type of Incentive	Tax Rate (%)	Tax Base
Investment deduction	100	Capital expenditure
Farm works	50	Capital expenditure
Mining specified minerals	40 10	Cost, year one Cost, year two to seven
Industrial building	2.5	Capital expenditure depreciation per year
Hostels and certified educational buildings	10	Capital expenditure depreciation per year
Approved residential buildings	5	Capital expenditure depreciation per year
Hotels	10	Capital expenditure depreciation per year
Approved roads, hospitals, public schools	100	Cost of approved project
Plant & Machinery – Class 1	37.5	Cost depreciation per year
Plant % Machinery – Class 2	30	Cost depreciation per year
Plant & Machinery – Class 3	25	Cost depreciation per year
Plant & Machinery – Class 4	12.5	Cost, depreciation per year
Residential corporations	30	Profits
Non-residential corporation	37.5	Profits
Export Processing Zones (EPZs)		
• First 10 years	0	Profits
• Next 10 years	25	Profits
Newly listed companies		
• With 20% issued shares listed	27	Profit, first 3 years
• With 30% issued shares listed	25	Profit, first 5 years
• With 40% issued shares listed	20	Profit, first 5 years
Non-resident shipping operations	2.5	Gross revenue
Non-resident telecommunications operations	5	Gross revenue
Non-resident withholding tax		
• Dividends	10	Dividends declared
• Interest, bearer instruments	25	Interest paid/payable
• Interest, government bonds	15	Interest paid/payable
• Other	15	Interest paid/payable
Royalty	20	Royalty paid/payable
Management and professional fees	20	Royalty paid/payable
Contractual fee	20	Fee paid/payable
Insurance commission	20	Commission paid/payable
Rent – immovable property	30	Rent paid/payable
Rent – others	15	Rent paid/payable
Lease Rental	15	Lease rental paid/payable
VAT on certain capital goods	0	Cost, remission subject to approval
Customs duty: capital goods, agricultural inputs	0	Cost

Source – Source: GoK 1969, GoK 1989 Cap 476; GoK 1996 and GoK 2000.

Table 3 FDI Inflows to Kenya, 1970 - 2007

Year	Net inflows US $ million	Net inflow % of GDP	Net inflow % of gross capital formation
1970	13.8	0.86	4.47
1971	7.40	0.42	1.83
1972	6.30	0.30	1.36
1973	17.26	0.69	3.32
1974	23.42	0.79	4.10
1975	17.16	0.53	2.61
1976	46.37	1.33	6.68
1977	56.55	1.26	6.00
1978	34.41	0.65	2.59
1979	84.01	1.38	5.81
1980	78.97	1.09	4.71
1981	14.15	0.21	0.88
1982	13.00	0.20	1.06
1983	23.74	0.40	2.20
1984	10.75	0.17	0.96
1985	28.85	0.47	2.69
1986	32.73	0.45	2.30
1987	39.38	0.49	2.52
1988	0.39	0.00	0.02
1989	62.19	0.75	3.86
1990	57.10	0.67	3.23
1991	18.80	0.23	1.21
1992	6.00	0.07	0.44
1993	2.00	0.04	0.21
1994	4.30	0.06	0.32
1995	33.00	0.36	1.71
1996	10.55	0.11	0.58
1997	52.52	0.49	2.81

1998	11.41	0.10	0.60
1999	13.82	0.13	0.86
2000	110.90	1.06	7.26
2001	5.31	0.05	0.34
2002	27.63	0.22	1.71
2003	81.75	0.59	3.37
2004	42.62	0.25	1.59
2005	12.03	0.06	0.33
2006	27.77	0.11	0.62
2007	742.93	2.57	12.46

Source: Source: Ngugi and Nyang'oro 2005, from UNCTAD 2006b; Central Bank of Kenya 2008 for supplementary data covering years 2003-2007, and UN Statistics Division 2009 for Gross Fixed Capital Formation

Table 4 Top 10 Mispriced Categories 2005

	US (US$ millions)			EU (US$ millions)		
Commodity Code According to Internationally Used Codes	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL
Pharmaceutical products	0.01	0	0.01	2.72	0	2.72
Electric machinery, sound equipment, TV equipment, parts	2.09	0	2.09	2.25	0.01	2.26
Nuclear reactors, boilers, machinery, etc., parts	0.89	0	0.89	4.26	0.01	4.27
Coffee, tea, mate, spices	0	0.68	0.68	0	2.13	2.13
Edible fruit, nuts, citrus fruit, melon peel	0	0.03	0	0	14.97	14.97
Vehicles, except railway or tramway, and parts	0.08	0	0.08	2.07	0	2.07
Apparel articles, and accessories, not knit, etc.	0	4.40	4.40	0.05	0	0.05
Live trees, plants, bulbs, etc, cut flowers, etc.	0	0.04	0.04	0.56	5.49	6.06
Edible vegetables and certain roots, tubers	0.09	0	0.09	0.04	5.96	6.00
Miscellaneous chemical products	0.20	0	0.20	2.01	0	2.01

