POLICY NOTE

Summary Policy Note on Tax Reforms in Kenya: Reforming Value Added Tax (VAT), Excise Taxes on Cigarettes and the Personal Income Tax (PIT)

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1. Introduction[1]

Designing and implementing tax systems that are both efficient and effective are essential for revenue generation, economic growth, and equity as well as fairness across income groups in Kenya. The existing highly complex and outdated tax structures and the lack of effective digitization undermines compliance and limit revenue collection. This, in turn, severely constrains the amount and quality of public services the Government of Kenya (GOK) can finance in support of economic transformation and development, on the one hand, and the well-being of its citizens, on the other. It has also led to a public debt level that is at high risk of distress, and harsh liquidity constraints due to the reliance on short-term borrowing instruments.

The overarching goals of the tax reform process in Kenya are to maximize revenues without distorting markets, and to ensure that the design of tax policy and tax instruments do not raise incentives to avoid and/or evade taxes. Simplification and unification of tax structures aimed at reducing government expenditures and the burden placed on taxpayers is central to achieving these goals. Therefore, this summary note (and the underlying policy notes) explores whether and how a re-design of taxes can help support change towards a combination of lower tax rates and higher revenue, and points to the associated needed range of adjustment in each of the tax instruments.

The general aim is to embark on reforms that ensure redistributive justice by introducing taxes that are progressive and fair. It is essential to uphold core principles that promote equity, transparency, and efficiency in the tax system. By adhering to core principles such as progressivity, fairness, and transparency in tax reforms, GoK can work gradually towards achieving a more equitable, efficient, and sustainable tax system that upholds redistributive justice and fosters economic and social well-being for all members of Kenyan society.

The specific tax reforms here focus on Value Added Taxes (VAT), Excise Taxes and the Personal Income Tax (PIT) as defined in our terms of reference (TOR). We argue that broadly implementing appropriate tax structures, as outlined in this policy note, is a sensible first step in equitably raising domestic revenues in line with the above objectives. As such, this note is a strategic input to the 2024 Finance Bill.

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[1] Prepared under the GOK-AERC-UCPH-DERG ECONOMIC RESEARCH AND POLICY MAKING PROJECT, based on four policy notes presented at the stakeholder engagement workshop held in Nairobi on 8 March 2024

2. Value Added Tax Reforms

Value-Added Tax (VAT) reforms serve as essential tools for governments to enhance their revenue systems, stimulate economic growth, and address specific policy objectives. While some studies suggest that VAT is regressive when measured as a percentage of current income, properly designed VAT policies can mitigate regressive effects and ensure a fair distribution of the tax burden. Accordingly, carefully, targeted VAT reforms can improve tax compliance, enhance revenue collection and promote growth and social welfare.

Moreover, VAT is the second largest public revenue source in Kenya. According to the KNBS 2023 Economic Survey (citing Treasury information) VAT income amounted to 587 billion KSh or approximately 4.4% of GDP and 26% of total tax revenue in fiscal year 2022/23. In the VAT policy note, we use an estimated 2022 annual calendar year VAT income of KES 502.8 billion or 3.76% of GDP in 2022, to calculate estimated VAT gaps. The overall gap is close to the 2019 IMF estimates, though the compliance and policy components of the gap differ.[2]

The two primary avenues for raising revenue through VAT are (i) reducing the expenditure gap and (ii) raising compliance rates. Estimates put the expenditure gap at 248 billion KSh (1.86% of GDP), and the compliance rate at roughly 47%. While the existing 16% VAT rate is common in the region,[3] a lower rate is an important policy goal to consider as noted above.

In a static analysis, lowering the VAT rate will (under present conditions) tend to reduce overall revenue potential. However, reducing expenditure levels by removing exemptions and zero-ratings can offset the lost revenue from the lower VAT rate. The analysis involved simulating the simultaneous effects of lowering the VAT rate and reducing expenditure to help clarify how overall VAT revenue is impacted. Specifically, the change in revenue from current levels assumed a reduction in expenditures by 0–100%, for VAT rates between 10% and 15%.

