

# Understanding the Public Revenue System in Kenya: An Overview of the Tax System

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**Working Paper GOK -AERC -UCPH-DE RG-001**

*Bringing Rigour and Evidence to Economic Policy Making in Africa*

**AFRICAN ECONOMIC RESEARCH CONSORTIUM  
COSORTIUM POUR LA RECHERCHE ÉCONOMIQUE EN AFRIQUE**

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AERC Working Paper GOK-AERC-UCPH-DERG-001  
African Economic Research Consortium, Nairobi  
February 2025

**THIS RESEARCH STUDY** was supported by a grant from the African Economic Research Consortium. The findings, opinions and recommendations are, however, those of the author and do not necessarily reflect the views of the Consortium, its individual members or the AERC Secretariat.

Published by: The African Economic Research Consortium  
P.O. Box 62882 - City Square  
Nairobi 00200, Kenya

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# Acknowledgements

The African Economic Research Consortium (AERC) would like to acknowledge the Royal Danish Embassy - Nairobi (for financial support) and the implementation partners including Development Economics Research Group at the University of Copenhagen (UCPH-DERG), Kenya Institute of Public Policy Research and Analysis (KIPPRA), Kenya Revenue Authority (KRA), Kenya National Bureau of Statistics (KNBS) & Central Bank of Kenya (CBK) (for technical and intellectual support). The AERC is also grateful to the project steering committee and the stakeholders for in-depth comments and suggestions that shaped this paper from inception to completion. The findings, opinions and recommendations are those of the authors and do not necessarily reflect the views of the Consortium, its individual members or the AERC Secretariat.

# Abstract

This paper provides a high-level analysis of Kenya's tax system, examining structures, performance, and potential reforms to enhance domestic revenue mobilization for economic development. Synthesizing data from national agencies, we identify the central challenges facing the tax systems in Kenya including compliance levels, a significant informal sector, and economic shocks. Our analysis underscores the need for data-driven policymaking, emphasizing Kenya's Medium-Term Revenue Strategy (MTRS) 2024-2027, aimed at reversing declining tax-to-Gross Domestic Product (GDP) ratios through a comprehensive modernization of the public revenue system. Our study further highlights major revenue streams such as income taxes and value added tax to show how a few taxes make up a large portion of domestic revenues and the urgency for optimization within these taxes. The stagnant or declining performance of many tax structures in Kenya reveal a need for comprehensive reviews and updates that enhance progressivity, encourage compliance, and raise revenues relative to GDP.

# 1. Introduction

The tax architecture of a country is a central piece of domestic revenue mobilization and thus a keystone in development. In low and middle-income countries, tax policies can play an outsized role in politics, bringing fiscal policy into the public eye. Moreover, taxation and the design of taxes in countries such as Kenya are often the topic of debate domestically and internationally. It is important, then, to ensure that policymaking is based on a comprehensive overview of the current systems, why they are in place, how they are structured and enforced, and what their performance tells us about the future trajectory of tax revenues. Although taxes are not the only source of domestic revenue in Kenya, their importance in the fiscal and political realms is undeniable and merits a high-level analysis to inform future policies and research.

Tax policy reforms must stem from verifiable data and analysis to ensure their viability and impact. In Kenya, this means synthesizing data from various sources, including the Kenya Revenue Authority (KRA), National Treasury, and the Kenya National Bureau of Statistics (KNBS) among other sources. This can be an inherently difficult task, and in Kenya, has led to gaps in the understanding of the domestic revenues system, especially in relation to taxation. Tax policies are complex, but understanding their impact and importance over time is essential to generating a picture of the health of the system and to identify potential areas where reforms could be beneficial. This is especially true thanks to the critical position tax policy in Kenya plays in terms of development and poverty-reduction goals (Aringo, 2023) Thus, reviewing the tax systems in Kenya from policy and impact perspectives can ensure that future reforms and alterations are done in consideration of the tax system as a whole and not in isolation of one another.

A central aim of Kenya's current public revenue system is to increase the tax to gross domestic product (GDP) ratio to support the development agenda of the Government of Kenya. To do this, the Government of Kenya (GOK) instituted the Medium-Term Revenue Strategy (MTRS) for 2024-2027. (Government of the Republic of Kenya, 2023; OECD, 2022). The MTRS aims to modernize and reform the Kenyan Public Revenue System (KPRS) and specifically address the decline in tax revenue relative to GDP from 18.1% in 2013/14 to 14.1% in 2022/23. The goals outlined in the MTRS are ambitious, but the steady growth in GDP in Kenya indicates that there is untapped potential that should be explored. However, the goals of the MTRS cannot be taken in isolation of the broader socio-political realities present in Kenya which emphasizes the need to contextualize the current tax structures and performance with broader socio-economic realities. The MTRS and National Tax Policy explicitly address low compliance, the development of online

business, international taxation, illegal trade, and a large informal sector that are hindering the performance of the KPRS (Fjeldstad, 2016; Government of the Republic of Kenya, 2023; IMF, 2011; Mascagni, 2014). Other economic shocks and conditions such as rising inflation and cost of living and factors such as the trade impact of Russia-Ukraine war present further challenges addressed by the MTRS (KIPPRA, 2023). These issues have been exacerbated in recent years by further shocks such as natural disasters and unrest over the rising cost of living in Kenya (Dahir & Walsh, 2024; OCHA, 2024). These challenges have a broad impact and further emphasize the need for data-driven policy making to make the tax architecture more progressive and conducive to development and growth in Kenya.

To create a progressive tax regime, the Kenyan Government (GOK) is calling for a variety of changes ranging from regional unification to domestic enforcement. While these calls are a direct response to the performance of the KPRS, the evidence as to why domestic revenues are lagging collectively is sparse and varied. Until now, there have not been efforts to generate a picture of the overall performance of the tax systems in Kenya with an aim to inform future policy reforms. We analyze the Kenyan public revenue system, focusing on tax revenues, to identify causes for underperformance and to provide an overview of the current state of the KPRS. To do this, we utilize taxation data from the Kenya Revenue Authority (KRA) and the Kenya National Bureau of Statistics (KNBS) to conduct a macro-level analysis of Kenyan domestic revenues.

