The KENYA INSTITUTE for PUBLIC POLICY RESEARCH and ANALYSIS

Understanding Domestic Tax Policy

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What is tax policy

- Identification of levels and methods of taxation
- What tax, to whom/on what tax is levied and at what rate
- For consumption taxes, specifies exemptions and zero rating
- Example: if Pay As You Earn:
  - who pays the tax – individuals in gainful employment
  - On what – income of the individual deducted at source
  - At what rate: graduated tax brackets and rates

Why Tax Policy

- Three main goals
  - Raise revenue
  - Redistribution – taxing those with higher incomes more
  - Encourage/discourage some activities, mostly using taxes on goods and services

- Redistribution – by knowing who bears the burden of a tax, civil society can advocate for reforms towards fair tax systems.

Principles guiding tax policy

- Equity – fairness – tax liability should be proportional to income
- Simplicity – Should be easily understood and easily administered e.g. too many rates & exemptions make tax system more complex
- Convenience – payment of tax should not be costly (time, money) to the taxpayer
- Adequacy – should raise enough money to fund government services
- Neutrality – should not affect economic decisions
- Exportability – extent to which taxes are paid by non residents

Structure of Tax Systems

- Mostly comprises of:
  - Income tax (PAYE & corporate taxes)
  - Value added Tax
  - Excise Tax – on few commodities (beer, cigarettes, fuel)
  - Trade taxes (mainly import duties)
  - Other taxes such as turnover tax, capital gains tax, withholding taxes on dividends, interest, royalties etc)

Composition of tax revenues in Kenya

- For decades, government policy has aimed at increasing reliance on indirect taxes.
- But, Income taxes have continued to play a dominant role in tax revenue – about 48% in 2015/16
- VAT & excise taxes also increased though at a slower pace.
- VAT under performing – lower compliance with ETR - 65% against target of 90%. Large delays in refunds.
- Excise tax – share dropped from 15% in 2007/08 to 11% in 2015/16 – change from ad valorem to specific tax regime.
- Trade taxes stagnated at 11% - regional integration

An equitable tax system

- Tax burden – amount of tax borne by an individual/entity
  - Statutory burden – legal liability
  - Ultimate burden – final burden
- Two measures
- Horizontal equity
  - Persons/entities with similar circumstances should pay similar taxes e.g. wage earners and other income earners
- Vertical equity
  - Persons/entities with greater ability to pay should pay more taxes e.g. high income earners vs low income earners

Vertical equity

- Two concepts
- Progressive Tax Policy – Imposition of higher tax rates on higher taxable amounts (graduated tax rates)
- Example of Uganda's income tax structure

Income (UShs)	Rate of Tax
0 - 1,560,000	Nil
1,560,000 - 2,820,000	10% of the amount over Shs 1,560,000
2,820,000 - 4,920,000	Shs 126,000 + 20% of the amount over Shs 2,820,000
Over 4,920,000	Shs 546,000 + 30% of the amount over Shs 4,920,000

- Example of Kenya's Tax structure

yearly income (Kshs)	Rate
0 to 121,968	10%
121,969 to 236,880	15%
236,881 to 351,792	20%
351,793 to 446,704	25%
Over 446,704	30%