High-level results from these simulations are in Table 1. We used as noted data from 2022 to provide a useful benchmark in measuring the impact on revenue based on the VAT rate and expenditure levels. The first column represents the simulated reduced VAT rate. The second, third, and fourth columns show the

[2] This estimate was calculated by summing the monthly revenue data provided by the KRA for each year. We relied on the most disaggregated level possible given data alignment issues between KRA and KNBS to calculate our estimated gap.

[3] A regional analysis of East African countries shows that Kenya is roughly in the middle in terms of VAT rates.

necessary reductions in expenditure levels on exemptions, zero-ratings, and overall expenditure, respectively, to maintain current revenue levels. For example, the last row shows that with a one-percentage point VAT reduction to 15%, there would need to be either a 31% reduction in expenditure on exemptions, a 33% reduction in expenditure on zero-ratings, or a 19% reduction in overall expenditure to achieve a revenue-neutral effect.

Table 1: VAT Rate and Expenditure Simulations at 47% Compliance

VAT Rate (%)	Reduction in Expenditure on Exemptions (%)	Reduction in Expenditure on Zero-Ratings (%)	Reduction in Overall Expenditure (%)
10	N/A	N/A	N/A
11	N/A	N/A	95
12	N/A	N/A	76
13	93	98	57
14	62	65	38
15	31	33	19

The analysis in Table 1 assumes that all other variables are static, including the compliance rate (estimated at 47%). To add realism, compliance levels were incorporated into the simulations.

Kenya's VAT architecture is currently extremely complex, with granular exemptions and zero-ratings that make the overhead cost and tracking of receipts burdensome for firms and opening space for loopholes and non-compliance. On this background, it is a priority to reduce complexity in the tax code (in part by removing exemptions and zero-ratings). This will in turn undoubtedly increase compliance levels. Additionally, the rollout of eTIMs[4] and other automation of the systems used by the Kenya Revenue Authority (KRA) will further boost compliance in both the formal and informal sectors, increasing the compliance rate to 90 percent by 2026/27 from 70 percent in 2022/23 (MTRS, 2023).

Table 2 shows the same information as in Table 1 combined with a moderate increase in compliance by three percentage points from 47% to 50%. Importantly, the table shows that raising compliance has a massive impact on revenue changes compared to the VAT rate and expenditure. With compliance at 50%, the policy changes needed to maintain current revenues with a lower VAT rate are much smaller. For instance, at a VAT rate of 15%, the GOK needs to

[4] eTIMs is a software solution that allows taxpayers to issue electronic tax invoices and access various solutions for a simple, convenient and flexible approach to invoicing.

only reduce expenditure levels by 7% overall, compared to 19% at current compliance levels.

Table 2: VAT Rate and Expenditure Simulations at 50% Compliance

VAT Rate (%)	Reduction in Expenditure on Exemptions (%)	Reduction in Expenditure on Zero-Ratings (%)	Reduction in Overall Expenditure (%)
10	N/A	N/A	N/A
11	N/A	N/A	83
12	100	N/A	64
13	69	73	45
14	38	40	26
15	8	8	7

More information is available in Appendix A on additional combinations of VAT rates, expenditure reductions, compliance levels, and revenue impact.

The VAT threshold is also an important aspect of the VAT system. Although policymakers may look to the VAT threshold as an important contributor to foregone revenues, the analysis shows that those firms falling below the Ksh 5 million threshold would not contribute significantly to VAT revenues. At the same time, such a policy initiative would raise administrative costs for both the firms and the KRA.

In sum, in addition to setting a lower VAT rate, it is recommended that tax reforms focus on reducing expenditure and raising compliance. On expenditures, the IMF estimates that the exemptions and zero-ratings of basic foods amounts to approximately 70% of the expenditure gap in Kenya. Much of this expenditure occurs during the manufacturing and transport of basic food items, in addition to the agricultural inputs and outputs. Accordingly, it is recommended that the Government consider removing such exemptions and zero-ratings with a view to lowering expenditure levels significantly.

However, care is required in the actual reform process to avoid introducing shocks from removing exemptions and zero-ratings that are effective in keeping the price of essential goods and services low, especially for poorer groups. Put differently, the GOK will in the reform process need to determine whether the removal of specific exemptions and zero-ratings of basic food items will place an undue burden on the intended beneficiaries of the policy.

In the extended VAT policy note, the list of specific exemptions and zero-ratings that appear as prime candidates for normal VAT rate treatment are provided.