In this paper, we provide a high-level analysis of the most important tax revenue streams in Kenya to provide a strong foundation for future research and policy making. We begin with a description of central issues facing the KRA and those issues most pertinent to taxation in Kenya. Then, in Section 3, we provide an overall picture of the tax revenues in Kenya contextualized by the challenges outlined in Section 2. Next, in Section 4, we provide an overview of the taxes that constitute most of the tax (and overall domestic) revenues in Kenya. These are Value Added Tax (VAT), Personal and Corporate Income Tax (PIT and CIT respectively), and excise taxes. We also touch on other sources of tax revenue such as customs stamps. These analyses are high-level, but we aim to contextualize tax performance with the issues outlined in section 2 of this paper. We then conclude the paper by looking at some policy and practice matters related to the high-level analysis of the Kenyan tax structure and performance.

## **2. Challenges in Raising Tax Revenues**

In this section we briefly explore some of the main challenges facing the KRA when it comes to raising tax revenues. Although this is not an exhaustive list of challenges, it provides valuable context when analyzing tax performance and in guiding future policies.

### **Structural Challenges**

When policy makers seek to introduce reforms to the various tax architectures in Kenya, they must first look at the structural challenges present that may impact the success of such reforms. These structural challenges are present in any country levying taxes as they relate to practical costs and challenges associated with the levying of taxes. From practical data-management to personnel, to logistical issues tied to distance and weather, any revenue authority will face certain self-imposed and uncontrollable challenges. The performance of individual taxes and the overall revenue system is tied to these specific challenges, making it important to understand how any reform might relate to a particular issue. Structural issues, for the purpose of this paper, are separate from those challenges tied to taxpayer morale and behavior and are instead those linked with the policy of collection and capacity to collect in varying circumstances.

Any tax policy comes with a collection strategy, in Kenya this strategy has recently been revolutionized with the introduction and implementation of new digital systems, namely iTax and eTIMS. These two systems are designed to solve many of the structural problems that the KRA has faced in the collection of all taxes. They are aimed at simplifying the filing process for citizens, synthesize data management for the KRA, and facilitate the automatic detection of discrepancies (KRA, 2024). The move to a fully digital tax filing and management system has been introduced progressively with the final full integration completed in March 2024. In theory, these new systems should ensure that sales, wages, and other relevant tax information are accounted for in a manner that is clear to the filer and the collector. Moreover, it should solve certain data management issues by creating a centralized system for collection and analysis. The full roll-out of these systems will merit further investigation in the coming years to ensure that they are having their intended impact.

While eTIMS and iTax are aimed at solving many of the structural problems present in the current collection strategy, there are still issues related to

policies that impact revenues. For example, complexities and changes in VAT and income tax policies may leave some taxpayers confused as to what they should file and pay. Internal reviews of KRA data show that some small business owners are paying turnover tax when they do not actually reach Ksh. 1 million annual threshold simply because they do not know whether they will reach that threshold come the years end. Such issues are sometimes inevitable as some tax structures can be inherently confusing and taxpayers are not always aware of what policies apply to their given situations (Hamudi 2022). Ensuring that tax policies are easily accessible, published and updated regularly, and accurately reflected in the electronic filing systems are the central strategies to counter such confusion.

Structural challenges to revenue collection can extend beyond the specific collection policies as there are external factors that interact with tax structures that can make revenue maximization difficult. For instance, environmental factors, rural locations, and a lack of internet access can all create chokepoints in tax collection (Martinez, 2013; Wambai et al., 2019). Some of these challenges cannot be addressed directly insofar as the KRA is concerned. Geographic challenges can be countered by introducing better digital practices, but natural disasters and other such events are issues that are difficult to account for through collection strategy and policy design.

There are numerous other structural challenges in raising tax revenues such as reliance on cash, difficulty in classifying transaction types, and exemptions and concessions in certain tax structures (Wambai et al., 2019). However, two non-structural challenges emerged as a focus for policymakers when it comes to raising tax revenues: non-compliance or evasion, and informality.

### **Non-Compliance**

Non-compliance in the Kenyan domestic revenue system is a broad issue that merits a deeper look. In this paper we only touch on the issue to emphasize its relevance in the analysis of tax structures. Non-compliance, evasion, and misreporting look different in each tax type. The issue can range from simple mistakes in accounting to deliberate efforts to avoid paying tax. Issues of non-compliance are particularly harmful to the integrity of the tax system as they can represent taxpayers exploiting loopholes or even the introduction of corruption into a system that relies on trust and transparency.

Non-compliance can be linked to issues of taxpayer morale (Lago-Peñas & Lago-Peñas, 2010; OECD, 2014; Unger, 2014). The morale of a taxpayer and their willingness to accurately pay taxes is a complex economic and behavioral matter that has been extensively investigated and is perhaps the central driver of noncompliance (OECD, 2019; Paleka et al., 2022). This is centrally due to the

cost-benefit analysis that individuals do when it comes to filing and paying taxes. Experimental approaches are an effective way to analyze non-compliance, and although this type of analysis is outside of the scope of this paper, such research can be fruitful in Kenya to understand different factors leading to noncompliance (Ghosh & Crain, 1995).

## **Informality**

The tax revenue systems in Kenya are, of course, linked with broader economic realities in the country. One of these realities that is particularly important when it comes to analyzing the performance of tax revenue systems is informality. There are complex, multi-directional linkages between tax revenues and informality. Tax policy can have a large impact on firm and worker informality, but this impact is not always linked directly to higher revenues (Fernández & Villar, 2017; Rocha et al., 2018). With an informal sector making up almost a third of Kenya's GDP, its importance becomes clear (Murunga et al., 2021). The cost of formalizing and the broader impacts of informal markets in Kenya can have widespread impacts on revenues and taxpayer morale (Gershuny, 1979; Ulyssea, 2020).

While lowering taxes may reduce informality, it does not necessarily lead to increased revenues (Benhassine et al., 2018; Lediga et al., 2020; Rocha et al., 2018; Rocha & Ulyssea, 2014). These findings run contrary to common conceptions that bringing firms into the formal market will lead to increased revenues. This is not to say that encouraging formalization would be harmful to the KRA or the Kenyan economy but does serve to nuance the idea that the presence of a large informal sector the main driver of underperformance in the tax system. Although this paper does not deal directly with the impacts of informality, its importance in the performance of the various taxes in Kenya should be appreciated and investigated further, especially considering the broader significance of informality when it comes to economic development (Boadway & Sato, 2009; Gershuny, 1979).