Pros & cons of progressive taxation

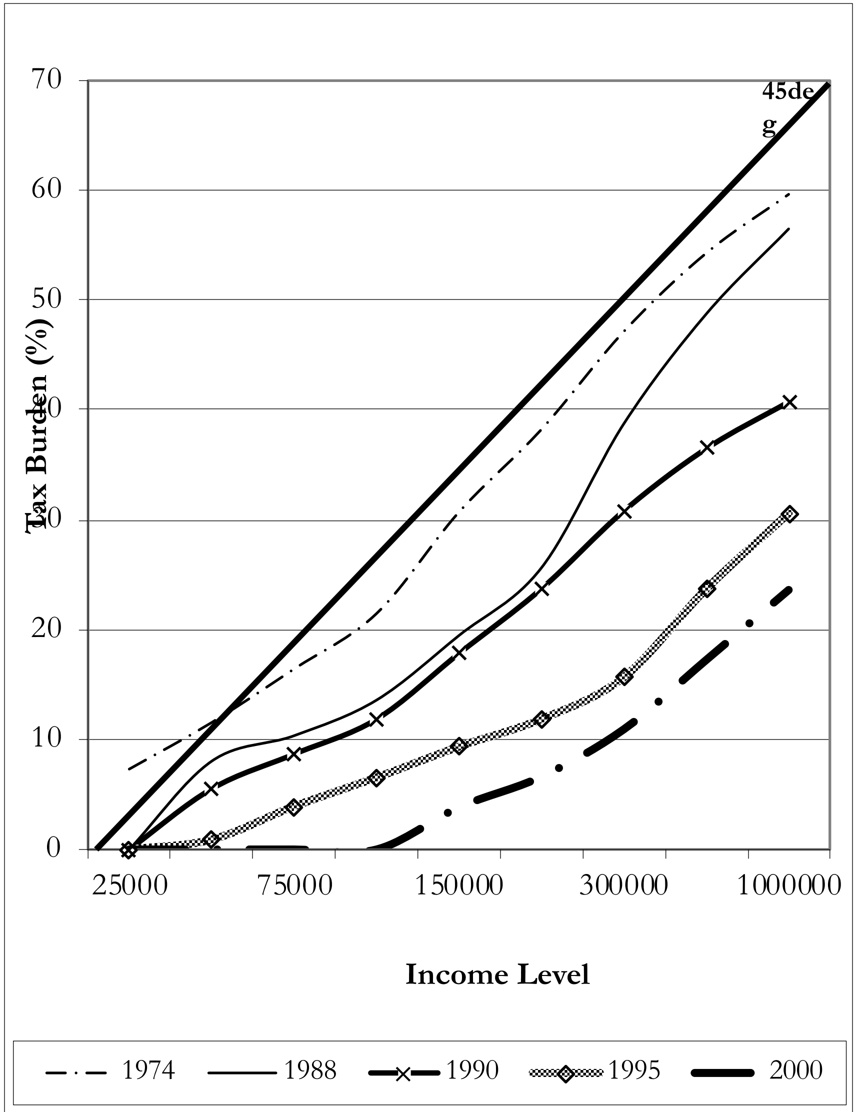
- Advantages
  - Diminishing marginal utility of money
  - Redistribution
  - Wealthy benefit more from public services
- Disadvantages
  - Disincentive
  - Unfair

Evolution of PAYE tax rates in Kenya

Year	Annual Taxable Income (Kshs.)	Rate (%)
1986 - 1987	1 - 36,000	10
	36,001 - 72,000	15
	72,001 - 180,000	25
	108,001 - 144,000	35
	144,001 - 180,000	45
	180,001 - 216,000	50
	216,001 - 252,000	60
	Over 252,000	65
1990 - 1991	1 - 42,000	10
	42,001 - 84,000	15
	84,001 - 126,000	25
	126,001 - 168,000	35
	Over 168,000	45

Year	Annual Taxable Income (Kshs.)	Rate (%)
1997	1 - 82,080	10
	82,081 - 164,160	15
	164,161 - 246,240	20
	246,241 - 328,320	25
	328,321 - 410,400	30
	Over 410,400	35
2004-2006	1-121,960	10
	121,961-236,880	15
	236,881-351790	20
	351,791-466,700	25
	Over 466,700	30

