Institute of
Economic Affairs

MEMO

Institute of Economic Affairs-Kenya's Comments on the Draft National Tax Policy by the National Treasury

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The **Institute of Economic Affairs (IEA Kenya)** is a think-tank that provides a platform for informed discussions in order to influence public policy in Kenya. We seek to promote pluralism of ideas through open, active and informed debate on public policy issues. We undertake research and conduct public education on key economic and topical issues in public affairs in Kenya and the region, and utilize the outcomes of the research for policy dialogue and to influence policy making.

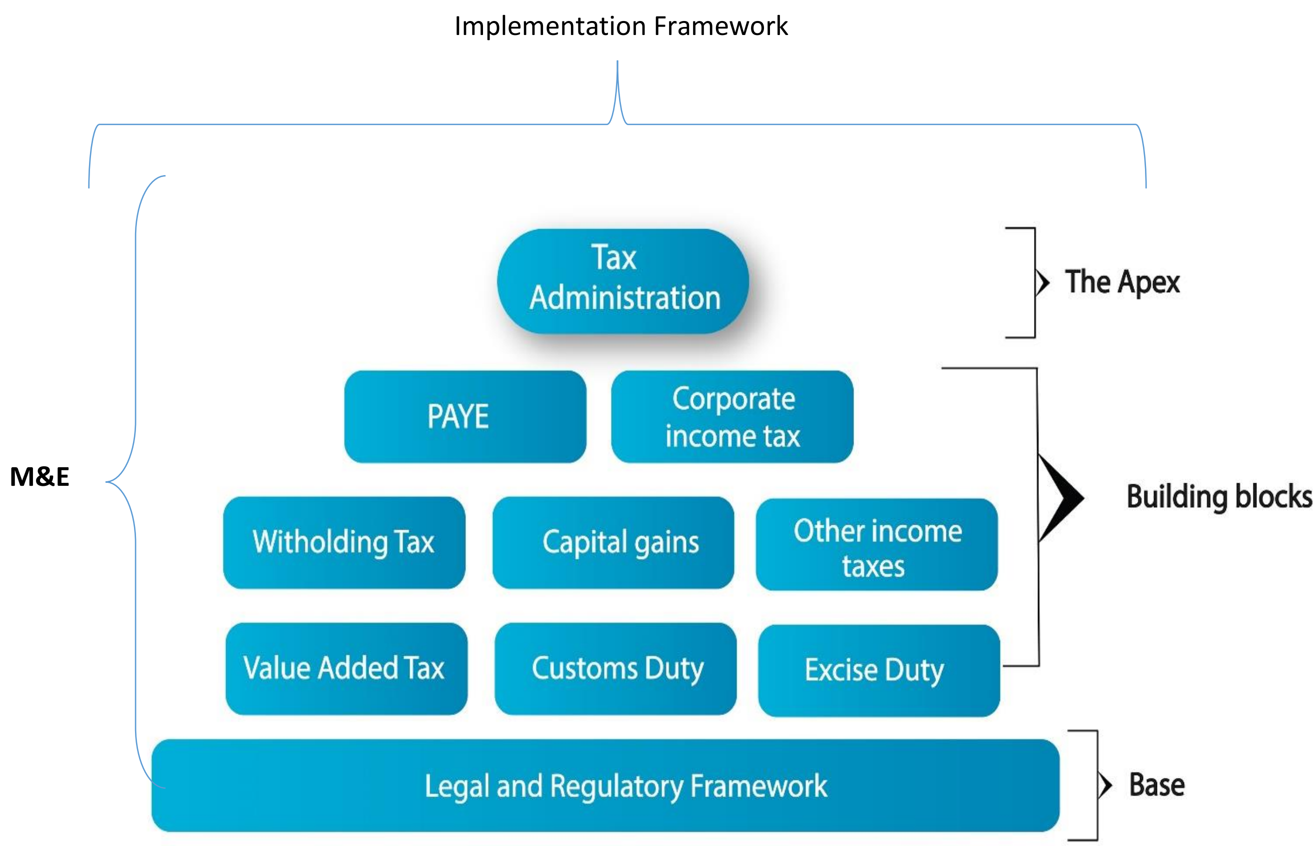
The IEA-Kenya in response to the National Treasury's call for the public to provide their input into the draft National Tax Policy (NTP). Our comments are divided into two parts, general and specific comments by the chapters of the draft NTP.