Source: Source: With courtesy of Christian Aid

Table 5 Top 10 Mispriced Categories 2006

	US (US$ millions)			EU (US$ millions)		
Commodity Code (HS2)	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL
Pharmaceutical products	0	0	0	15.00	0	15.00
Electric machinery, sound equipment, TV equipment, parts	1.20	0	1.20	8.10	0	8.10
Nuclear reactors, boilers, machinery, etc., parts	0.10	0	0.10	4.57	0	4.57
Coffee, tea, mate, spices	0	1.27	1.27	0.01	7.92	7.93
Edible fruit, nuts, citrus fruit, melon peel	0	0.04	0.04	0	0.05	0.05
Vehicles, except railway or tramway, and parts	0	0	0	5.96	0	5.96
Apparel articles, and accessories, not knit, etc.	0	3.24	3.24	0.01	0	0.01
Live trees, plants, bulbs, etc, cut flowers, etc.	0	0.01	0.01	0.10	3.49	3.59
Edible vegetables and certain roots, tubers	0	0	0	0.02	0.72	0.74
Miscellaneous chemical products	0.09	0	0.09	2.41	0	2.41

Source: Source: With courtesy of Christian Aid

Table 6 Top 10 Mispriced Categories 2007

	US (US$ millions)			EU (US$ millions)		
Commodity Code (HS2)	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL	OVERPRICED EXPORT	UNDERPRICED IMPORT	TOTAL
Pharmaceutical products	0.17	0	0	5.16	0	5.16
Electric machinery, sound equipment, TV equipment, parts	1.13	0	1.13	7.02	0.01	7.03
Nuclear reactors, boilers, machinery, etc., parts	5.22	0	5.22	5.99	0.05	6.04
Coffee, tea, mate, spices	0	1.27	1.27	0	5.66	5.66
Edible fruit, nuts, citrus fruit, melon peel	0	0.09	0.09	0	0.23	0.23
Vehicles, except railway or tramway, and parts	0.06	0	0.06	4.75	0	4.75
Apparel articles, and accessories, not knit, etc.	0	5.00	5.00	0.02	0	0.2
Live trees, plants, bulbs, etc, cut flowers, etc.	0	0.02	0.02	0.06	1.97	2.02
Edible vegetables and certain roots, tubers	0.56	0	0.56	0.02	1.42	1.44
Miscellaneous chemical products	0.26	0	0.26	2.17	0	2.17

Source: With courtesy of Christian Aid

Glossary

Arm's length principle: A principle stating that a transfer price should be the same as if the two subsidiaries of the same group were not part of the same corporate structure

Country-by-country Reporting: A proposed accounting standard under which a multinational corporation will be required to report on its accounts in each countries and territories it operates, what the names of its subsidiaries are in each and every one where it operates.

Direct taxes: Taxes that are charged upon physical or legal persons directly upon their salary, profits, dividends, rents or other types of income.

Double Tax Treaty (DTA): An agreement between two sovereign states or territories to ensure, as far as possible, that income arising in one and received in the other is taxed only once. Includes rules to define Residence, and Source, and limits on Withholding Taxes.

Export Processing Zone (EPZ): Artificial ring-fenced territory within states where export orientated industries with little interaction to domestic markets operate while the usual laws and regulation are suspended or relaxed

Flat tax: A tax system in which as income increases above an agreed tax free sun the amount of tax paid remains constant in proportion to total income.

Fiscal architecture: A set of factors including economic and demographic factors, health and education levels, institutional and technological factors and the extent of the tax base that determine tax capacity.

Fiscal state: A state which has a high capacity to tax its citizens, and resulting policy autonomy allowing it to define its own tax and social policies.

General anti-avoidance Principle: A legal principle that seeks to prevent a taxpayer from obtaining the taxation benefit arising from any transaction if it was undertaken solely or mainly to obtain a tax benefit.

High net-worth individual: Otherwise known as HNWIs (Hen-Wees) in the wealth management sector. Generally categorised as individuals with more than US$ 1 million in liquid financial assets available for investment, which excludes the primary residence and motor vehicle.

Illicit capital flight:The process whereby wealth holders and businesses place their funds and other assets outside the country of residence. The process is illicit if funds are of criminal origin, are illegally transferred, or used for illicit purposes.

Indirect taxes: A form of tax charged upon transactions, usually on their gross value. Examples include sales taxes, value added taxes, goods and services taxes, stamp duties, land taxes and excise and customs duties and levies of all sorts.

Money laundering: The process of 'laundering' money from criminal or otherwise illicit activities to give it the appearance of originating from a legitimate source.

Poll tax: A tax that levies the same sum on each person irrespective of their means to pay. In Kenya also known previously as the Hut Tax, where native Kenyan households paid a fixed sum of tax for each residential building.

Poor laws: Set of laws enacted in the 19th century Europe and the Americas to provide social security related with rapid urbanisation, mobile rural population, and other social problems. Some argue they were a response to peasant and urban revolts, while others consider that they were designed to foster a healthier and more productive workforce. Poor Laws were a precursor to the welfare state.

Progressive taxes: A tax system in which as income rises, the amount of tax paid increases in proportion to the income as well as in absolute amount i.e. the percentage tax rate increases as the income rises. Regressive taxes are the opposite phenomenon.