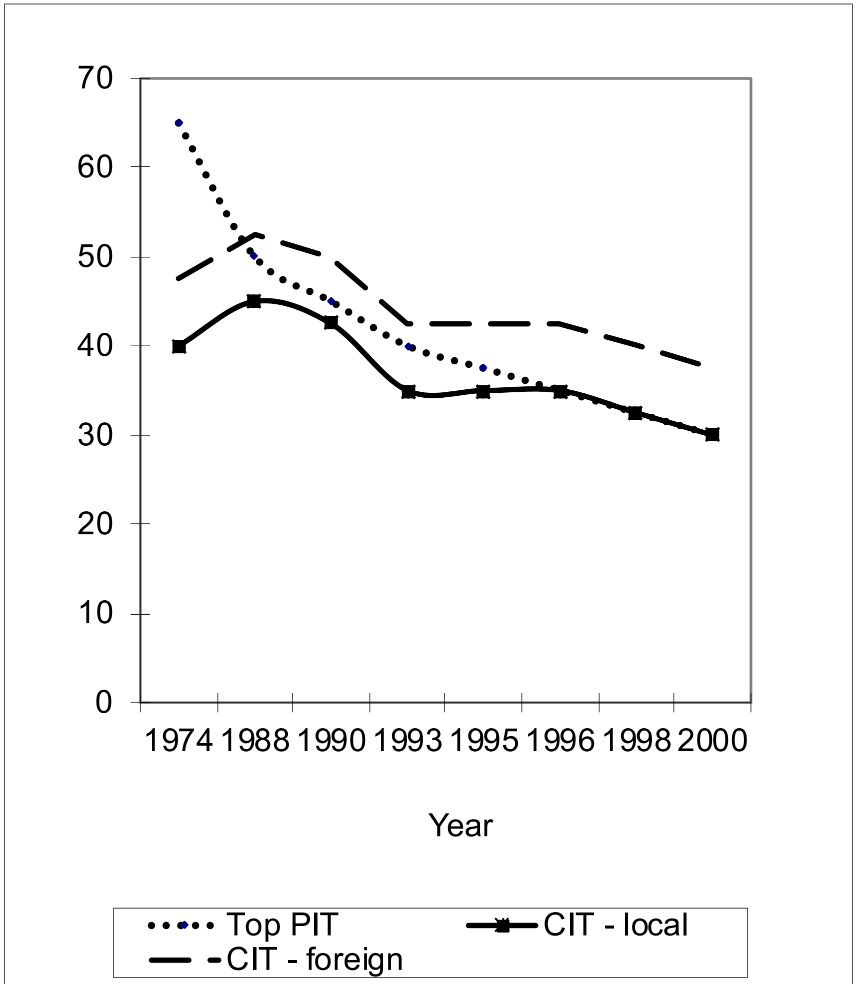
Income tax and progressivity in Kenya



- Over time, widening of tax brackets & increasing the level of tax relief reduces amount of tax payable and consequently tax burden.
- Continued rationalization of tax rates, increase in relief & widening of tax brackets has made the income tax system more progressive and hence more equitable.
- More people have fallen out of the tax net as a result of widening the brackets and increasing the relief/threshold over time.

Corporate income tax rates

- Evolution of CIT in Kenya



- Tax imposed on company’s gross income less allowable deductions (expenditure on production and losses)
- **Kenya**: CIT 30% local; 37.5% foreign; 20-27% for 3-5 years for newly listed companies
- **Uganda**: CIT 30% for both domestic & foreign. Mining companies 25-45%
- **Tanzania**: CIT 30%; 25% for 3years for newly listed