3. Excise Tax Reforms

This policy note, which was in the final preparation divided into two notes, addresses respectively the excise taxes on alcohol and on cigarettes, levied to offset the negative externalities associated with these products and to raise government revenues. The current configuration of the excise on alcohol does not link directly with alcohol content. Thus, there is a good case here for excise tax reforms. A compelling justification from the perspective of long-term public health concerns is present. Furthermore, many reforms have over time resulted in a very complicated structure. Consequently, the existing system does not align with the international best practice of taxing pure alcohol content and creates administrative burdens for both the government and producers. For cigarettes, the specific rate system is the preferred one, but a unified, instead of tiered system may be more effective to reduce smoking and increase revenue.

Changing to an excise tax on the amount of pure alcohol reflects an international best practice. The calculated own- and cross-price elasticities show there is room to increase the current excise rates relative to their current position. This is especially true of the tax on spirits, which falls further to the left on the Laffer curve than beer. However, there is need to consider the possible revenue gains from raising excise taxes need against the negative effects on the industry and the possibility of increasing consumption of illicit spirits.

Thus, two reform options are provided in Figure 1 to show how a new structure could generate a 10% increase in excise revenues. Reform A has no change in the relative tax burden on beer and raises spirits to a similar level on the Laffer curve. Reform B includes a small increase in the relative tax on beer to avoid the possible distortions that could accompany the 24% increase in the excise tax on spirits alone in reform A. It is recommended to set the tax per cl of alcohol on wine at the same rate as for spirits in both scenarios.

Figure 1: Two Reform Scenarios for Excise on Alcohol

Reform A	Reform B
Excise Rates:	*Excise Rates:*
Beer: 36 Ksh/cl (0%)	Beer: 45 Ksh/cl (+5%)
Spirits: 19 Kshcl (+24%)	Spirits: 15 Ksh/cl (+14%)
Projected Revenue Change:	*Projected Revenue Change :*
Baseline: +10%	Baseline: +10%
Pessimistic: +3.9%	Pessimistic: +4.9%

Note: Author's Calculations. See Appendix for elasticities and Laffer curve estimations.

A similar approach was used for cigarettes by calculating elasticities and generating Laffer curves, partial and joint, between filtered and unfiltered cigarettes. As is the case with alcohol, the current tax structure falls to the left of the peak on the Laffer curve. Figure 2 shows two reform scenarios that, based on these Laffer curves, should raise baseline excise revenues by 10%. Reform A includes a moderate excise increase on both types of cigarettes and generates revenues even under moderately high elasticities. Reform B offers a unified approach, simplifying the payment and collection process, but introducing a large increase in the tax on unfiltered cigarettes.

Figure 2: Reform Scenarios for the Excise on Cigarettes

Reform A	Reform B
Excise Rates:	*Excise Rates:*
Filtered: 4900 KSh/mille (+20%)	Filtered: 4450 KSh/mille (+9%)
Unfiltered: 3400 KSh/mille (+16%)	Unfiltered: 4450 KSh/mille (+52%)
Projected Revenue Change:	*Projected Revenue Change:*
Baseline: +10%	Baseline: +10%
Pessimistic: +5.4% Very Pessimistic: -0.8%	Pessimistic: +2.7% Very Pessimistic:0%

Note: Author's Calculations. See Appendix for elasticities and Laffer curve estimations.

The potential positive revenue impacts from both reforms depend on compliance and enforcement. Two administrative steps that can have immediate impact (by reducing administrative costs and increasing compliance through simplicity) are (i) unifying rates, whenever feasible, and (ii) utilizing and publicizing automatic inflationary adjustments.

Currently, filing and paying for excise taxes for alcoholic products takes place every 24 hours, giving little time for filing, so this timeframe could be re-examined. There is no international consensus on this but from a brief review, moving to a weekly or bi-monthly remittance filing system might be a sensible starting point for reform. Moreover, for alcohol, issues of illicit brewing and trading reduce potential revenues and introduce worse health externalities. For cigarettes, illicit cross-border trade hinders growth and reduces revenues. Tax reforms must address these broader issues based on experiences gained over the coming period for the excise structures to operate eventually at optimal levels.