# **3. The Tax System**

## **Outline of Tax Policies**

Kenya tax structure has been updated and altered regularly. These updates have been met with varying levels of acceptance from the public. The MTRS and larger government goals in Kenya rely on increasing tax revenues through reforms and enforcement, a policy which has been met with opposition from the public (Dahir & Walsh, 2024). The burden to deliver services, pay public debts, and deal with issues ranging from decaying roads to overburdened health systems are placing pressures on the public revenue systems in Kenya,

placing fiscal sustainability in jeopardy (Chapman, 2008). Finding a balance between tax policies and broader government fiscal policies has been difficult but is necessary to create sustainable growth and maximize revenues in such a way that benefits the Kenyan public.

Kenya’s tax revenues come mainly from four tax types. A fifth type, customs and import duties, do not constitute the same revenue significance but it is important to analyze as well because it is most representative of regional tax policy cooperation. Table 3.1-1 shows these main tax types, the primary bases that they target, and some of the main factors that drive their revenue performance. While this is a high-level overview, it does set the scene for deeper analysis of the different tax types in Kenya and contextualizes the broader performance of the tax system. Each tax type faces its own set of challenges when it comes to implementation and enforcement, but they also interact and overlap in complex and important ways.

**Table 3.1-1: Bases and drivers by tax type**

<b>Tax type</b>	<b>Tax base(s)</b>	<b>Revenue Drivers</b>
<b>Personal Income Tax (PIT)</b>	<ul style="list-style-type: none"> <li>• Number of taxpayers registered.</li> <li>• Taxable or earned income.</li> <li>• Business income.</li> </ul>	<ul style="list-style-type: none"> <li>• PAYE compliance</li> <li>• Income tax rates applicable</li> <li>• Salary rates and employment growth</li> <li>• Withholding tax</li> </ul>
<b>Corporate Income Tax (CIT)</b>	<ul style="list-style-type: none"> <li>• Corporate incomes</li> <li>• Remittances from private firms</li> </ul>	<ul style="list-style-type: none"> <li>• CIT rate setting</li> <li>• Investment deductions</li> <li>• Interest rates</li> <li>• CIT-compliance</li> <li>• National economic performance</li> </ul>
<b>Value Added Tax (VAT)</b>	<ul style="list-style-type: none"> <li>• Vatable goods and services</li> <li>• Vatable turnover for the case of domestic VAT</li> </ul>	<ul style="list-style-type: none"> <li>• Withholding VAT</li> <li>• VAT rate adjustments</li> <li>• Exemptions and zero ratings</li> <li>• Administrative capacity</li> <li>• VAT compliance</li> <li>• Refunds and claims</li> </ul>
<b>Excise Tax</b>	<ul style="list-style-type: none"> <li>• Volumes of excisable products.</li> <li>• Number of commodities on which tax is levied.</li> </ul>	<ul style="list-style-type: none"> <li>• Excise duty rates</li> <li>• Compliance levels</li> <li>• Exemptions</li> </ul>
<b>Customs and Import Duty</b>	<ul style="list-style-type: none"> <li>• Import volumes</li> </ul>	<ul style="list-style-type: none"> <li>• Compliance of importers and agents.</li> <li>• Duty remission schemes.</li> </ul>

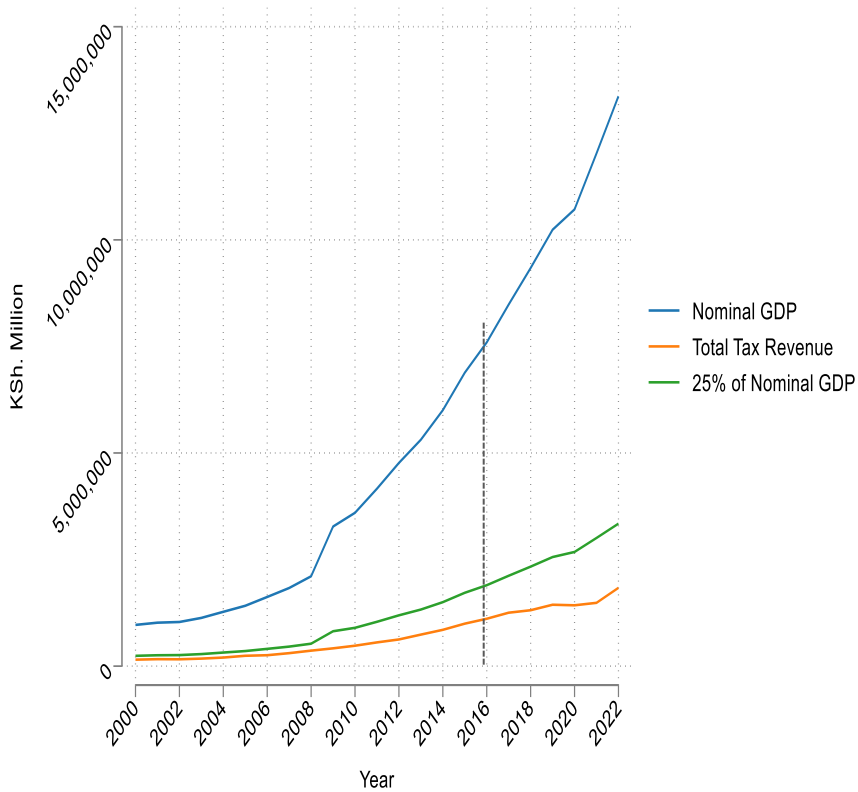
## **Current Performance**

While a top-down overview approach to tax policy can leave many questions unanswered, it is a necessary starting point especially given the fact that such analysis is not readily available to researchers and policymakers. A starting point tax research and policy design in Kenya should first consider the overall performance and linkages between different tax revenue streams. The entirety of the domestic revenues system in Kenya is interwoven by complex policy and behavioral linkages that are difficult to unravel. In this section we look at recent trends in tax revenues and describe some of the leading causes behind these trends. In doing this, we begin unpacking the intricacies of tax revenue analysis in Kenya.