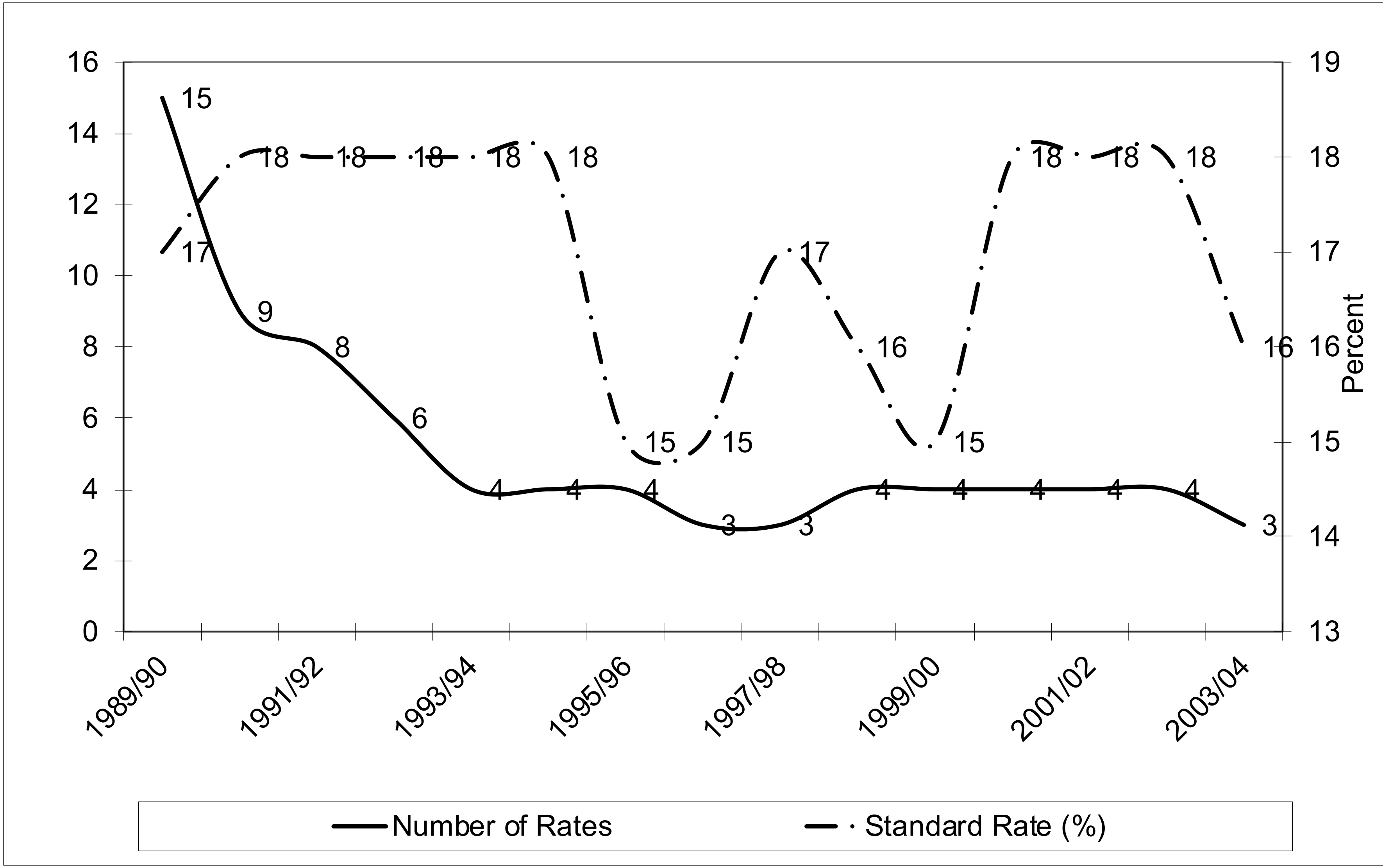
Value Added Tax

- Imposed on supply of taxable goods and services (both domestic and foreign)
- For some countries, those below VAT threshold pay turnover tax. For Kenya, 3% of gross sales
- Presumptive tax in Uganda: 1% of gross turnover for sales between 20 million and 50 million: sales between 5 million and 20 million pay shs100,000

- VAT rates across selected countries

Botswana	12%	Tanzania	18%
Burundi	18%	Uganda	18%
Ethiopia	15%	Zambia	16%
Kenya	16%	Zimbabwe	15%
Malawi	16.5%	Rwanda	18%
Morocco	20%, 7%, 10%, 14%	South Africa	14%
Nigeria	5%		