4. Personal Income Tax Reforms

This section explores the possibilities for reform of the personal income tax (PIT) structure, with emphasis on options that increase both progressivity and revenue. This aligns with the medium and long-term goals of the GOK as described in the Medium-Term Revenue Strategy. Results show revenue gains from expanding the tax base by lowering personal relief (currently at Ksh 288,000) would be moderate and come at the cost of introducing horizontal inequities and significant administrative costs. On the other hand, the revenue potential of further hikes in top marginal tax rates crucially depends on how strongly the incomes of the rich react to them – and this potential might be limited under some plausible assumptions.

The main opportunities to increase progressivity and revenue collection lie in raising marginal tax rates more gradually along the income distribution. Progressivity of the PIT structure runs up against the fact that most taxpayers face marginal tax rates of 30%, while the first effective marginal tax rate is very close at 25%. To demonstrate the effects of addressing these issues through PIT reform, the analysis considered lowering the tax rate for the first tax bracket after personal relief (expanded up to Ksh 425,000a year) from 25% to 22.5%, and/or introducing an additional tax bracket (up to Ksh 600,000) with a tax rate of 27.5%.

Such tax cuts are costly, implying revenue losses of 1.5% each – or 2.6% when combined.[5] However, lowering the threshold (referred to as T) at which the top tax rates introduced in 2023 start applying may generate fiscal space to reduce the burden on a larger number of taxpayers in the middle class, while affecting only a minority of Kenyans.

Taxpayers earning between KSh 1M and 6M a year constitute a large share of reported income (41%), but a much smaller share of those reporting personal incomes to KRA (16%). More broadly, less than 5% of Kenyan workers earn as much. Thus, raising average tax rates for this group is key to simultaneously increasing revenue and reducing post-tax inequality. In addition, above 50% of filers in this bracket are public workers, who will react less to increases in marginal tax rates than other taxpayer groups.

Summing up, and according to our estimates, Table 3 shows that lowering the threshold for the 32.5% tax rate to levels around KSh 1.5M (950k) would allow funding one (both) of the tax cuts suggested above.

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[5] The revenue losses do not add up because both reforms include a common component lowering tax rates for incomes between Ksh 388,000 and Ksh 425,000.

Table 3: PIT reforms to increase progressivity. Revenue implications

	Rate between T and KShs. 9.6M			
	32.50%		35%	
Reforms	Rev. Change at T = 1M	Rev. neutral T	Rev. Change at T = 1M	Rev. neutral T
288k - 425k: MTR = 22.5%	0.82%	1.55 M	3.40%	2.93 M
425k - 600k: MTR = 27.5%	0.93%	1.65 M	3.50%	3.08 M
Both reforms	-0.14%	950,000	2.43%	2M

Note: Revenue increases (as a percentage of total PIT revenue) and revenue-neutral T shown with respect to projections for 2022 data under the 2023 PIT schedule, based on an income elasticity to net of tax rates of 0.475 for top incomes. To approximate revenue changes wrt 2022, add the effect of the 2023 reforms (≈1.45%).

On the other hand, if the GOK is ready to increase marginal tax rates to the current top marginal tax rate of 35% from this threshold, such measures can be self-sustaining already for T = 2M (3M when implementing only one of them) and bring substantial revenue increases above KSh 10 Bn. for T = 1M.

The additional progressivity introduced by these reforms will reflect in reduced post-tax inequality among formal workers, as measured by the Gini coefficient. Increased tax rates beyond T are the main driver of these effects, which can reduce inequality by up to 1.5% with respect to the 2023 PIT structure. At first, this may seem a small change, but it is quite large in relative terms, i.e. 30% of the overall equalizing effect of the PIT structure.

More moderate reforms, which would raise rates to 32.5% instead of 35% or lower T to levels ensuring revenue-neutrality would reduce inequality by around 0.8%. Tax cuts at the bottom, and particularly lower rates for the first bracket, have themselves some perceptible impact on inequality, but only account for around 10% of the overall decline.

As opposed to other reliefs and exemptions, personal tax relief enhances the progressivity of the PIT structure. However, we find that a substantial share of individuals whose (reported) yearly incomes are below the amount theoretically covered by tax relief are paying positive amounts of income tax, possibly due to being formally employed only for part of the year. Information campaigns or automatic reimbursement of taxes may be effective ways to ensure that personal relief fully achieves its role of shielding low-income earners and improve their perception of tax authorities.