Secrecy jurisdiction: Secrecy jurisdictions are countries and territories that intentionally create regulation designed to undermine the regulation of another jurisdiction for the primary benefit and use of those not resident in their geographical domain.

Social security payments: Payments made towards maintaining government provided health, unemployment, pensions and other basic social rights. Frequently considered as taxes.

Special Economic Zone (SEZ): Similar to the EPZ, but the activities can include domestic market orientated business activities.

Tax: A fee levied by a government or a regional entity on a transaction, product or activity in order to finance government expenditure. Taxes rates and the tax base are decided by a representative legislative body, based on constitutional provisions.

Tax arbitrage: The process by which a sophisticated taxpayer plays off the tax systems of two or more different countries to obtain a tax benefit as a result.

Tax avoidance: The term given to the practice of seeking to minimise a tax bill without deliberate deception (which would be tax evasion or fraud). The term is sometimes used to describe the practice of claiming allowances and reliefs clearly provided for in the national tax law. It is, however, now generally agreed that this is not tax avoidance, but rather called tax compliance.

Tax base: The range of transactions, items and activities that a country chooses to tax.

Tax capacity: A term that denotes the capacity of a sovereign country to raise revenue with regard to its fiscal architecture.

Tax competition: The pressure on governments to reduce taxes usually to attract investment, either by way of reduction in declared tax rates, or through the granting of special allowances and incentives.

Tax compliance: It can mean payment of tax due without engaging in tax avoidance or evasion. It is used in contrast to the terms tax avoidance and tax evasion. A person who has acted in the spirit of the law is 'tax compliant'.

Tax effort: A term used to determine the extent to which a government translates tax capacity into revenue.

Tax evasion: A term used to denote illegal methods used to pay less tax. Also known as tax fraud.

Tax expenditure: Used to describe the cost of tax incentives of all types in terms of lost potential tax revenue. As with any other expenditure, it should be considered as an investment and evaluated on the basis of cost and benefit.

Tax gap: The difference between nominal tax ratios and actual tax revenues. This can be calculated by using various methodologies, for instance the difference between tax capacity and tax effort, or random tax inspections of taxpayers.

Tax haven: See Secrecy Jurisdiction

Tax holiday: A period during which a company investing in a country does not have to pay tax under an agreement with the government.

Tax planning: A term used in two ways. It can be used as another term for tax evasion. When, however, tax legislation allows more than one possible treatment of a proposed transaction the term might legitimately be used for comparing various means of complying with taxation law.

Transfer-pricing: A transfer pricing arrangement occurs when two or more businesses which are owned or controlled directly or indirectly by the same group trade with each other. If a transfer price can be shown to be the same as the market price then it is always acceptable for tax. What is not acceptable is transfer mispricing that increases costs or reduces sales value for purposes of shifting profits to low-tax countries and territories.

Tribute: Money or payment in goods and services to a ruler or a state that is not regulated by any tax law, and can thus be arbitrary and highly discretional. Precursor to taxation in feudal and traditional societies.

Washington Consensus: The term originally described the economic policy prescriptions by Washington D.C.-based institutions such as the US Treasury Department, the International Monetary Fund and the World Bank, but subsequently evolved to denote a belief and vigorous advocacy of free-market ideology. The term is generally attributed to British economist John Williamson.

Welfare state: A state provider of comprehensive social security services to its residents, and in some cases non-resident, on the basis of a fiscal contract where taxes are levied subject to the agreement that they are used for welfare services. Fiscal crisis and the Washington Consensus have tended to erode this.

Kulipa Ushuru ni Kujitegemea - Paying taxes is being independent.
-- Kenya Revenue Authority

What is the relationship between tax and democracy? What links can we make between revenue collection, human rights and human welfare? Are tax exemptions justifiable?

This report into tax and state building in Kenya studies the evolution of the Kenyan tax system, and considers ways to foster economic and social development by improving revenue collection. Broadening the tax base and engaging citizens in a tax dialogue should be the key priorities.

The Kenyan state is today one of the most active tax collecting states in Africa. However this burden is imposed primarily through consumption taxes and import levies, leaving vast parts of the economy outside the tax net. The tax gap in the country, the difference between potential and effectively mobilised revenue stands at 55.1 per cent, leading to lost revenues at the order of Ksh 264 billion (US$3.4 billion), of which nearly half is the untapped capacity of corporate tax.

While residents' associations like the one in Karen-Langata in Nairobi have challenged taxes that don't allow for representation, many Kenyans are ill-prepared to participate in a tax dialogue. Tax, if it is perceived as unjust, will hinder rather than advance development. For this reason, the report also considers civil society advocacy on tax issues, and proposes ways for different sections of Kenyan civil society to become involved in a dialogue about tax policies.

Civil society has a crucial role to play in shaping tax policy and practices. The challenge is first to make citizens aware of their rights and obligations as taxpayers. Secondly, there is a need to elaborate tax policies that respond to the needs of poor people who are currently excluded from tax dialogue, and consequently end up paying higher consumption taxes and levies.