Evolution of The Value Added Tax (VAT) in Kenya



Efficiency of VAT revenue collections

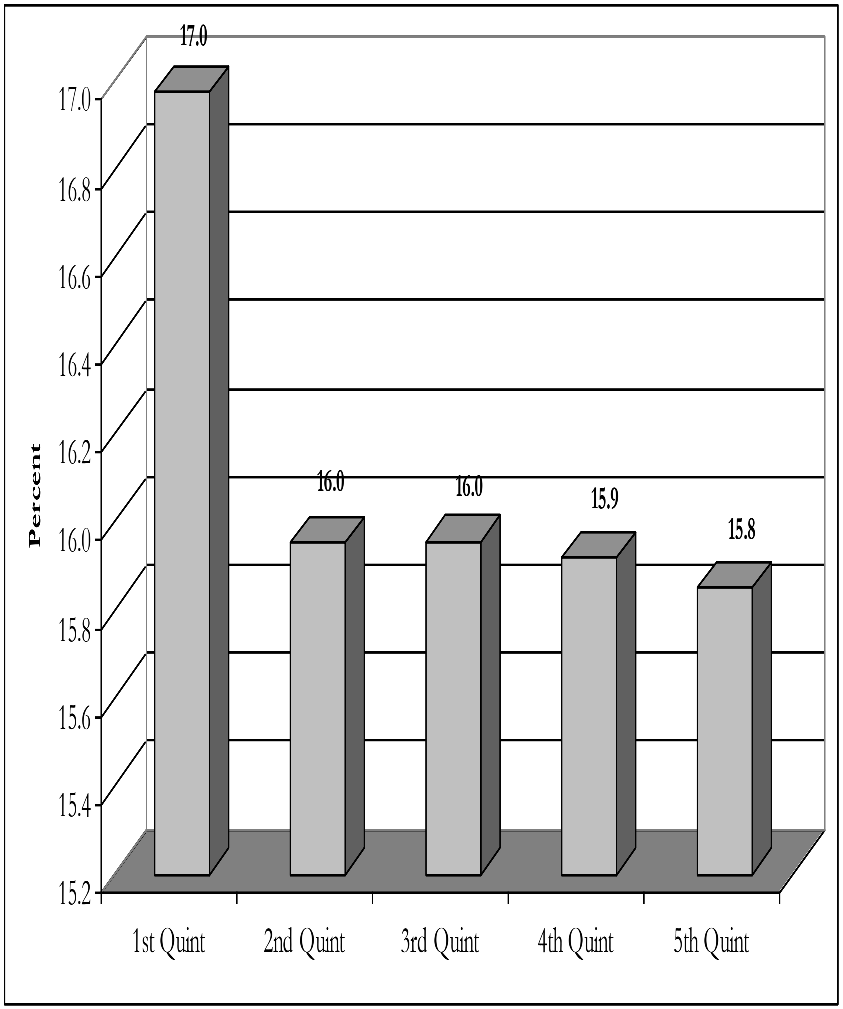
	VAT standard rate	VAT revenue (% of GDP)	Efficiency
Benin	18	7.4	44.7
Burkina Faso	18	6.3	36.6
Central African Republic	18	3.7	20.6
Chad	18	0.7	5.1
Ethiopia	15	6.1	42.9
Ghana	**12.5**	**9.7**	**80.4**
Guinea	18	3.3	22.6
Kenya	16	8.5	57.2
Madagascar	**20**	**6.2**	**34.5**
Malawi	17.5	8.1	44.1
Mali	15	7.3	52.4
Mozambique	17	7.1	44.7
Niger	19	4	22.9
Nigeria	**5**	**1.5**	**47.9**
Rwanda	18	5.9	35.7
Tanzania	18	6.5	38.6
Togo	18	3.2	19.5
Uganda	18	7.3	45.9
Zambia	17.5	7.4	54.6