Tax revenues make up the vast majority of overall domestic revenues, making them the main subject of internal and public scrutiny and discussion. To begin with the overview, we focus on domestic revenues as a percentage of GDP. This is a good measure of performance as it accounts for the natural and imposed fluctuations in currency value in a clear manner. Furthermore, analyzing tax performance in relation to GDP is the indicator used by the Government of Kenya in the MTRS as well as by the East African Community (EAC) in terms of their goal setting. Looking at trends over time provides the best analysis as revenue changes can be analyzed in context with specific policy changes and events.

Kenya's GDP growth in the 21st century has been sharp, but this growth has not been matched by a corresponding increase in tax revenue. Figure 3.1-2 shows the widening chasm between GDP and tax revenues. Importantly, at the turn of the century tax revenues were close to 25% of GDP goal, but as GDP has grown, tax revenues have lagged. This is despite regular updates to tax and broader economic policies. Herein lies the central issue facing the KRA and the Kenyan government when it comes to the public revenue system. As mentioned in section 2, there is no one reason that easily explains the widening gap between tax revenue and GDP, but the slow growth of tax revenues is a clear concern for Kenya if the country hopes to reach its lofty goals.

**Figure 3.1-2 Tax revenue compared with nominal GDP**



Note: vertical dashed line indicates GDP rebasing.

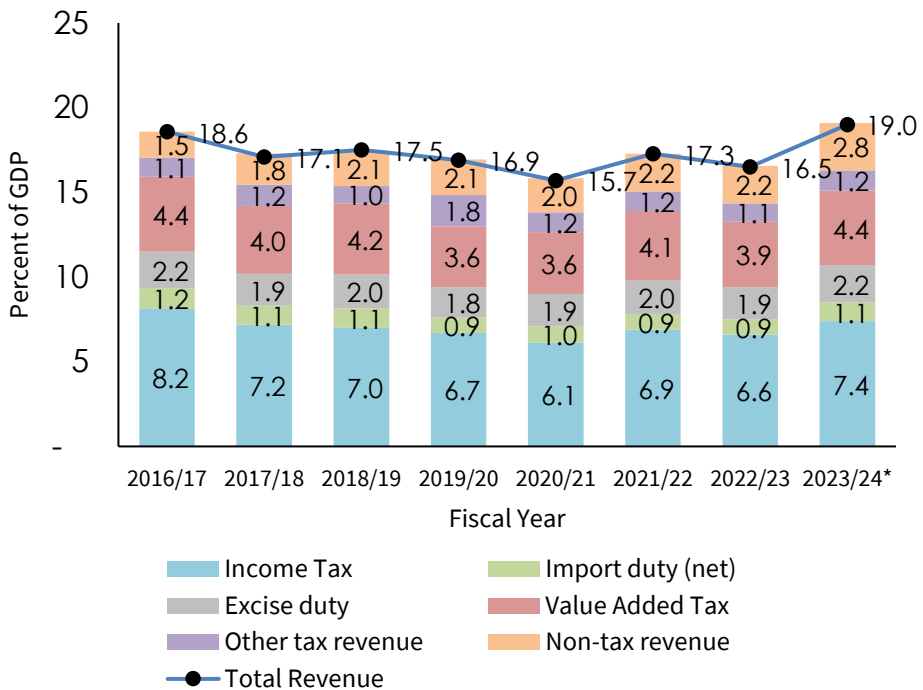
Source: Authors' Computations based on KRA and KNBS data.

While Figure 3.1-1 is a useful indicator for the lagging tax performance relative to GDP, it is useful to further disaggregate this finding. Figure 3.2-2 shows domestic revenues as a percentage of GDP from fiscal year 2016/17 to 2023/24. It is further disaggregated by revenue type, a point which is explored in section 4 of this paper. The revenues for fiscal year 2023/24 are projections obtained from the KRA. The trendline clearly shows that domestic revenues have declined slightly as a percentage of GDP in the past eight years. This is especially true of tax revenues and is driven by a reduction in revenues as a percentage of GDP in most tax types. Clearly visible is the impact of the COVID-19 pandemic in 2020/21, but the negative trend was present even before the economic shocks related to the pandemic. This indicates that domestic

revenues, while still greatly impacted by COVID-19, were already performing below targets at the outset of the pandemic.

Also visible in figure 3.2-2 is the importance of two taxes: income taxes and Value Added Tax. These are examined in more detail in sections 4.1 and 4.2 respectively. It is worth noting that non-tax domestic revenues do play a role in the overall trends, especially in the projections for FY 2023/24. These non-tax revenues are government earnings from investments in public sector undertakings, fees, and other similar activities. While these revenues are not a focus of this paper, their performance and role in the larger domestic revenue architecture should be explored further. It is also important to note that figure 3.2-2 depicts PIT and CIT together, they are disaggregated in section 4.2, but for the purpose of analyzing overall trends it is fitting to keep these two tax types under the blanket term ‘income tax. This is chiefly because, in Kenya, many small businesses would file their business income as personal income tax (see table 3.1-1), meaning that they are large in the data, and it is difficult to know what PIT comes from wages and what comes from business activities.