General Comments

The draft NTP is indeed timely and a major step in realization of the country's dream of having an efficient and fair tax system that promote equity in tax administration and predictable tax environment for business.

The IEA-Kenya acknowledges that the overall structure of the policy as shown in the schema below, captures important and interconnected elements, the need for a coherent legal and regulatory framework that guide tax administration in revenue mobilization towards the aforementioned dream.

The tone of the NTP is however more in-ward looking and yet the design of tax systems is critical to economic development. Besides, the context of economic structure of the country and fiscal health is completely missing. Notably parliament's roles seem to come at the end in drawing of this policy.



Chapter I: Introduction

1.3 Objectives of the National Tax Policy

Widen the scope of the objective of the NTP

The objectives of the national tax policy are rather in-ward looking and narrow towards revenue generation. On the contrary they objectives should be cognizant of other roles of tax systems including to facilitate economic growth and development.

Composition of Tax structure and design - which way to go between reliance on direct taxes or shift to indirect taxes as tax of the future (optimal tax mix)

The draft NTP is not clear/explicit on whether our focus as a country is to tax income (direct taxes), PAYE overburdened salaried taxpayer (increase in PAYE component – from 24% in 2010/11 to 40.5% in 2020/21) in the context of a large informal sector (83.2% in 2021[1]) vis a vis a small formal sector or shift reliance to taxation of consumption (indirect taxes) – by contrast VAT component has plateaued. Again, there is need for evidence based assessment to inform the direction of focus in terms of optimal tax mix on the principles of equity vs efficiency (whether tax enhances or diminishes the welfare of those that are taxed) and economic consequences. This is important so as to design a compensatory measures if the poor are made worse off by the targeted shift.

Chapter II: Situational Analysis

There is need to be cognizant of the intergovernmental fiscal relations

The legal and regulatory framework should be expanded to take cognizant of the context **of** devolved system of government. This is important because the administration of Kenya's tax system affects the functionality of intergovernmental fiscal relations. Besides, it is also critical in situating other emerging tax challenges such as double taxation and separation of powers in revenue collection, control and management.

2.5 Revenue Performance

The revenue performance section could be beefed up and made richer by not only providing information on revenue performance in real terms but also an assessment of the composition of tax revenue against basic tax concepts and principles of efficiency and equity. Others are:

- Economic implications e.g. consumption vis-à-vis turnover based taxes
- Effect on wealth allocation

Revenue Forecasting

Data shows an upward trend for ordinary revenue collection and set target for the last decade (FY 2012/12- FY 2020/21), both in nominal terms. The variance between the target and actual collection has been widening up to FY 2019/2020. Nevertheless, there is a break by the end of FY 2020/21,

[1] KNBS Economic Survey 2022

with the variance narrowing, nearly converging. That said, the situational analysis on revenue forecasting does not bring out the issues to guide development of the national tax policy in a comprehensive manner.

To this end, the **IEA-Kenya proposes** the need to strengthen part (v) of revenue performance further, in the following way:

(i) Need to improve accuracy of revenue projections

With the exception of FY 2020/21, the increasing variance raises questions about the accuracy of revenue projections. In fact, IEA Kenya (2022)[2] shows errors in revenue projection to be a major cause of delayed disbursement of funds, particularly to county governments (functionality of intergovernmental fiscal relations). This has negative implications on county budget execution. Our observation is that revenue forecasting is not so much a question of capacity/technical given the existence of a Tax Policy Unit, NT but more a political economy question.

(ii) For greater integrity in revenue projections, there is need for improved transparency through revenue forecasting reports to facilitate more meaningful public participation.

There is need to democratize tax forecasting tool and transparent as this will foster increased civil society engagement in fiscal policy affairs.

Chapter III: Policy Guidelines

3.1 Predictable Tax rates and tax bases

The policy states that analysis should be undertaken to assess the impact of proposed tax law changes on tax revenue, development, investment, employment and economic growth.

The stated indicators do not capture welfare indicators and impact on different social groups that will arise given that government revenue raising measures and expenditure affect the groups differently.

The policy further states that the National Treasury will submit annual report to the cabinet on the implementation of the tax policy. There is need to capture implicit biases that arise during implementation to ensure principles of equity and fairness are upheld.