Regressive Tax policy

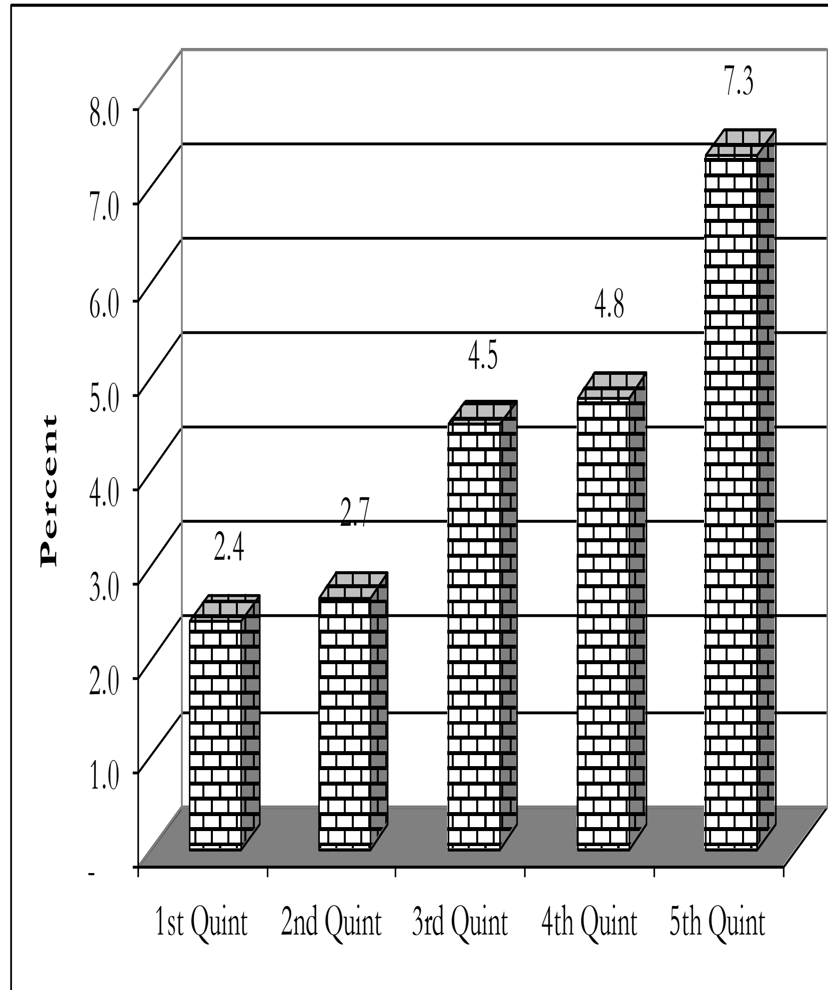
- Persons/entities with lower income pay a greater proportion of their income
- Classic example is the consumption tax e.g. VAT
- Can be made more progressive by exempting or zero rating certain commodities, especially basic necessities

Regressive/Progressive VAT

VAT burden without zero rating and exemptions



VAT burden with exemptions and zero rating



Tax gap

- Difference between actual tax collection and potential tax revenue – non-compliance
- Mainly caused by:
  - Tax evasion
  - Tax avoidance
- Results in higher tax burdens and less government revenue
- Example: Kenya's revenue potential and gap in 2001/2
  - Income tax – 66.9%
  - VAT – 64%
  - Import duty – 49%
  - Corporate tax - 35%
  - Excise tax on cigarettes – 52%
  - Excise tax on beer – 85%