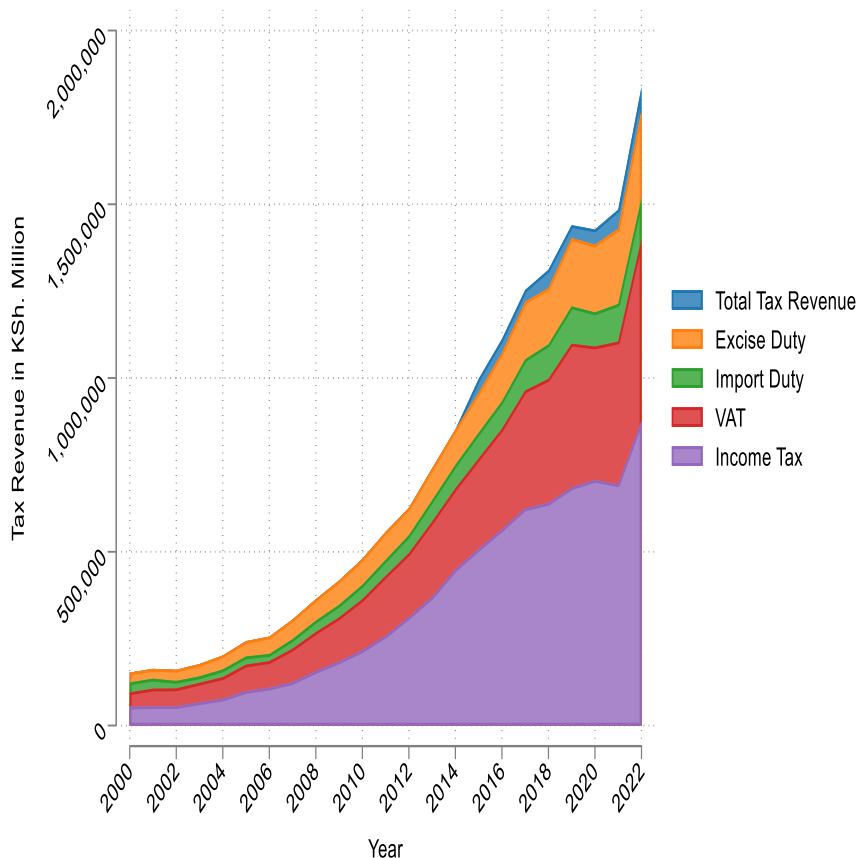
**Figure 3.2-2: Domestic revenue sources as a percentage of GDP**



Source: Authors' Computations based on KRA and KNBS data.

Visualizing this relationship in another way, as in Figure 3.2-3, we can see just how important income taxes and VAT are when it comes to raising tax revenues. Also visible in this graph is a trend where the performance of one tax usually resembles the performance of another. This is despite the taxes targeting different bases and undergoing different reforms over the past two decades. While this could be attributed to the tax revenues in each stream following broader economic trends, their similar performance should be investigated more. Especially considering the findings depicted in Figure 3.2-4, the different performance levels of each tax type merit deeper investigation. The sharp increase in revenues in 2021 and 2022 are most likely due to recoveries from the lows related to the COVID-19 pandemic. This figure illustrates the nominal growth, but taken in conjunction with Figure 3.2-2, it is easy to see that tax revenues need to be analyzed both in nominal and relative terms. One should note just how important VAT and income taxes are to the summative tax revenue in Kenya. These taxes can be difficult to levy and enforce due to numerous factors that will be explored in section 4, and even with some compliance issues they contribute most of the tax revenue.

**Figure 3.2-3: Tax types as a portion of tax revenue (cumulative)**



Source: Authors' Computations based on KRA and KNBS data.

The picture in a nominal sense, then, is one that shows domestic revenue performances that are not keeping up with the GDP growth in Kenya. This picture becomes starker when we return to the relationship between tax revenues and GDP. Figure 3.2-4 shows the growth in nominal tax revenue on the left and the growth in revenue-to-GDP ratio on the right for years 2016 to 2022. One can clearly see that while the total tax take has increased, the gap between tax revenues and GDP has declined significantly. This can be attributed to many factors, namely economic shocks such as COVID-19. The negative growth, particularly in income taxes and VAT are of concern to the Kenyan Government specifically due to their importance in raising and stabilizing domestic revenues. In section 4 of this paper, we look more specifically into why these two taxes are experiencing the highest negative growth.

**Figure 3.2-4: Nominal growth in tax revenue and growth relative to GDP**



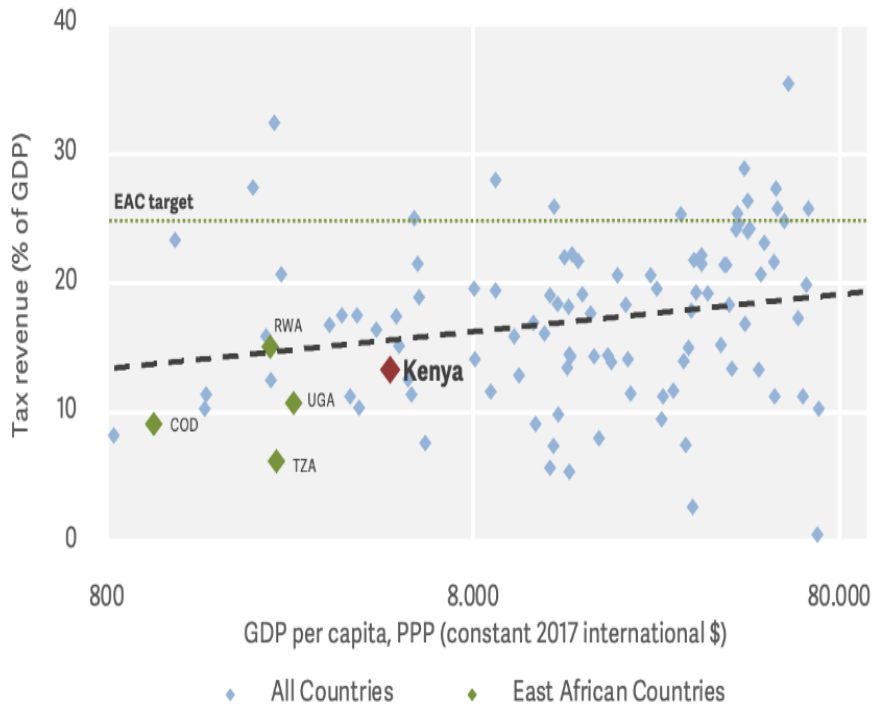
The high-level analysis of tax performance in Kenya clearly shows that revenues are not reaching the desired levels. This has a widespread impact on the ability of the government to deliver services but is also tied to issues of taxpayer morale and broader economic realities in the country such as informality. Before moving to a more detailed analysis of different tax types, it is important to see how Kenya’s tax revenue performance compares to similar countries.

### **Geographic Contextualization**

The ambitious goals set by the Kenyan Government and the East African Community (EAC) further motivate this study (see figure 3.3-1). The EAC aims to reach a tax revenue equal to 25 percent of GDP by 2030, a benchmark that few countries in the world have reached. Kenya is positioned well to be the first EAC country to reach this lofty goal as it has a relatively high GDP per capita compared to its neighbors. The 25% target is a benchmark, but countries in the EAC must consider how the collection of such revenues will relate to the services provided by the government. In other words, a revenue goal and the policies used to reach that goal must also consider the socioeconomic and sociopolitical ramifications of any policy change. And despite Kenya’s relatively high GDP per capita, it still lags behind Rwanda in total tax revenue and behind other similarly placed countries. This is a clear indication that policy changes must be made to increase tax revenue relative to GDP. Although this figure does not serve to portray the benefits of unifying tax policies within the EAC, this point should be noted as the close economic ties

between EAC countries also contribute to the performance of taxes through factors such as trade (both formal and informal) and immigration.