Beyond changes in the tax structure, a further potential avenue for increased revenue is as noted throughout improved compliance. On that note, it is important to keep in mind that a large majority of those not reporting their incomes to KRA would be exempt anyway from PIT through personal relief. Therefore, targeted enforcement efforts towards those in the shadow economy with sufficiently high incomes to be tax liable (with particular emphasis on High-Net-Worth individuals) are much more likely to be cost-effective than broad registration initiatives harvesting large numbers of unproductive taxpayers in the informal sector.

5. Conclusion[6]

Each of the policy initiatives discussed in this note, while independent in application, form part of a larger concerted GOK reform initiative of the existing tax architecture that has widespread economy-wide impacts. The new tax structures in Kenya will appropriately reformed surely complement each other and as the analysis shows broader economic trends are critically important for the overall success of domestic revenue systems.

However, it is important to stress that by generally unifying taxes and removing complexities and loopholes, GOK can generate higher revenues without introducing economic shocks or placing undue burdens on its citizens or hindering the functioning of markets. Thus, there are promising ways to move forward in the needed tax reforms in Kenya.

Beyond reforms discussed in this note, it is essential that all opportunities are used to build trust in the public administration and tax authorities with a view to increase compliance leading to better mobilization of public revenue. There is for example quite convincing empirical evidence (e.g. based on Afrobarometer data), that compliance is higher in countries where service delivery is higher. Thus, appealing to the 'social contract' literature is also relevant here.

In conclusion, we emphasize that the analysis in this note refer to data from recent years. Assessment of any concrete actual policy changes for introduction in the 2024 Finance Bill, should adjust the values contained here to reflect 2024 Kenyan Shilling values. Finally, in addition to the detailed policy notes considered here (i.e. VAT, excise, and PIT), the GOK-AERC-UCPH-DERG project will also complete in due course the experimental studies designed to give insight into possibilities for affecting tax behavior alongside other agreed studies.

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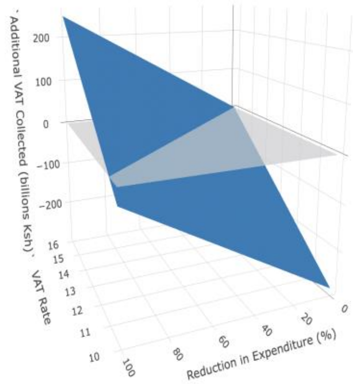
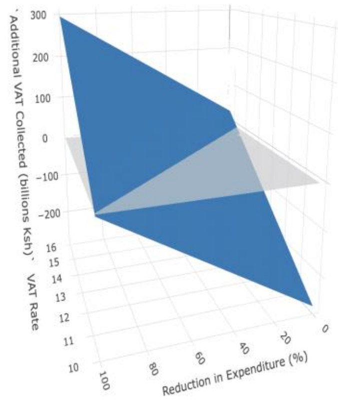
[6] We have not considered property taxes in this note as they fall outside of the agreed terms of reference.

Appendix A – VAT Rate Simulations

Figure A-1: Revenue Simulation at 47% Compliance	Figure A-2: Revenue Simulation at 50% Compliance
	

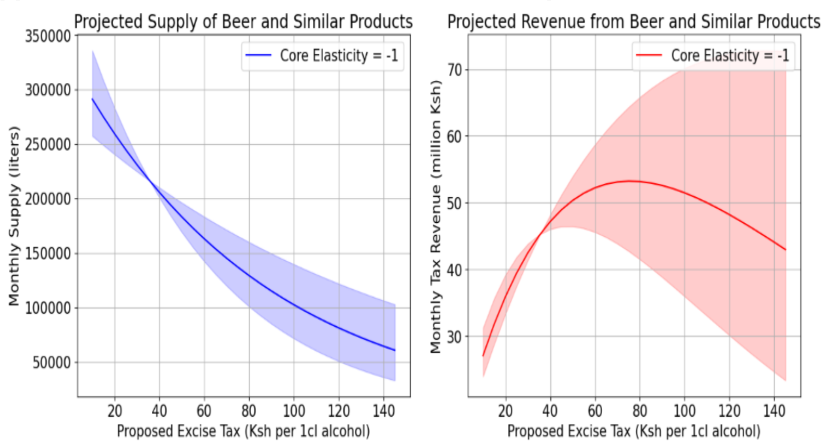
Appendix B – Elasticities for Beer and Spirits