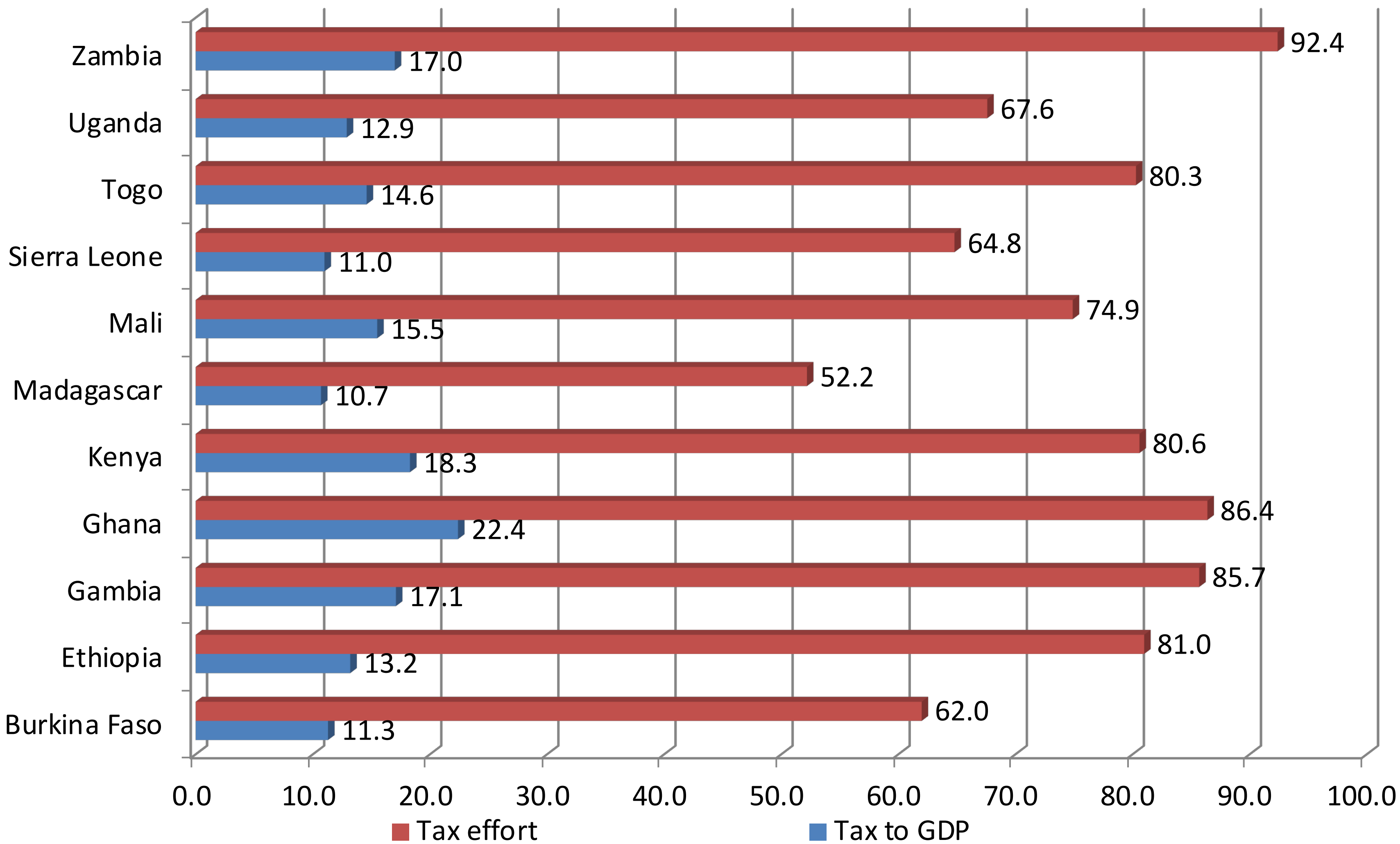
Penalties for non-compliance

- **Kenya**: 20% penalty for late payments plus 2% interest per month; 5% penalty (minimum of KShs 5,000 for individuals and Kshs 10,000 for companies) for late filling.
- **Uganda**: 20% penalty on any tax liability that is less than 90% of the actual; 2% penalty per month on late payments.

Tax to GDP ratios in selected African countries

	2011	2012		2011	2012
Angola	19.9	18.8	Mali	15.3	15.6
Benin	15.9	15.6	Nigeria	1.8	1.6
Burkina Faso	14.2	16.3	Rwanda	13.1	13.8
Botswana	**23.8**	**27.1**	SSA	14.8	14.3
Cote d'Ivoire	11.5	15.6	Togo	16.4	16.4
Egypt	14.0	13.2	**Tunisia**	**21.1**	**21.0**
Ethiopia	9.4		Tanzania	17.3	16.1
Ghana	14.9		Uganda	16.1	13.0
Kenya	19.5	19.9	**South Africa**	**26.0**	**26.5**
Morocco	**23.8**	**24.5**	Zambia	19.7	

Tax potential for selected countries



Challenges facing African tax systems

- Narrow tax bases – a large informal sector; too few workers in formal wage employment
- Inability to tax agriculture, capital gains, rental income etc
- Tax evasion and avoidance
- Complex tax systems with many exemptions that lower revenue
- Limited capacity for tax administration
- Poor quality databases
- Politics
- Influence from international community

Increasing revenue generation

- Tax reforms (broadening VAT base; excise tax regimes)
- Enhance compliance: for Kenya; through use of PIN as a common identifier and also enhanced audit; voluntary compliance thro better service delivery.
- Electronic filling of tax returns
- Capital gains tax: on net gain of transfer of property (a lot of exemptions) @ 5%; applicable in Uganda on disposal of assets at 30% and Tanzania (single installment tax) at 10% and 30% for corporates: **Kenya has room to raise capital gains tax revenue.**
- Taxation of the informal sector and SMEs – turnover tax?
- Property income e.g. rental income: Kenya 12% of gross income below 10 million per year (**case of horizontal inequality**); Uganda: 20% of gross income less 20% allowable deduction for expenses; Tanzania @ 30% for businesses and 10% otherwise.
- Taxation of natural resources

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