**Figure 3.3-1: Kenya’s tax revenue relative to other countries**



Source: KNBS & KRA

The lofty EAC target and current performance levels in Kenya and other EAC countries show that they are often dealing with similar challenges to the revenue system. There are nine key challenges facing Kenya and its neighbors when it comes to raising tax revenues to the EAC goal. Outlining these central challenges provides a useful reference for future policy recommendations to utilize as they seek to understand the potential impact of their suggestions. The nine key challenges are:

1. A relatively small tax base, especially for personal and corporate income tax.
2. Non-compliance (including evasion) and low enforcement rates and limited auditing.
3. Large tax expenditures.
4. Potential loopholes exploited by firms.

5. Economic shocks such as COVID-19, drought, the Russia-Ukraine war, etc.
6. A large, untaxed, informal economy.
7. Sector specific exemptions and loopholes.
8. Low tax morale and limited public trust in revenue administrations, partially due to slow refunds and refunds issued on credit.
9. Other economic factors influencing revenues include inflation and shifts in economic activities.

While many of these challenges are broad and may not be specifically targetable through tax policy reforms, they should be considered when potential changes are put forth. For example, a potential reform to input duties should consider how it could weather shocks such as wars impacting trade as well as the potential expenditures that arise from its implementation. Policymakers should consider how inflation might impact compliance and how it might interact with levels of taxpayer morale.

Table 3.1.1 briefly outlines the bases and revenue drivers of the most important taxes in Kenya. Although this table is not comprehensive, it is a useful tool to identify the people and factors that impact each tax individually. The drivers and bases, along with enforcement and compliance, determine the actual and potential revenues associated with each tax type.

## **4. Evaluation of Major Taxes**

In this section, we briefly look at the most important taxes in terms of revenues for the KRA independently of one another. These taxes are: Personal Income Tax (PIT) and Corporate Income Tax (CIT), Value Added Tax (VAT), excise taxes, and customs and import duties. The importance of PIT, CIT, and VAT to the domestic revenues of Kenya as a whole show the urgency of their optimization. The development of these taxes into progressive and efficient architectures would facilitate the fastest and most sustainable growth in tax revenue. Moreover, their optimization, in conjunction with efficiency and enforcement improvements, could reduce the relative cost of collection in the long run as new systems such as eTIMS and iTax are implemented. These systems, along with other tax modernization efforts, are central to growing the tax base and improving morale by ensuring taxes are less confusing to those who file and pay PIT, CIT, and VAT.

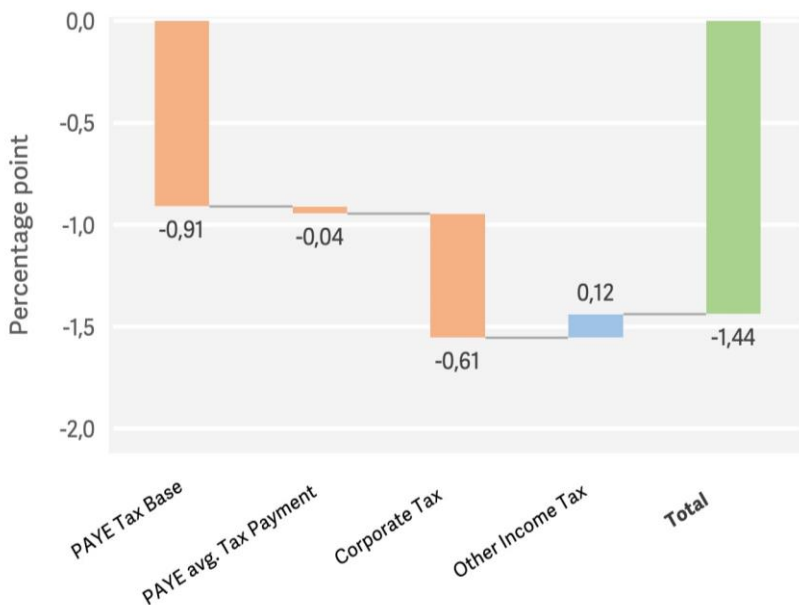
## **Income Taxes**

As income taxes, both PIT and CIT, make up the largest portion of tax revenues as of 2022, their efficiency and performance are a high priority for the Government of Kenya. Combined, PIT and CIT represent about one third of total annual revenues for the government. However, performance in both taxes has stagnated and declined in recent years. Before analyzing this decline, we must first briefly discuss what these taxes are and how they are levied.

Personal Income Tax (PIT) is structured such that a taxpayer pays rates between 10% and 35% based on their monthly income. These taxes can be filed and paid online and even those who are exempt from the tax are required to enter their information. Personal relief is currently set at Ksh. 28,800 per annum (KRA, 2024). A factor complicating the analysis of PIT is that it sometimes includes income earned from a business. This occurs because the threshold for filing and paying turnover tax is set at Ksh. 1 million. Any business with a turnover below this threshold must report its earnings under PIT. Additionally, PIT can be structured as 'Pay As You Earn (PAYE). Corporate Income Tax is payable by resident and non-resident companies at 30% and 37.5% respectively. A firm whose income exceeds Ksh. 50 million per year pays CIT and is exempt from turnover tax. There are various exceptions and nuances to CIT that can be examined individually, but for the purposes of this paper they are not relevant. Despite updates trying to make PIT and CIT more progressive and easier to file, they have both been declining in recent years.

Examining the negative growth of these taxes in Figure 4.1-1, we can see that PAYE decline has had the biggest impact on the overall performance of the tax. This is closely followed by a decline in CIT relative to GDP growth. Importantly, COVID-19 has had a large impact on the performance of PIT and CIT. Non-compliance, misreporting, and tax evasion could account for some of this negative growth as could stagnate earnings in the formal sector.