3.3 Tax Incentives

[2] IEA Kenya (2022) Intergovernmental Fiscal Relations in Kenya 2014/15-2019/20: Implication for County Budget Execution via https://ieakenya.or.ke/?wpdmdl=2595

The draft NTP provides a correct diagnosis of twin challenge of tax incentives. The need for a coherent legal framework and erosion of tax base, despite the fact that foregone revenue has reduced from 5.15% of GDP in 2017 to 2.96% of GDP in 2020.

According to the IEA Kenya, the National Treasury should publicize reports with comprehensive tax expenditure analysis and estimates as part of the Budget Policy Statement and Budget Estimates for improved budget transparency.

Besides, it is a constitutional and PFM, Act 2012 requirement to publish all tax waivers and reports of tax exemptions and concessions. Public availability of such reports will facilitate more meaningful engagement and scrutiny by citizens on the justification to grant tax incentives. By and large this will lead to an improved score and ranking for Kenya in the Open Budget Survey.

3.4 Increase in Tax Compliance Level

The draft NTP focus to progressively increase tax compliance by enhancing public tax education and awareness and administrative reforms to among other things detect, deter and sanction non-compliance is apt.

The IEA-Kenya however notes the importance of public expenditure management as the missing piece of the puzzle. Reports from both the Office of Controller of Budget and the Office of Auditor General raise accountability questions on the use of public funds including wastages. Without proper oversight and corrective action, this often translates to poor results in service delivery. **IEA-Kenya, therefore proposes the need for adequate focus and commitment by the government towards prudent utilization of revenue, thus improved service delivery as this is ostensibly correlated to rise in levels of tax compliance**

The National tax policy indicates the focus will be strengthening the mechanism of educating different segment of taxpayers on changes to the tax laws and procedures; enhancing taxation awareness in the Kenyan education system and enhance public awareness on revenue collection and utilization for improved service delivery. This is a good move but the **IEA-Kenya notes that the National Tax policy should have a specific programme with dedicated resources to ensure continuous taxpayer engagement, education and awareness**.

3.7 Income Tax

The policy proposes that the maximum tax bands for personal income tax shall be five to ensure progressivity. In as much as the tax policy does not explicitly state gender responsive measures**, the progressivity of the income tax system can reduce gender inequality by providing stronger work incentives to women at the low end of the income distribution. Women tend to be overrepresented at the bottom of the income distribution.**

Therefore, with a more progressive system, poorer individuals, the majority of which are women, face lower marginal tax rates and, hence, have stronger incentives to work more.

3.10 Tax administration

viii. Enhance collaboration between the National and County Government on sharing information for increase tax collection.

Following the promulgation of the constitution 2010, the tax system reflect a two-tier system of governance at national and county government where some fiscal power and responsibilities is delegated to the county government by the national government. The draft NTP mentions that it will put in place measures that promote sharing of taxpayer information across government agencies and County Governments. The draft NTP **should address how** the national and county government would increase tax collection. For example, the National Government can incentivize the county government through establishment of fund to act as a buffer whenever there are delays in payment towards licenses. Licenses and certificates for business operations are renewable annually and payments is submitted to county governments. Disclosure of beneficial ownership of organization should be made mandatory before payment of business permits by entities.

- **Tax Refunds**

The huge backlog of tax refund claims is difficult to administer. Taxpayers complain that tax refunds process in Kenya is long and tedious and delay in tax refunds payment has led to businessmen and traders accusing Kenya Revenue Authority (KRA) of being quick to collect tax, but slow in refunding which affects their cash flow. The draft NTP acknowledges these issues and provides guidelines for enhancing timely processing of tax refunds. Moreover, the policy mentions government commitment to review guidelines on tax refund processes with a view to make the process effective and efficient; enhance automation of tax refund process including integration of iTax or any other tax administration systems and adopt the *'de minimis'* rules in law for tax refunds**. The National Treasury should reconsider the funding model of refunds as the current state of funding has proven to be inadequate to enable KRA monthly settlement of tax refund arrears. Further, KRA should in the future separate revenue collections functions from the processing of the fund.**

Separately, the IEA-Kenya takes note that there should be acknowledgement in the policy on the transformation of Kenya Revenue Authority into Kenya Revenue Service as noted during the Budget Statement presentation for the FY 2022/2023. The Cabinet Secretary proposed to amend the Kenya Revenue Authority Act for the name change. The name change was intended to rebrand the Authority and transform its public image thus enhancing tax compliance through improved public relations and maintain clear focus on taxpayers' needs.

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