Table of Supply Elasticities

	Beer	Spirits
Own-price	-0.85	-0.66
	[-1,32 ; -0.38]	[-1.29; -0.04]
Cross-price	0.64	0.59
	[0.53, 0.76]	[0.49; 0.69]

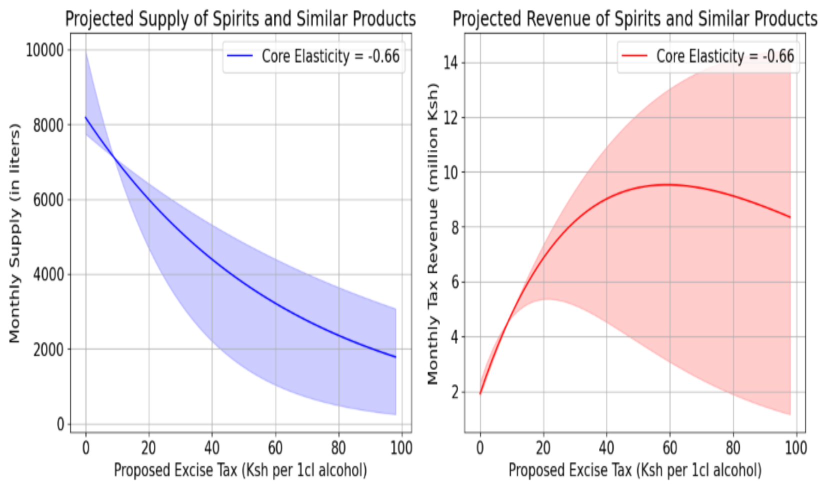
Reported intervals are 95% CI with Huber-White robust std. errors

Appendix C – Partial Laffer curves for Beer and Spirits



The error bands represent the range of demand and tax revenue outcomes based on varying elasticities. Elasticities used are: Low = -0.586, Central = -1, High = -1.48.

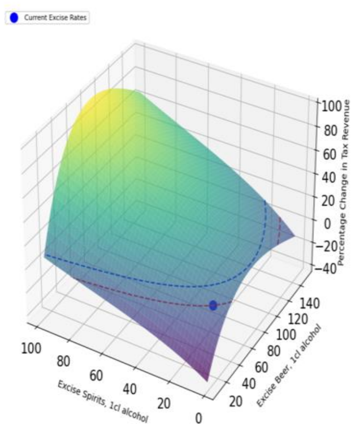
Appendix D – Joint Laffer curve for Beer and Spirits



The error bands represent the range of demand and tax revenue outcomes based on varying elasticities. Elasticities used are: Low = -0.4, Central = -0.66, High = -1.6.

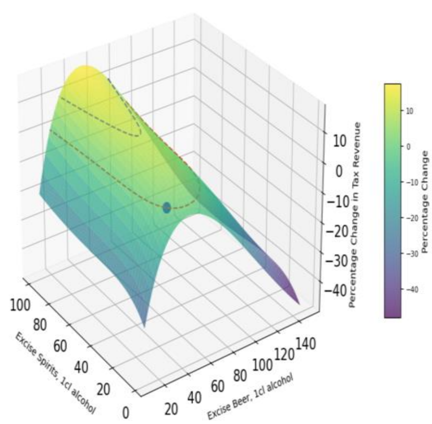
Appendix E – Elasticities for Filtered and Unfiltered Cigarettes