**Figure 4.1-1: Income tax growth contributions to tax revenues relative to GDP (2000-2022)**



Source: KNBS and KRA

One of the primary factors that could help to close the gap between income tax growth and GDP growth is a reevaluation of income tax brackets both in PIT and CIT. The fact that the PAYE tax base has been the largest driver of the negative growth shows that the KRA may not be capturing workers within the structure. This could be due to factors such as work in the informal sector, evasion, loopholes, and issues with the tax brackets. Ensuring that these brackets are progressive and that the threshold to pay income tax is set at a level that does not overtax the poorest people is essential to ensuring revenue maximization in the tax while considering the needs and desires of the population.

As corporate tax has also suffered in recent years, the KRA should seek policy reforms that are conducive to economic growth and revenue mobilization. To address this, the KRA could review enforcement and auditing practices to ensure compliance levels in those firms with a high enough turnover (Ksh. 25 million annually) to pay CIT are in full compliance. Efficient audit processes and increased taxpayer morale can lead to higher compliance levels. It is important to note that the linkages between PIT, CIT, and broader socio-economic trends are crucial. Ensuring that tax systems are resilient to shocks can help prevent revenue declines. Since both CIT and PIT are crucial to KRA's success and the implementation of government initiatives due to their

revenue-raising potential, they should be a key focus for researchers and policymakers. As taxpayer morale is central to the success of these taxes, the government should be aware of further political and social ramifications that come with any reforms within these tax structures. Seeking more progressivity, simplicity, and compliance can be broad goals for the KRA as it seeks responsible revenue maximization.

## Value Added Tax

VAT is currently the second-highest grossing tax in Kenya, but it is currently falling well below its targets in terms of revenue maximization and compliance. The GOK has indicated that VAT should be the largest grossing tax in Kenya, but issues such as low compliance and expenditures are preventing this from happening. VAT underperformance can be attributed to many different factors as shown in table 4.2-1.

Table 4.2-1: Key Factors Contributing to VAT Underperformance

Factor	Causes
<b>Exemptions and Zero-Ratings</b>	<ul style="list-style-type: none"> <li>• A high number of exemptions and zero ratings.</li> <li>• Not all exemptions and zero-ratings following international trends</li> <li>• Some exemptions and zero-ratings are not on essential goods, representing lost revenue for the KRA.</li> <li>• Firms that report dealing in only exempt goods do not have to file VAT returns, resulting in a lack of data and reducing capacity to monitor and audit firms.</li> </ul>
<b>Threshold</b>	<ul style="list-style-type: none"> <li>• The Ksh. 5 million threshold leaves many SMEs out of the VAT architecture.</li> <li>• The threshold complicates the filing process as goods can move in and out of the VAT system in business-to-business transactions.</li> </ul>
<b>Evasion and Misreporting</b>	<ul style="list-style-type: none"> <li>• Because audit rates are low and data management is difficult, VAT is hard to enforce.</li> <li>• Without proper enforcement and education for filers, the firm-level benefits of VAT are not present, incentivizing misreporting.</li> </ul>
<b>Informality</b>	<ul style="list-style-type: none"> <li>• A large, untaxed, informal sector means many vatable goods are not captured within the VAT structure.</li> <li>• The difficulty in measuring and accounting for informal firms makes VAT difficult to enforce.</li> <li>• Firms may see more benefits to informality, especially at lower turnovers.</li> </ul>

**Capacity Issues**

- Specific receipts are needed to file VAT, increasing the cost of compliance for firms and necessitating a high capacity.
- Within the KRA, data management and analysis of massive datasets can complicate VAT enforcement and understanding.

**Lack of Trust**

- Slow VAT returns issued to businesses by the KRA reduces trust and faith in the VAT system and the tax structures as a whole.
- Issuing returns on credit can also lead firms, especially those near the threshold, to misreport or underreport sales.

It is worthwhile, even in an executive overview, to highlight some of the specific issues facing VAT performance in Kenya. For example, exemptions and zero ratings are a central piece of VAT policies around the world and are used to keep the costs of essential goods low or to encourage growth in particular sectors. However, a brief review of current exemptions and zero-ratings reveals that some of these may not be fulfilling their purpose of keeping *essential goods* prices low. Moreover, data gap forms as firms producing exempt goods are not required to file these with VAT. New electronic filing systems should help with this data gap. Examining exemptions and zero ratings is a clear way for the GOK to ensure that revenues are maximized *and* the taxes on essential goods and services are kept low to ensure they are accessible to all Kenyans.

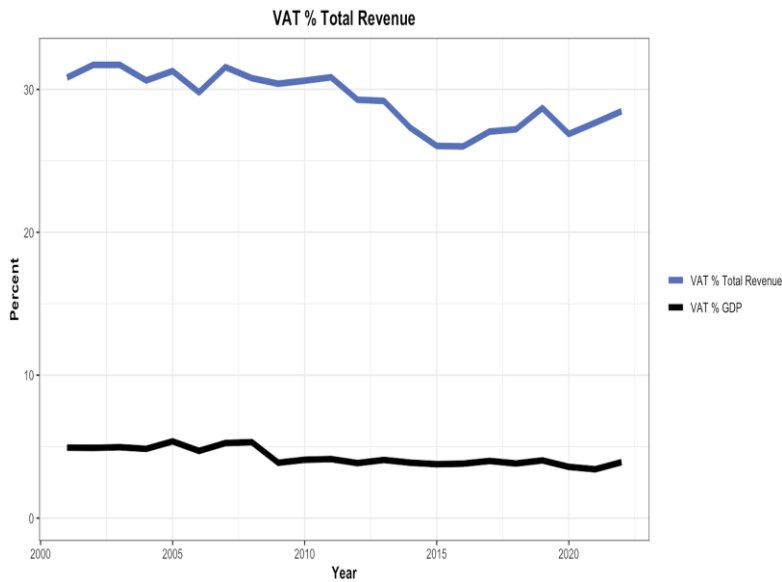
Issues of compliance and enforcement are also essential to VAT success and are a primary challenge to the GOK. While VAT theoretically captures value at each stage of the production and distribution chain, practical challenges in enforcing compliance have hampered its efficacy. Tax evasion and non-compliance are persistent issues, leading to a substantial VAT gap. Much of the gap from evasion and non-compliance can be ascribed to a lack of enforceability, administrative capacity, and incentives to participate in the VAT system. Building capacity in the public and private sectors and issuing prompt and accurate VAT returns for filers will encourage compliance. This, coupled with modernized filing methods and more comprehensive auditing techniques, can increase VAT revenues.

