POLICY BRIEF

A Poor Man's Portfolio?

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What is the key issue?


Unequal Scenes, https://unequalscenes.com/nairobi

Over the 10-year period between 2005 and 2015, Kenya experienced a significant decrease in both wealth and income inequality. This decline in inequality has been characterized by a fall in both the income and wealth shares of the richest members of the population, as well as modest gains for the poorest. This is contrary to what has been observed in many advanced countries where inequality has been on the rise. To understand why the Kenyan experience has been different, we investigate macroeconomic variables linked to top-end income and wealth inequality.

Why is it important?

Our analysis shows that the risk-free rate, and tax revenue to GDP ratio are key factors in explaining the decline in inequality in Kenya. The data show that between 2005 and 2015, the real risk-free rate in Kenya was mostly negative, and the tax revenue to GDP ratio rose from 2.5% to at about 8%. These two variables are interlinked: when the government can finance a large share of its expenditure from taxes, its borrowing from bond markets is lower, so "Treasury Bill" rates fall. When these two features of the data – a low risk-free rate and approx. 10% tax-to-GDP ratio – are worked into a model of the Kenyan economy, they can explain up to 92% of the decline in top wealth shares and ultimately, the fall in income inequality. However, recent evidence indicate that the risk free rate is rising, while the tax system has become regressive.

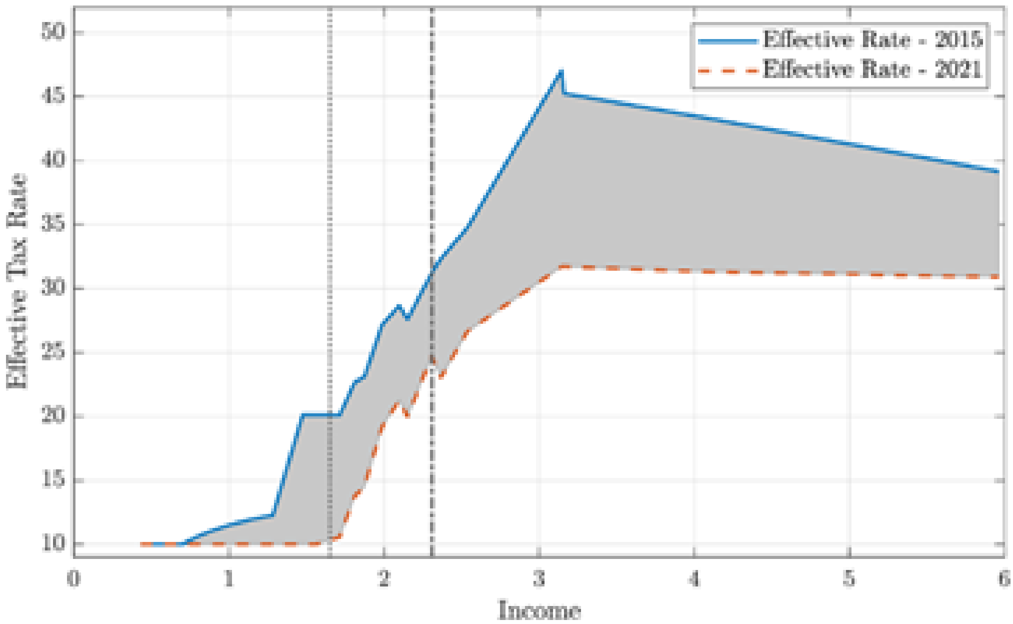
Policy recommendations

Given these facts, we recommend two policies that can be implemented by policymakers to pre-empt a rise in inequality in Kenya:

First, the government should target a real risk-free rate no higher than 4%. Why so? – When the risk-free rate is high, wealthy individuals invest a larger share of their net worth in government bonds for a high return and zero risk. This increases their wealth at the expense of investments in risky production activities which would benefit the poor through employment. With low investment in productive capital, wages are depressed, and inequality rises. However, since the risk-free rate is determined in the market for loanable funds, the road to keeping a low-risk free rate is fiscal: generating enough tax revenue to finance government expenditure.

Second, the government should implement a progressive tax system where higher net worth individuals always pay a higher effective tax rate at all levels of income. The Kenyan tax system is already progressive, but we found that the after-tax income distribution is more unequal than the pre-tax distribution. Applying the tax brackets of 2015 on an "simulated" population with a pre-tax income distribution matching that of Kenya's population, we find that the effective tax rate – the ratio of tax liability to taxable income is not always increasing in income. In fact, in some instances, there reversals in the effective tax rate as income increases: people with slightly lower earnings pay an effective tax rate that is higher than those who are richer.

This can be seen by plotting the effective tax rates against income, using the Kenya Revenue Authority tax brackets and rates between 2015 and 2021.



Author's Computation, based on Kenya Revenue Authority Tax Rates and Brackets, 2015 - 2021

The 2015 tax rules have five brackets and rates, while a reform implemented in 2021 reduces both rates and brackets to just three. As can be seen in the gray shaded area, the tax reform of 2021 is effectively a large tax cut for the richest members of the population.

We consequently recommend that the tax brackets and marginal tax rates be revised so that effective tax rates are always increasing in income. These policies can help to reduce the concentration of wealth and income among the richest members of society and promote a fairer, more egalitarian society. This mix or portfolio of policies; progressive taxation, and low interest rates, will lead to an economy that works for the poor and not just for the rich. These policies will bring us closer to one of the key sustainable development goals: reducing inequality within and among countries.

Mission

To strengthen local capacity for conducting independent, rigorous inquiry into the problems facing the management of economies in sub-Saharan Africa.

The mission rests on two basic premises: that development is more likely to occur where there is sustained sound management of the economy, and that such management is more likely to happen where there is an active, well-informed group of locally based professional economists to conduct policy-relevant research.

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