Baseline Specification



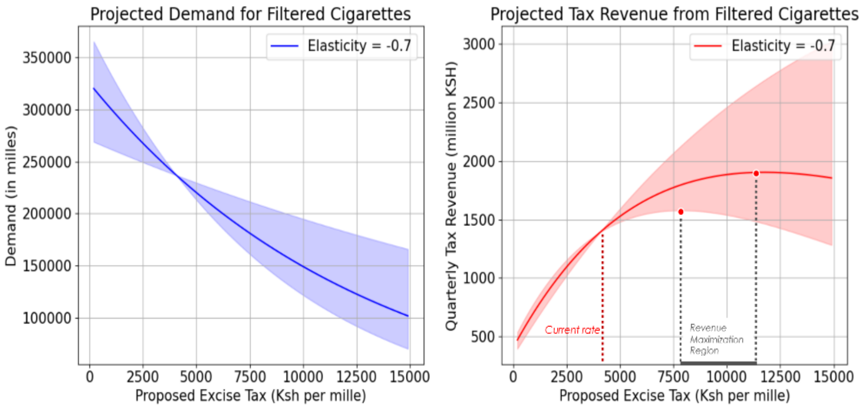
Beer own-price elasticity -1, spirits own-price elasticity -0.66. Cross-price elasticities 0.25

Pessimistic Specification

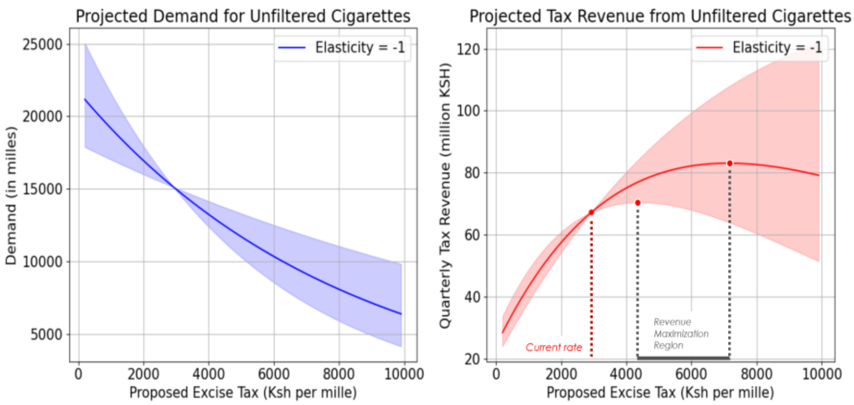


Beer own-price elasticity -1.48, spirits own-price elasticity -1.6. Cross-price elasticities 0.1

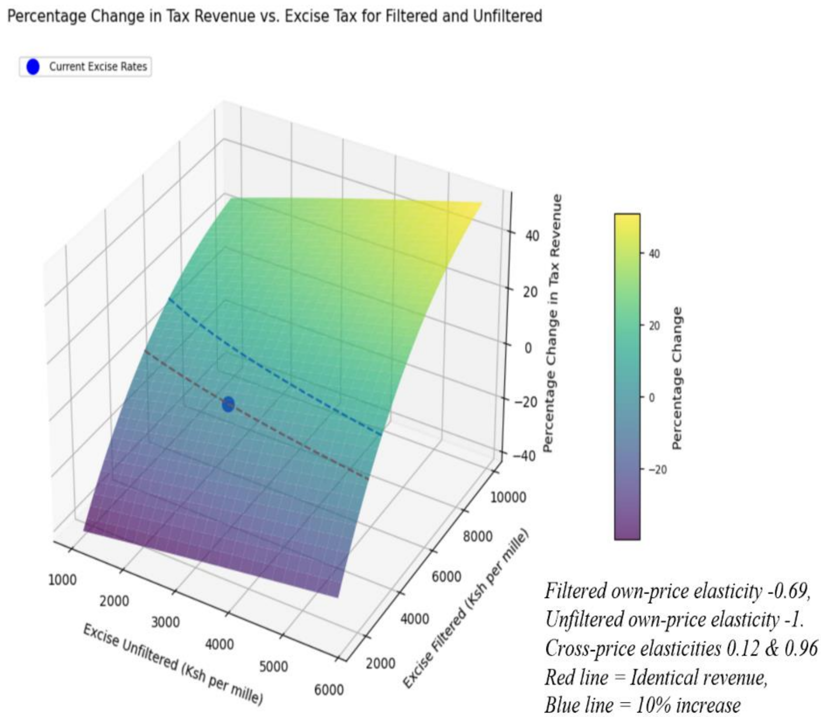
Appendix F – Partial Laffer curves for Filtered and Unfiltered Cigarettes



Appendix G – Joint Laffer curve for Filtered and Unfiltered Cigarettes



Appendix F – Status of experimental studies



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