Finally, informality can be particularly harmful to VAT revenues. The informal nature of many economic activities in Kenya complicates VAT administration. Small and medium-sized enterprises (SMEs) often operate informally, and they are often not large enough to reach the Ksh. 5 million threshold to file VAT, they still represent a revenue and data loss for the KRA. Interruption in

value chains due to informality can discourage potential taxpayers from reporting as they may not be able to claim refunds. The VAT structure, designed for formalized business practices, struggles to address the complexities introduced by informality.

These issues, coupled with other complexities contribute to VAT performance that has been stagnant or declining since 2000. Figure 4.2-1 shows how VAT has not grown as a percentage of total revenue nor as a percentage of GDP, indicating that it is falling well short of its targets.

**Figure 4.2-1: VAT as a Percent of Revenue and GDP**



With VAT performance behind its targets, the GOK will struggle to support its public spending efforts. The complex nature of the taxes and complexities introduced by regular reforms and the threshold can make it difficult to analyze. However, unifying policy with regional and international best practices and focusing on compliance efforts within these policy structures can lead to increased revenues from VAT.

### **Other Taxes**

Other taxes also present clear and immediate opportunities for domestic revenue growth. This is largely because taxes such as excise and customs duties can have a low cost of collection due to their enforceability and the relatively small number of taxpayers who contribute most payments. While this paper does not go into detail on specific policy reforms that could improve these other tax revenue sources, engagements with stakeholders and a review

of literature and tax performance show clear areas of potential improvement for these taxes. Reforms in excise taxes and customs and import duties especially could translate to quick and significant revenue growth.

Excise taxes are levied on specific goods and services and are usually linked with an effort to offset negative externalities associated with these goods and services. For example, excise duties are levied in Kenya on alcohol and tobacco to address negative health externalities, and on petroleum to account for negative environmental externalities. However, a brief review of current policies shows that there are areas where the GOK can increase the linkages between the tax itself and its unique mandate. For example, switching from a tax on value to one on pure alcohol content of beverages would more closely link alcohol the price of alcohol, insofar as it is impacted by the excise duty, with the negative externalities associated with its consumption. Moreover, the excise duty on petroleum should be analyzed in conjunction with other taxes and exemptions present in this sector to identify areas where unification and simplification could increase compliance and revenues.

In addition to reviewing excise duties, examining customs and import duties can also present opportunities for the GOK to raise revenues without negatively impacting Kenyan citizens. These taxes are imposed on goods and services imported from other nations and in Kenya and are harmonized with the EAC through a common external tariff (CET). Thanks to the CET, the GOK need not focus on rate or tariff changes but instead can focus on issues of noncompliance, misreporting, and evasion. This can be a difficult task, but through digitization and infrastructure improvements at ports of entry, revenues can be increased. Preliminary findings suggest that there are high instances of misreporting at the Port of Mombasa which should be investigated further to determine the underlying factors contributing to these findings.

Implementing institutional changes at ports of entry and reconstructing excise schemes could both be efficient methods to increase domestic revenues relatively quickly. Although these taxes rely on a broad base of consumers, the taxes themselves are quite narrow, presenting a clear opportunity for the KRA to maximize revenues despite issues of informality that complicate the development of other revenue streams. Just as with other taxes, though, any policy and enforcement changes should be cognizant of social and political externalities that could impact the performance of the tax.

## 5. Conclusion and Recommendations

Although the analysis in this paper only captures a high-level snapshot of the tax revenue system and its current state in Kenya, some clear policy implications appear. In general, there is a clear motivation for comprehensive policy action, especially regarding income taxes and value added tax. These taxes present clear opportunities for long-run improvements in revenue collection, but other revenue sources, such as excise duties and customs duties, should not be overlooked. These taxes are relatively simple to levy and enforced, thus, their optimization can lead to increased revenues in the short-term that can then be used towards long-term improvements. The KRA should not overlook the importance of these “smaller” taxes as their potential can have significant impacts on domestic revenues.

In general, policy reforms in the tax system should aim to increase progressivity, broaden the tax base, and encourage formalization. Many of the issues hindering performance of the KRA stem from broader economic challenges for firms and individuals in Kenya. These challenges, including inflation, climate events such as drought, and insecurity in neighboring countries all influence taxpayer’s ability and likelihood to pay taxes.

To broaden the tax base, the GOK should analyze PAYE tax brackets to ensure they are progressive and encourage individuals (and firms) to partake in formal employment. This requires building trust and improving taxpayer morale. Central to this is transparency and accountability on all levels. The simple fact holds that taxpayers are more inclined to comply when they know the money collected is used for projects they care about. Thus, building closer ties between the National Treasury, KRA, and individual taxpayers will be central to growing the tax base.

Central to building trust and morale is the optimization of the various tax refund systems. This is especially true in VAT, where expenditures issues slowly and on credit are discouraging compliance and participation while also creating a costly backlog for the KRA. Tax modernization programs, and increased enforcement and filing capacities will help clear this backlog and prevent it from building again as filings become easier for taxpayers to do and for the KRA to analyze and audit when necessary.

Also important to the general growth of tax revenues is capacity building within the KRA. This includes data management capabilities and the smooth and swift implementation of the proposed tax modernization schemes such as iTax and eTIMS. Carrying automation and digitization over to other taxes and

filing processes will lower the cost of collection and the cost of filing, freeing up more time for firms to engage in economic activities and more time for the KRA to engage in compliance and enforcement activities. Moreover, the taxpayer data that can be collected through digitization will facilitate better informed policymaking in the future.

With the understanding of tax revenues in Kenya portrayed in this paper, the government will be able to point to high-level issues it seeks to address in future policies. The GOK cannot simply seek to raise revenues relative to GDP without justifying this with clear goals on what these revenues will support. In other words, collection and expenditure are two sides of the same coin and policy changes should consider the economic realities in Kenya. This approach will allow the government to increase domestic revenue while demonstrating its direct benefits to citizens, thereby expanding the tax base and improving compliance.

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